



Suite 700 - 1188 West Georgia Street Vancouver, B.C. V6E 4A2

C A N A D A

Tel: (604)669-3555 Fax: (604)689-5845 <http://www.cga-canada.org>

August 18th, 1997

Sir Bryan Carsberg
The Secretary-General
International Accounting Standards Committee
167 Fleet Street
London EC4A 2ES
England

Dear Sir Bryan:

Re: IASC E55: Impairment of Assets

We take pleasure in enclosing, for consideration by the International Accounting Standards Committee, the comments of the Certified General Accountants' Association of Canada on the above-noted topic.

We hope that these comments will prove useful in your deliberations. Please advise if we could provide further information on the subject.

Yours truly,

Guy Legault, B.Sc., MBA, CAE, FCGA
President and Chief Operating Officer

Enclosure

Response of the
CERTIFIED GENERAL ACCOUNTANTS' ASSOCIATION OF CANADA

to the
INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

Exposure Draft E55

Impairment of Assets

CGA-Canada
700 - 1188 West Georgia Street
Vancouver, Canada V6E 4A2
(604) 669-3555

18 August 1997

The Certified General Accountant's Association of Canada has reviewed the IASC exposure draft entitled *Impairment of Assets*, and we are pleased to offer these comments. Our response will take the form of a general discussion regarding the exposure draft as we have been unable to properly review the text in order to prepare detailed comments. However, to sum up our position, the Association is uncomfortable with the standards proposed in the exposure draft, not because they are “wrong”, but rather because they will lead to significant difficulties with respect to extant Canadian GAAP. Nevertheless, we hope that the views expressed will be useful to the Steering Committee.

General Remarks

There is a widely-held perception that companies have been recording large asset write-offs in recent years. The timing and amount of these reductions in value often appear to be fairly subjective, leading many users to question the motive behind such actions. The most common view is that a firm and/or its management are engaging in a “big bath” or “cleaning house” phenomenon — take large losses now to generate large profits and potentially larger stock prices in the future. These concerns have lead many countries to clarify the situations in which impairment losses can be recorded. In Canada, the CICA revised §3060, “Capital Assets”, of the *Handbook* in 1990. Recently, the FASB in the US issued FAS 121: *Accounting for the Impairment of Long-Lived Assets and Identifiable Intangibles*. The proposed International Accounting Standard which will result from E55, *Impairment of Assets*, is another step in establishing standards with respect to this important issue.

However, the IASC draft takes a fairly significantly different approach to the issue than that adopted in Canada and the US. These differences may hinder or even restrain acceptability of E55 in North America. The International Accounting Standards Committee has adopted an approach of recognising and booking impairment losses when it is probable that the asset is impaired. This contrasts with the North American approach of recognising impairment losses if a *situation determined to be permanent* suggests that cost will not be recoverable in the long-term [emphasis added]. Since we are dealing with long-lived assets in use,

the North American approach with its fairly high threshold ensures that impairment is an infrequent event for a going concern. The lower threshold of E55 may actually increase the number of write-offs.

Furthermore, E55 suggests writing down long-lived assets in use at their recoverable amount based on present value. This implies that the purpose of the standard is valuation. It also exchanges a current loss for future profit on the use of the asset. The arguments below argue against such an approach for long-lived assets in use and adopt the principle that the main purpose of testing for asset impairment is determining future recovery of costs. Accordingly, the position adopted in CGA-Canada's response is consistent with the standards adopted in Canada.

Identifying a Potentially Impaired Asset

In both Canada and the US, companies must first review events or changes in circumstances for possible signs of impairment. E55 begins in a similar fashion by listing external and internal sources of information for identifying impaired assets. In fact, the three standards require the investigation of potential impairment on an "exception basis" where some event or condition must have occurred which would indicate that an impairment may exist. If impairment is not an exception, then one has to question the going concern concept. As suggested in ¶9, no list will ever be exhaustive or all-inclusive but E55's list is fairly comprehensive.

