# Impairment of Long-Lived Assets — Background Information and Basis for Conclusions

## Section 3063

**Foreword**

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

The Accounting Standards Board believes Background Information and Basis for Conclusions material will assist:

- readers of the CPA Canada Handbook – Accounting in understanding and applying the Recommendations in the new Section;
- users of financial statements in understanding the information provided by reporting enterprises; and
- everyone interested in financial reporting in obtaining a better appreciation of the work that has gone into the development of the new Recommendations.

The contents of this document do not form part of the CPA Canada Handbook – Accounting. The Accounting Standards Board does not intend to include in Background Information and Basis for Conclusions documents any guidance that is necessary for applying a Recommendation.

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**INTRODUCTION**

1 This document summarizes considerations that were deemed significant by the Accounting Standards Board (AcSB) members in reaching the conclusions in IMPAIRMENT OF LONG-LIVED ASSETS, Section 3063. It sets out the reasons the AcSB undertook the project to develop the standard, the process of research and deliberation, the key decisions made and the principal reasons for accepting certain approaches and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

2 Nothing in this document is to be taken as overriding the Recommendations in Section 3063; however, the discussion may assist Handbook users in understanding the Recommendations and the AcSB's intent with respect to its interpretation and application. This Section is intended to harmonize with the impairment provisions of the Financial Accounting

Standards Board (FASB) Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The FASB has provided a detailed analysis of its deliberations and conclusions, 1 which might also be of value to Handbook users.

**BACKGROUND**

3. This Section replaces the write-down provisions of PROPERTY, PLANT AND EQUIPMENT, Section 3061. It applies to all long-lived assets, except those specifically excluded.

4 In recent years, standard setters in the US and internationally have issued standards on the impairment of long-lived assets that differ considerably from those in Section 3061. While these standards contain some differences, in one significant respect they are consistent — each of them uses a measure of impairment that incorporates present value methodology (i.e., discounts future cash flows). International Accounting Standard IAS 36, "Impairment of Assets," uses the present value of estimated future cash flows in the recognition and measurement of impairment. In the US, FAS 144 measures impairment using the fair value of the asset, which is often estimated using the present value of future cash flows. (FAS 144 determines when to recognize an impairment loss by comparing the asset's carrying amount to its undiscounted future cash flows.)

5 This use of discounting represents a significant difference to current Canadian accounting, which recognizes and measures impairment by comparing the carrying amount of the asset to its undiscounted expected future cash flows. Discounting cash flows will often result in a large difference in impairment write-downs. AcSB staff carried out a survey of US GAAP differences reported in 2000 by major Canadian companies that have registered securities with the US Securities and Exchange Commission (SEC). This survey found that 10 percent of these companies reported GAAP differences due to the difference in accounting for impairment, with impacts that were as high as 45 percent of reported earnings.

6 One of the objectives of the AcSB is to facilitate access by Canadian enterprises to US and global capital markets by eliminating, or minimizing, GAAP differences within North America and internationally, as appropriate. Accordingly, the AcSB added this topic to its agenda in November 2000. The appropriateness of this decision was confirmed by the August 2001 public survey of potential future projects of the AcSB, which identified impairment as the number one priority of survey respondents.

7 The AcSB issued an Exposure Draft, "Impairment or Disposal of Long-Lived Assets," in February 2002. This was based on FAS 144, amended to conform with Canadian standards and terminology, with the intent that this would result in harmonized accounting with the US on this topic.

8 The responses to the Exposure Draft did not result in the AcSB making any fundamental changes to the proposals, although several clarifications and other improvements were made (without conflicting with the objective of harmonizing with FAS 144). The AcSB also decided to publish the final Recommendations as two Sections: IMPAIRMENT OF LONG-LIVED ASSETS, Section 3063, and DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475.

**ACCOUNTING FOR IMPAIRMENT**

**Comparison of different approaches**

9 In its deliberations the AcSB reviewed and compared the international and US accounting standards on impairment (IAS 36 and FAS 144). It also noted that Australia, New Zealand and the UK had impairment standards, or proposed standards, that are based on these two standards.

10 The purpose of this review was to understand the key elements of the two standards, the similarities and differences between them, and to assess their overall fit with FINANCIAL STATEMENT CONCEPTS, Section 1000, and Handbook Recommendations. While the AcSB wanted to harmonize the accounting for impairment, it also needed to be satisfied that the proposed accounting would meet the objective of improving the quality of information reported by Canadian entities, with due consideration for the costs and benefits to preparers and users.

