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Invitation to Comment

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Impairment of Assets

Issued for comment by the International Federation of Accountants

This Invitation to Comment was issued by the Public Sector Committee of the International Federation of Accountants.

Information about the International Federation of Accountants and copies of this Invitation to Comment can be found at its internet site: http://www.ifac.org.

The approved text of this Invitation to Comment is that published in the English language.

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Commenting on this Invitation to Comment

This Invitation to Comment of the International Federation of Accountants was prepared by the Public Sector Committee. Comments should be submitted in writing so as to be received by 30 January 2001. E-mail responses are preferred. Unless respondents specifically request confidentiality, their comments are a matter of public record once the Public Sector Committee has considered them. Comments should be addressed to:

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INVITATION TO COMMENT

IMPAIRMENT OF ASSETS

3

Executive Summary

The Public Sector Committee (PSC) has prepared this Invitation to Comment (ITC) to elicit views on how the impairment of assets held by public sector entities should be recognized and measured in their financial statements. The purpose of an impairment test is to ensure that the carrying amount of an asset is not overstated. When assets, either individually or collectively, generate net cash inflows, an impairment test can be applied that compares the carrying amount with the recoverable amount (the higher of net selling price and the estimated present value of net cash inflows recoverable from their use and subsequent disposal). A number of standard setters have developed impairment tests on this basis. There is, however, no generally agreed approach as to how an impairment test should be applied to assets that are not held with the objective of generating net cash inflows, such as assets held for social or cultural purposes.

The PSC's tentative views are that an impairment test should be applied to all assets when certain impairment indicators are triggered. In the event that impairment is indicated for assets held with the objective of generating net cash inflows, it should be measured by comparing the carrying amount of the asset against the higher of the net selling price and value-in-use (in a manner consistent with International Accounting Standard IAS 36, *Impairment of Assets*). For assets not held with the objective of generating net cash inflows, impairment should be measured by comparing the carrying amount of the asset with:

- the observable market value (for those assets which have an observable market value);
- the disposal value (for assets which do not continue to have utility for the entity); and
- the depreciated replacement cost (for assets which continue to have utility for the entity).

The PSC notes that some argue that only permanent impairment losses should be recognized. Others argue that in practice the relevance of asset values may be compromised by recognizing "permanent" impairment losses only. The tentative view of the PSC is that all impairment losses (both temporary and permanent) should be recognized and that where the conditions that give rise to an impairment loss no longer apply, that impairment loss may be reversed.

Although the PSC has carefully considered these issues, the views it has formed are tentative only, and the PSC welcomes the views of its constituents on the issues raised in this ITC.

The Purpose of this Invitation to Comment

Introduction

1. The purpose of this Invitation to Comment (ITC) is to seek comments on the appropriate accounting treatment for the impairment of assets in International Public Sector Accounting Standards (IPSASs). This ITC explores certain issues associated with a general impairment test. It does not deal with the impairment of assets for which a specific impairment test is established through another accounting standard. For example, the impairment of inventories is not covered in this ITC because it is dealt with in International Public Sector Accounting Standard ED 11 *Inventories*.

2. In preparing International Public Sector Accounting Standard ED 14 *Property, Plant and Equipment*, the Public Sector Committee (PSC) noted that the impairment test previously found in International Accounting Standard IAS 16, *Property, Plant and Equipment* had been superseded by International Accounting Standard IAS 36, *Impairment of Assets*. As part of the process of developing a core set of IPSASs, the PSC has recognized the need for an effective impairment test for all assets held by public sector entities.

3. An "impairment" is a loss in the service potential or future economic benefits of an asset, over and above the systematic recognition of the loss of an asset's service potential recognized through depreciation. Impairment therefore reflects a decline in the utility of an asset to the entity that controls it. For example, an entity may have a purpose-built military storage facility that it no longer uses and is now derelict. In addition, because of the specialized nature of the facility and its location, it is unlikely that it can be sold and therefore the entity is unable to generate cash flows from its disposal. In this case, the asset is impaired because it is no longer capable of providing the entity with service potential — it has little, or no, utility for the entity in contributing to the achievement of its objectives.

4. When an asset's remaining service potential falls below its carrying amount there could be a material overstatement of an entity's assets (and an understatement of its expenses). An effective impairment test therefore plays a key role in ensuring relevant and reliable information is reported about an entity's assets.

5. The PSC acknowledges that in some cases it may be difficult to apply an impairment test to assets held by public sector entities — especially where those assets are not held with the objective of directly generating net cash inflows. This issue is considered within this ITC.