The indicators generally suggest a long-term or permanent change in the value of the asset. This is important because an impairment loss should not be recognised if changes are temporary or transitory. It is the persistence of various conditions and not the mere probability of decline that is most important for long-lived assets in use. Thus, an additional explanatory paragraph, similar to CICA *Handbook* ¶3060.47, might be useful: "The persistence of such conditions [or impairment indicators] over several successive years increases the probability that a write down is required unless there is persuasive evidence to the contrary."

Recognition of Impairment Losses

One very important issue is the impairment test. Canada and the US basically consider that there is impairment if *undiscounted* future cash flows from using the asset are less than its book value. This represents a fairly high threshold for impairment recognition and is consistent with the going concern concept that assumes that the firm can recover the cost of the investment in its assets. This high threshold also suggest that the change in value is long term or permanent as opposed to merely transitory. E55's impairment test based on *discounted* values reduces considerably the threshold for impairment recognition and would lead to more instances where firms take write-offs. Thus, if one objective for having more precise standards on asset impairment is to set restrictive criteria for asset write-offs in accordance with the going concern principle, the impairment test in North America better attains this objective. The proposed standard adopts a view which is closer to what some have labelled the "probability criterion" rather than the North American approach based on the "permanence criterion".¹

Measurement of Recoverable Amount

There is also much controversy over the measurement of impairment. E55 suggest writing down the value of the asset to its recoverable amount which is the higher of its net selling price and its value in use (both, implicitly or explicitly, are based on present values) . In the US, the change in context is viewed to be so important that it implies changing the basis of accounting for the asset to its fair value. In Canada, assets are written down to their recoverable amount which is net undiscounted future cash flows.

The fundamental issue is whether the purpose is to determine recovery or valuation. Depreciation is an allocation of cost and in a similar fashion impairment should be the process of writing off costs that cannot be recovered from future revenue. Write-downs to market value or value in use are valuation concepts. While it is true that using market price is inappropriate if the value in use of the asset is greater,

¹ Zucca, L. J., Regulating the "Unexpected" Loss : A Critique of Asset Impairments Under FAS 5 and FAS 121, *The Journal of Corporate Accounting and Finance*, Autumn 1996, pp 27-30.

a reduction to value in use (discounted net future cash flows) generates a current decrease that will allow the firm to show profit from the use of the asset in the future and, further, this profit is directly determined by the complex valuation process of forecasting future cash flows and the appropriate discount rate.² The result of such write-offs may be fairly misleading to future users of the financial statements in determining and comparing the firm's use and return on assets. Thus, reducing the carrying value to its recoverable amount based on the amount of cash that will be recovered from the use of the asset in the future without discounting is the only approach that is consistent with an objective of determining recovery. Further, determining recovery is consistent with the going concern and expense recognition concepts while adopting a certain amount of conservatism even though realisation has not occurred.

Reversals of Impairment Losses

The exposure draft suggest that an impairment loss recognised in prior years should be reversed when there has been a change in the estimates used to determine an impaired asset's recoverable amount. Such a practice is consistent with a valuation process but is unacceptable if the purpose is to determine recovery of costs as discussed above. Realisation of the impact of the change in estimates should be recognised when they actually occur in the future.

Other remarks

While very detailed in explaining how firms should proceed in determining value in use, the proposed standard leaves very little leeway for adopting other practices that may be used in a firm's decision making process. If one adopts E55's definition of recoverable amount, it may not be necessary to establish a very precise method of determining value in use. It should be the best estimate based on reasonable and supportable assumptions and projections. It may be fairly costly to apply E55's approach, and it could be

² Skinner, R. M., *Accounting Standards in Evolution*, Holt, Rinehart and Winston of Canada, 1987.

argued that the benefits are debatable. Management and auditors will ensure that best estimates are used in a fashion consistent with management's internal information systems.

Finally, we suggest that the Board reconsider its decision not to publish Appendix 4 (or some form of it) with the final IAS. One of the more useful aspects of FASB standards is the basis for conclusions often published with the SFAS. Moreover, the Canadian Institute of Chartered Accountants has just released an interim report by its Task Force on Standard Setting. One of its conclusions was that greater attention needs to be paid to explaining to users and other interested parties why a particular recommendation was made. It is CGA-Canada's view that the IASC could gain considerable goodwill (not to mention cooperation by user groups) if it were to do the same.