11 The standards are similar in viewing the decision to continue to operate an impaired asset as "economically similar to a decision to invest in that asset." 2 This leads both standards to measure impairment on a basis consistent with the present value of future cash flows. IAS 36 uses the present value of future cash flows directly. FAS 144 focuses on fair value, which conceptually incorporates future cash flows on a discounted basis. In most cases fair value will be estimated by the present value of future cash flows. Other consistent aspects are the requirement to assess an asset for impairment whenever there is an indication it may be impaired, the identification of examples of impairment indicators that would trigger an impairment review, and guidance on grouping assets for an impairment review when the cash flows of the individual asset are not independent of the cash flows of other assets.

12 While IAS 36 and FAS 144 are consistent in these aspects, they differ in certain key aspects of the application of the present value concept to impairment. There are three basic differences:

(a) the measurement of impairment (recoverable amount or fair value);

(b) the ability to reverse impairment losses; and

(c) the criteria for recognizing an impairment loss.

13 These three aspects were important in the AcSB's determination of the approach to be used in accounting for impairment. The AcSB also viewed them as interlinked, rather than stand-alone items, and determined that the Handbook Section

should be based on the impairment provisions of either FAS 144 or of IAS 36, but not on a mixture of them, unless unique Canadian circumstances could be identified that would require this. The key considerations from the AcSB's discussions on the approach to accounting for impairment are provided in the following sections of this document.

**Measurement of impairment**

14 IAS 36 measures impairment by comparing carrying amount to recoverable amount while FAS 144 measures impairment by comparing carrying amount to fair value. Each of these approaches is discussed in the following paragraphs.

15 IAS 36 states that "the objective of the measurement of recoverable amount is to reflect an investment decision." 3 This investment decision is whether to retain or dispose of the asset, and is based on (management's) estimate of the net future cash flows it can achieve from the asset.

16 IAS 36 defines recoverable amount as the higher of an asset's selling price (net of disposal costs) and its value in use. Value in use is the present value of the estimated cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its life. Management generally will retain the asset only if its value in use is greater than the amount it could obtain by selling the asset.

17 Advocates of measuring impairment based on recoverable amount argue that if value in use is higher than net selling price, measuring the asset at value in use is consistent with management's decision. If management decides to keep the asset, even though net selling price is higher than value in use, the loss represented by the difference between these two amounts properly falls into later periods because it results from management's decision in these later years to keep the asset.

18 Value in use may be different from fair value for several reasons. The enterprise may have different (better) information than the marketplace participants about future cash flows. In making the judgments inherent in estimating future cash flows it may be more, or less, optimistic about future events and conditions. Marketplace participants will assume the asset will be used for its most profitable purpose and operated at a certain level of efficiency, and this will reflect in fair value. The enterprise may expect to operate the asset more or less efficiently than this and possibly to use the asset differently from the market's view of best use.

19 In considering the recoverable amount approach, AcSB members were concerned with the subjectivity inherent in measuring a write-down on the basis of management's best estimate of the future cash flows from the asset. The same impaired asset could be recorded at different amounts depending on management's views of the future and their intended use of the asset. For example, the less efficiently that management expects to operate the asset, the lower the recoverable amount at which the impaired asset will be recorded in the balance sheet (and the lower the future depreciation charges). This would also result in a lack of comparability for impairment write-downs of similar assets in similar circumstances.

20 Following an impairment write-down based on recoverable amount, the asset's contribution to the enterprise's earnings will represent the interest factor in the present value calculation used to derive value in use, and the degree to which management's estimates were accurate. This will address how management operated the asset compared to their expectations, but will not show how well the asset was operated against an objective standard (i.e., compared to a baseline of market expectations).

21 AcSB members were also unconvinced of the appropriateness of valuing an asset at the higher of net selling price and value in use when the asset is retained. The net selling price in this situation is irrelevant to the future cash flows expected from the asset.

22 The fair value model is based on the view that impairment is a "fresh start" measurement, which results in a new cost basis that replaces the existing cost basis. It is not viewed as an adjustment to the existing carrying value, where the gross carrying amount maintains its meaning and the adjustment is an amount that is deducted from the gross amount to derive the net amount.

23 In Statement of Financial Accounting Concepts No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements," FASB defines a fresh start measurement as "measurements in periods following initial recognition that establish a new carrying amount unrelated to previous amounts and accounting conventions." (It then quotes a remeasurement of assets due to impairment as an example of a fresh start measurement.)