Impairment Tests in National and International Accounting Standards

6. It is generally accepted that where assets are held for their ability to generate net cash inflows, either directly or indirectly, an impairment test should be applied to the carrying amount of those assets. Many standard setters (such as those of Australia, Canada, the International Accounting Standards Committee, New Zealand, Sweden, the United Kingdom and the United States of America) have impairment tests that require the carrying amount of an asset to be "tested" against its recoverable amount. The recoverable amount is generally either based on the present value of the future net cash inflows an asset is expected to generate through its continued use and subsequent disposal or determined by reference to its net selling price, sometimes referred to as market value or fair value.

7. For example, in the context of IAS 36, impairment is determined by comparing the carrying amount of the asset to the recoverable amount of the asset (the higher of an asset's net selling price and its value-in-use). Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. Value-in-use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life (IAS 36, paragraph 5).

8. There is, however, no generally agreed approach on how to apply an impairment test to assets that are not typically held for the purpose of directly generating net cash inflows, such as hospitals and recreational parks. IAS 36 does not explicitly deal with such assets.

9. Approaches adopted by various jurisdictions in respect of impairment tests for such assets include:

- the recognition of impairment when an asset no longer contributes to an entity's ability to provide goods and services, or when the carrying amount of an asset exceeds its fair value;

- the recognition of impairment when the carrying amount of the asset is greater than the service potential of the asset, with such service potential being measured in accordance with the measurement model adopted by the entity in respect of those assets; and
- an impairment may be indicated where the carrying amount is greater than the expected, unrestricted cash flows (or funding) the entity expects to receive in the future. In such cases, if the fair value of the assets is less than their carrying amount, the assets are written down and an impairment loss recognized.

Proposals and Request for Comments

Scope of an Impairment Test

10. Some argue that an impairment test should be applied only to assets whose service potential is directly related to their ability to generate net cash inflows. They contend that many public sector assets may provide utility to the public sector entity in meeting its service delivery objectives even though those assets may have a nominal fair value on disposal. Accordingly, they would exclude many heritage and infrastructure assets from being subject to an impairment test.

11. The PSC's tentative view is that an impairment test should be applied to all assets (other than those assets dealt with specifically by other Standards, such as inventory). The PSC's view is predicated on the fact that all assets are capable of being impaired — even natural assets, such as a national park, can become impaired if they are not maintained adequately. Often the concern about the application of an impairment test to all assets stems from a concern that entities will be required to make significant write-downs to the carrying amounts of their asset base. However, this is not a scope issue but rather a question of how an impairment test is triggered and the subsequent measurement of an impairment loss.

Comments sought

1. Do you agree that an impairment test should be applied to all assets except those assets covered by a specific impairment test in another accounting Standard? If so, what are the reasons for your conclusions? If you do not agree, which specific classes of assets should be excluded and what is the basis for excluding them?

Measurement of an Impairment Loss

12. Consistent with the PSC's tentative view that an impairment test should be applied to all assets, the measurement of impairment losses needs to be considered both for assets which are held with the objective of generating net cash inflows and those that are not.

13. There are two established approaches to measuring an impairment loss:

- estimating the present value of the net cash inflows an asset is expected to generate; and
- making reference to market prices.

These two approaches are discussed further below.

14. One approach is to measure an impairment loss by comparing the carrying amount of an asset against its recoverable amount based on the future net cash inflows (either discounted or undiscounted) that an asset is expected to generate. However, for assets that are not held for the purpose of generating net cash inflows, some argue that such a test is likely to result in a significant number of assets being written down because they do not generate net cash inflows sufficient to recover the cost of the asset. Some contend that assets should be aggregated into cash generating units to measure an impairment loss — for some public sector entities this would require an assessment of the future total cash flows an entity is expected to generate as a whole.

15. The PSC is concerned that such an approach may not be effective in isolating impairment and may result in inappropriate recognition of impairment losses.

16. The other established approach is to measure an impairment loss by comparing the carrying amount of an asset against its value as evidenced from the market. This is normally based on the amount recoverable from the sale of an asset (selling price). For some assets in the public sector, the absence of active and liquid markets may result in difficulties in obtaining values based on recent sales and it may be necessary to rely on an alternative to a selling price.

17. The PSC's tentative view is that where an asset is held for its ability to generate net cash inflows, the IAS 36 impairment test should be applied to these assets regardless of whether the entity holding that asset has not-for-profit objectives. For example, a government department may operate a commercial activity such as a public car park. There appears to be no reason why the impairment test applied to assets held by the private sector should not apply equally to similar commercial assets held by public sector entities.

18. This tentative view is consistent with the PSC's strategy of developing IPSASs by adapting IASs issued by the International Accounting Standards Committee (IASC) to a public sector context.