24 FASB views impairment as a fresh start because the decision to continue to operate rather than sell an impaired asset is economically similar to a decision to invest in that asset. "When an entity determines that expected future cash flows from using an asset will not result in the recovery of the asset's carrying amount, it must decide whether to sell the asset and use the proceeds for an alternative purpose or to continue to use the impaired asset in its operations. The decision presumably is based on a comparison of expected future cash flows from those alternative courses of action and is essentially a capital investment decision. In either alternative, proceeds from the sale of the impaired asset are considered in the capital investment decision. Consequently, a decision to continue to use the impaired asset is equivalent to a new asset purchase decision, and a new basis of fair value is appropriate." 4

25 AcSB members did not agree with the argument (used in both IAS 36 and FAS 144) that impairment can be viewed as analogous to an investment decision. However, they did agree with the view that impairment is a recognition that the existing cost basis for the asset is not supportable and as a result a new cost basis is required. Use of fair value to measure this new cost basis is consistent with the measurement basis of assets on initial acquisition, while use of

recoverable amount (higher of net selling price and value in use) is not. Measurement of an asset at the time of original recognition is usually based on the cash price, which represents market value (i.e., fair value). Where the asset is acquired for other than cash (for example, debt or equity securities), the objective is still to measure the fair value of the transaction and record it at that amount. Normally this is done by using the market value of the securities or other consideration.

26 FINANCIAL STATEMENT CONCEPTS, Section 1000, describes the qualitative characteristics that make information useful to users. To be reliable, information should be representationally faithful, verifiable and unbiased. Information should also be comparable — unlike things should not appear alike and like things should not appear to be different. Market value information is consistent with these qualitative characteristics. It encompasses the consensus view of all marketplace participants about an asset's utility, future cash flows (including their uncertainties), and the amount that marketplace participants demand for bearing those uncertainties. As such, it is not based on management's (subjective) expectations and judgment and is not enterprise-specific.

27 The principles that apply to measurement at initial recognition also apply to subsequent fresh start measurements. Consistent use of fair value as the measurement method for both initial recognition and subsequent fresh start accounting also maintains comparability in the valuation of assets in the financial statements and their subsequent impact on the income statement.

28 The AcSB noted that fair value and value in use may be similar amounts, or even the same. For most long-lived assets there is not an observable market value, and fair value must be estimated by using the present value of future cash flows. Under fair value, the market's estimates of future cash flows would be used, while management's best estimates would be used for value in use. These may not be significantly different, particularly in those cases where market participants rely heavily on management for input into their future cash flow estimates.

29 In some situations, the amount for which an asset can be sold in the market may appear to be significantly less than the present value of the future cash flows it is expected to generate. This could be, for example, because the enterprise has some specialized technical or market knowledge, or understands how to successfully operate a business in a certain country. Such knowledge or ability may not be available to potential buyers of the assets. As a result, the fair (market) value of the identified assets may be considerably less than the value to the current owners of the ongoing stream of cash flows. It can be argued that writing an asset down to the value obtainable in the marketplace in such circumstances results in too great an impairment, since under the existing ownership the asset will generate positive cash flows with a discounted value in excess of the amount it could be sold for. The AcSB noted that in this case there is an (often unrecognized) intangible asset to be considered in arriving at the fair value of the asset group. The inclusion of this intangible asset in the asset group would increase the fair value to an amount consistent with the present value of future cash flows. In effect, the asset for sale can be viewed as the future cash flows that will be generated by the asset, with the fair value being that of the cash flow stream.

30 After considering the above points, the AcSB concluded that, for the reasons described in the previous paragraphs, remeasurement of an impaired asset represents a fresh start in accounting for the asset and that fair value should be the measurement basis used.

**Ability to reverse impairment losses**

31 IAS 36 requires that an impairment loss be reversed if, and only if, there has been a change in the estimates used to determine an asset's recoverable amount since the last impairment loss was recognized.

32 Reversal of impairment losses is supported by the following arguments 5:

(a) consistency with the IASC Framework and the view that economic benefits that were not previously expected to flow from an asset have been reassessed as probable;

(b) reversal of an impairment loss is not a revaluation (and so is consistent with historical cost accounting);

(c) a change in the measurement of an impairment loss is similar to a change in an estimate;

(d) reversals provide users with a more useful indication of the potential for future benefits; and

(e) depreciation or amortization will not be understated due to a previous impairment loss that is no longer relevant.

33 Reversals of impairment losses are prohibited under FAS 144 (as they are under PROPERTY, PLANT AND EQUIPMENT, Section 3061). This is consistent with the view that impairment triggers fresh start accounting. Fair value is a market-based price that becomes the new cost basis of an impaired asset. Once established the new cost basis is fixed (subject to any impairment write-downs). Any reversal of an impairment loss would be an upward revaluation of the amount established under that new cost basis.

34 In contrast, the IAS 36 use of recoverable amount is a means of estimating a provision for impairment, similar to an allowance for doubtful accounts. Accordingly, it does not establish a new cost basis and, consistent with the accounting for estimates, is re-evaluated each period and adjusted if a better estimate is available.

**Criteria for recognizing an impairment loss**

35 IAS 36 recognizes an impairment loss when a long-lived asset's recoverable amount is less than its carrying amount. This is the same basis used to measure an impaired asset. In contrast, FAS 144 has a two-step impairment process. An

impairment loss is recognized when the undiscounted future cash flows are less than the asset's carrying amount, and is then measured using the asset's fair value.

36 AcSB members felt there was an inherent logic in using the same criteria to recognize and to measure impairment. However, they also recognized that certain pragmatic factors may support recognition criteria that are different from the measurement methodology discussed above.

37 A general concern related to the potential that impairment write-downs might result in understated assets and unreasonably low depreciation charges in future periods. This could result in overstated earnings and returns in future periods.

38 If assets are written down whenever fair value is less than the carrying amount, with no ability to reverse such write-downs if fair value increases, this may introduce a significant bias to understate assets. An asset may be impaired at a single point in time and written down. In future periods, expected future cash flows might indicate the original carrying amount is not impaired. IAS 36 would require the asset write-down to be reversed. As a result, impairment is only recognized for assets that are impaired at the balance sheet date. As discussed in paragraph 33, reversing an impairment write-down is inconsistent with the fair value measurement approach.

39 FASB discussed whether impairment should be recognized only when it is permanent. This was rejected as being too restrictive and not practical to implement. 6 A permanence criterion would require management to predict the future with certainty.

40 The criterion adopted by the FASB was probability: "an impairment loss would be recognized when it is deemed probable that the carrying amount of an asset cannot be fully recovered." 7 As a practical way to determine this, impairment write-downs are recognized under FAS 144 only when the carrying amount exceeds the undiscounted expected future cash flows. If the undiscounted cash flows at a point in time are less than the carrying amount, this is sufficient evidence that it is probable that the asset is impaired, and an impairment loss should be recorded. If the undiscounted cash flows exceed the carrying amount, even though the fair value is less than the carrying amount, there is insufficient evidence that the asset is impaired and no impairment loss is recognized.

41 By making the recognition criterion more difficult to meet than the measurement criterion, the likelihood is reduced that an impairment loss is recorded that appears in a future period to be unnecessary.

42 A related concern is so-called "big-bath" accounting, where an enterprise records extensive accruals and write-downs in a year. This has the effect of reducing expenses in future years and potentially overstating future income. Recognizing impairment losses only when the carrying amount exceeds undiscounted expected future cash flows makes these write-downs less easy to record and serves to limit the occurrences of big-bath accounting.

**Conclusion on the approach to accounting for impairment**

43 AcSB members saw merits in both the IAS 36 and FAS 144 approaches. While fair value measurement of impaired assets was generally supported, some AcSB members were concerned that there was an insufficient conceptual basis for use of a different recognition criterion (two-step approach) and with the inability under FAS 144 to reverse impairment write-downs.

44 One of the objectives of the AcSB is to facilitate access by Canadian enterprises to US and global markets by eliminating or minimizing GAAP differences within North America and internationally, as appropriate. In considering the approach to impairment in light of this objective, the AcSB decided that either the FAS 144 approach or that of IAS 36 should be used in its entirety and that it was not appropriate to select those aspects that they preferred from each standard. To do so would result in Canadian GAAP that was not harmonized with either US or international GAAP. The AcSB also agreed that using either FAS 144 or IAS 36 as the basis for a harmonized Canadian standard would improve the quality of information reported by Canadian enterprises, considering the benefits and costs to both users and preparers.

45 The AcSB further considered whether there were any unique Canadian circumstances that would necessitate distinct Canadian standards on accounting for impairment, or support adopting either the FAS 144 or IAS 36 approach over the other. No such unique circumstances were identified. (The AcSB did note that use of fair value in the impairment of intangible assets with indefinite lives and of goodwill had recently been adopted in GOODWILL AND OTHER INTANGIBLE ASSETS, Section 3062.)

46 Consistent with its general approach to harmonization, the AcSB concluded that in the absence of an international convergence initiative on accounting for impairment, at this point in time the interests of Canadian enterprises and their stakeholders are better served by harmonizing with US GAAP rather than with IAS 36.