19. Under Guideline No. 1, *Financial Reporting by Government Business Enterprises*, the PSC already recommends that Government Business Enterprises (GBEs) apply IASs. Accordingly, the requirements in IAS 36 are applicable to assets held by GBEs. As stated in paragraph 17, the PSC wishes to adopt the same impairment test as that in IAS 36 for assets which are held with the objective of generating net cash inflows. Failure to do so would lead to the application of a different impairment test to the assets of GBEs when consolidated into an entity applying IPSASs compared to the test applied to assets within the financial statements of the GBE itself. The PSC considers that such a difference would be unnecessary and undesirable.

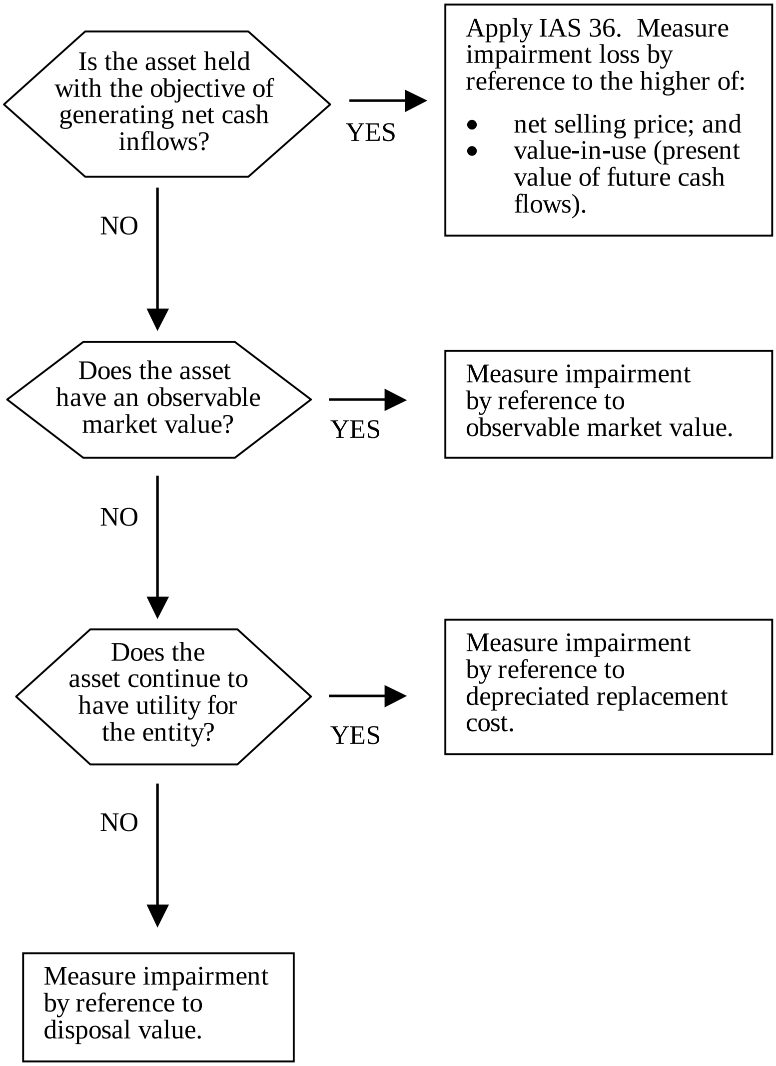
20. Although the approach to be adopted for assets held for the purpose of generating net cash inflows is clear, the type of impairment test that should be applied to assets not held principally for their ability to generate net cash inflows is less clear.

21. The PSC's desire is to establish an impairment test for such assets which is as consistent as possible with IAS 36. The PSC notes that although the cash flow based test will not be appropriate for some of these assets, market-based approaches may be able to be applied.

22. The PSC's tentative view is that where an asset has an observable market value, that value should be used in measuring any impairment loss. Where an asset does not have an observable market value and the asset continues to have utility for the entity, its depreciated replacement cost should be used in measuring any impairment loss. Where the asset no longer has utility for the entity holding it, or its ability to utilize the asset has been significantly restricted, a disposal value (net selling price) should be used. This is consistent with generally accepted measurement requirements in accounting pronouncements that assets held for disposal are treated in the same manner as inventory and measured at the lower of their cost and net realizable value.

23. The approach the PSC is contemplating is summarized in Figure 1 below.

Figure 1



Comments sought

2. *Do you agree that an impairment test for assets which are held with the objective of generating net cash inflows should be measured by comparing the carrying amount of the asset against the higher of net selling price and value-in-use (in a manner consistent with IAS 36)? If not, what alternative method would you recommend, and what are your reason(s)?*

3. *Do you agree that an impairment loss for assets which are not held with the objective of generating net cash inflows should be measured by comparing the carrying amount of the asset against:*

   - *the observable market value (for those assets which have an observable market value);*
   - *the disposal value (net selling price) (for assets which do not continue to have utility for the entity); and*
   - *the depreciated replacement cost (for assets which continue to have utility for the entity)?*

   If not, what alternative methods would you recommend and what are your reason(s)?