**Other issues**

47 Some respondents were concerned that the impairment process in the Exposure Draft was not identical to that in Section 3062. The AcSB disagreed with this concern. The principle is that impairment is measured by comparing the carrying amount of the asset with its fair value, and this principle is consistently applied in Sections 3062 and 3063. The differences in the application of this principle are due to differences in the nature of the assets involved. Because they are not being amortized, intangible assets that do not have a finite life and goodwill are at greater risk of being impaired and are tested for impairment annually.

48 The AcSB determined that the provisions in FAS 144 on the grouping of assets in order to test for impairment are consistent with existing provisions in PROPERTY, PLANT AND EQUIPMENT, Section 3061, but provide more

guidance. It noted that some enterprises, particularly small enterprises, might find that the asset group contains all the assets of the enterprise, since there is no smaller grouping for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.

49 The guidance on the cash flow test for recoverability is broadly consistent with the impairment test in Section 3061, although the AcSB noted that directly attributable general and administrative costs and carrying costs that will be expensed are excluded. Some AcSB members were concerned that this could result in an asset that would be impaired under current Canadian GAAP not being impaired under the new Handbook Section. However, this is not likely to be a common occurrence and there was no compelling reason to create a GAAP difference on this.

50 Several respondents to the Exposure Draft were concerned that the guidance provided on determining fair value was not sufficient. The AcSB noted that the objective was to estimate fair value. Any technique used to do this should consider all elements that impact fair value. Appendix A was modified to emphasize this, and to provide added guidance on incorporating risk and certain other aspects. However, the AcSB did not view it as appropriate that accounting recommendations include detailed "how to" guidance on valuation. The AcSB also noted that the guidance provided is based on and is consistent with the FASB's Statement of Financial Accounting Concepts No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements."

51 The inclusion or non-inclusion of taxes in cash flows used for the recoverability test and in cash flows used to estimate fair value was an issue raised by some respondents. The AcSB noted that the principles to be used are stated in the Section. The cash flows in the recoverability test include only those directly associated with, and expected to arise as a direct result of, the asset's use and eventual disposition. Taxes are one of several cash flows to be considered in light of this principle and the asset being tested for impairment. In estimating fair value, all elements that impact fair value should be considered. The AcSB did not view it as appropriate to provide more detailed "how to" guidance on this one specific element of cash flow.

**DISCLOSURES**

52 Consistent with its decision on the disclosure requirements of GOODWILL AND OTHER INTANGIBLE ASSETS, Section 3062, the AcSB decided against including in the Exposure Draft the FASB requirement for disclosure of the method or methods of determining fair value used in measuring impairment. The AcSB did not view this as a necessary disclosure, but noted that enterprises (both those who also report under US GAAP and others) may disclose this if they choose. However, respondents to the Exposure Draft felt this to be an important disclosure for impaired assets. The AcSB added this disclosure to the final standard.

53 The AcSB determined that the other disclosure requirements of FAS 144 were largely similar to those under existing Canadian GAAP and that the benefits of the disclosures would be greater than the costs.

**TRANSITIONAL PROVISIONS**

54 The new Handbook Section was approved in October 2002. A January 1, 2003, effective date could cause practical difficulties for a number of preparers, who would only have seen the final Handbook Recommendations shortly before that date. (The AcSB noted that details of its decisions are posted on its web site following each AcSB meeting, providing constituents with a way to keep current as the AcSB reviews Exposure Draft responses and finalizes a Handbook Section.) The effective date was therefore set as years beginning on or after April 1, 2003.

55 Certain Canadian enterprises are also required to prepare financial statements under US GAAP. The AcSB is sympathetic to these enterprises' desire to minimize GAAP differences and the additional work of keeping separate accounting records for Canadian and US GAAP. Early adoption is encouraged. This permits an enterprise to report its full year 2002 results on a consistent basis for the impairment of long-lived assets.

56 The AcSB decided this Section should be adopted prospectively. Paragraph 3063.09 requires a long-lived asset to be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The adoption of this Section will not in itself cause an impairment loss. Thus, in no case should adoption of Section 3063 result in a charge to retained earnings or to restatement of earnings of a prior year.

**DIFFERENTIAL REPORTING**

57 The Exposure Draft was reviewed by the Differential Reporting Advisory Committee. They requested certain clarifications, which have been incorporated in the final standard, but did not recommend a differential reporting option.

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# Footnotes

1. FAS 144, Appendix B, Background Information and Basis for Conclusions (August 2001).

2. FAS 144, paragraph B34. See also IAS 36, paragraph B20.

3. IAS 36, paragraph B24.

4. FAS 144, paragraph B34.

5. IAS 36, paragraph B111.

6. FAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," paragraph 61.

7. FAS 121, paragraph 62.