Indicators of Asset Impairment

24. A number of standard setters, such as the IASC, have developed a two-step impairment test. The first step is to establish whether there are any indications that an asset may be impaired. If there is evidence that a "trigger" or "indicator" has been satisfied, an impairment test is applied and, if appropriate, an impairment loss recognized.

25. Developing an appropriate set of "indicators" is a key feature of an effective and workable impairment test. The PSC's tentative view is that a two-step approach is preferred and should be applied to all assets of public sector entities. The indicators listed below attempt to capture whether there may have been a decline in the utility of the asset for the entity holding it — noting that "utility" or "usefulness" will often have two components for an entity: a value-in-use and a value-in-exchange. This list is not meant to be exhaustive and there may be other factors relevant to testing for impairment.

26. Possible indicators of impairment include:

(a) a change in the extent to which an asset is used;

(b) a change in the manner in which the asset is used;

(c) significant technological development;

(d) physical damage;

(e) a decline in, or cessation of, the demand or need for services provided by the asset;

(f) a decision to halt the construction of the asset before it is complete or in an usable condition;

(g) a change in the law, government policy or environment that limits the extent to which the asset can be used; or

(h) a significant decline in the observable market value of the asset.

27. The indicators listed above differ slightly from those in IAS 36. The reason for this is that IAS 36 focuses only on the impairment of assets held by profit-seeking entities with the objective of generating net cash inflows.

Comments sought

4. Do you agree that a two-step impairment test should be developed? If you do not agree, what are your reasons for not supporting a two-step approach?

5. If you support a two-step approach, do you agree with the indicators of impairment set out above? If you do not agree with these indicators of impairment, what are your reasons for disagreeing and what alternative indicators do you suggest?

Recognition of all Impairment Losses, or Permanent Losses only

28. There are differing views on whether all or permanent impairment losses only should be recognized and whether impairment losses should be able to be reversed.

29. One view is that an impairment loss should be recognized only when it is apparent that the events that created the loss will not reverse. In some cases it will be clear that an impairment loss will not reverse, for example, when an asset is physically damaged and can no longer function properly. In other cases,

such as a decline in demand for a service, the permanence of any impairment will only be known with the passage of time. Accordingly, some impairment losses resulting from economic factors (such as a decline in property values) may not result in any loss being recognized because of cyclical movements in prices.

30. Those who hold this view also argue that an impairment loss should not be reversed if the conditions that caused the impairment no longer apply. It is argued that under the historical cost basis, it would be inappropriate to reverse an impairment loss as it would represent a revaluation outside a regular revaluation or current value model. This approach has typically been adopted by standard setters in Canada and the United States .

31. Another view is that it is extremely difficult to distinguish between "temporary" and "permanent" impairment losses. Changes in the value of assets, resulting from, for example, a significant fall in asset prices may not be recognized on the grounds that price movements are a function of economic cycles and may recover. Financial statements may be distorted if an impaired asset continues to be carried at an amount that exceeds its market value.

32. Those who support recognition of both permanent and temporary impairment losses permit reversals of impairment losses when the conditions that gave rise to the impairment loss have reversed. Standard setters in Australia New Zealand and the IASC have adopted this approach.

33. The PSC's tentative view is that all impairment losses (both temporary and permanent) should be recognized as they occur and that where the conditions that gave rise to an impairment loss no longer apply, an impairment loss may be reversed.

Comments sought

6. *(a)* *Do you agree that all impairment losses should be recognized, without making any judgment about the "permanence" of the loss? If so, what are your reasons for reaching that conclusion?*

OR

(b) *Do you consider that an impairment loss should only be recognized when it is likely to be permanent? If so, what*

factors should be taken into account to determine that an impairment loss is permanent?

OR

(c) Do you support some other basis for the recognition of impairment losses? If so, provide an explanation of that alternative basis with supporting reasons.

7. (a) Do you support the reversal of impairment losses where temporary and permanent impairment losses are not distinguished (option 6(a) above) and the conditions leading to the initial impairment loss have reversed? If so, what are your reasons for reaching that conclusion?

OR

(b) Do you support the reversal of impairment losses where only permanent impairment losses are recognized (option 6(b) above)? If so, what are your reasons for reaching that conclusion?

OR

(c) Do you support some alternative basis for the reversal of impairment losses? If so, provide an explanation of that alternative basis with supporting reasons.