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NORTHERN ILLINOIS UNIVERSITY

Analysis of Impairment of Debt and Assets

A Report submitted to the
University Honors Program
in Partial Fulfillment of the
Requirements of the Baccalaureate Degree
With Upper Division Honors

Department of Accountancy

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INTRODUCTION

The United States has been in an economic recovery for seven to eight years. This recovery comes after a period of high inflation and high interest rates. Coinciding with this recovery has been an accounting phenomenon. Debt and asset impairments and write-offs have occurred at a rate that has not been seen before. The debt impairments or restructurings are the result of obtaining debt in the 1970s at high interest rates, while current interest rates are sometimes half that of the 1970s rates. Asset impairments are the result of lower inflation rates than those of eight to nine years ago. Because the cost or value of assets is not increasing at the previous high rate, the carrying amounts of assets are sometimes higher than the value of the assets.

While both debt restructuring and asset impairments are caused by the same economic conditions, they are handled quite differently in practice. The purpose of this study is to examine how each separate issue is treated in practice compared to the guidelines of the Financial Accounting Standards Board (FASB) Conceptual Framework. This study is broken into two separate sections: the first discusses troubled debt restructuring and the second examines asset impairments.

DEBT RESTRUCTURING

INTRODUCTION

In June 1977, The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No.15, Accounting by Debtors and Creditors for Troubled Debt Restructuring. The major provisions of SFAS No.15 pertain to: (1) settlement of troubled debt in full, (2) modification(s) of the terms of the troubled debt, and (3) the financial statement disclosure requirements after the restructure has taken effect. Later, the FASB developed its conceptual framework by issuing Statements of Financial Accounting Concepts (SFAC) No's 1-6. The concepts statements of the conceptual framework applicable to troubled debt restructuring include: Recognition and Measurement in Financial Statements of Business Enterprises (SFAC No.5), Objectives of Financial Reporting by Business Enterprises (SFAC No.1), Qualitative Characteristics of Accounting Information (SFAC No.2), and Elements of Financial Statements (SFAC No.6). The purpose of this section of study is to evaluate SFAS No.15 against the concepts of the conceptual framework to determine if the provisions of SFAS No.15 are consistent with the guidance of the conceptual framework. To simplify the evaluation, contingency payments are excluded from this study. Also, unless

it is indicated otherwise, the term "debt" refers to both the debt of the debtor and the receivable of the creditor.

PROVISIONS OF STATEMENT OF FINANCIAL ACCOUNTING STANDARD No. 15

When troubled debt is restructured by transferring assets or granting of an equity interest and the forgiving of debt, the debt is settled in full. A gain/loss is recorded by computing the difference between the carrying amount of the debt and the market value of the assets transferred or the equity interest granted.[1]

When the debt is continued through modification(s) of terms (reduction of the face value, reduction of the interest rate, and/or extension of the maturity date), usually the carrying value of the debt is left on the balance sheet. As long as the total future cash flows of the restructured debt exceed the carrying value, the carrying value is unchanged. The balance sheet is affected, only when the total future cash flows are less than the carrying value.[2]

When the total future cash flows are larger than the carrying value, a new effective interest rate is computed. The new effective rate is the interest rate that equates the total future cash flows to the carrying value. Then as interest payments are made/received, the carrying value is reduced by the difference between the (new) stated rate and the new effective rate.

When the total future cash flows are smaller than the carrying value, a gain/loss is recorded for the difference

between the carrying value and the total future cash flows. The debt is then carried at the amount of the total future cash flows. After restructure, all "interest payments" are used to reduce the carrying value of the debt since the effective interest rate in these situations is zero.

SFAS No.15 requires the debtor to disclose the troubled debt restructure in the period that the restructure takes place. The disclosure includes changes in terms, aggregate gain(s) on restructured debt (net of tax), aggregate gain(s)/loss(es) on transfer of assets, and per share amount of the aggregate gain(s) on restructured debt.[3]

In periods following the restructure, SFAS No.15 does not require debtors to make any additional disclosures concerning the restructured debt. The only disclosures required would be those that are required for all debt: type and term of debt, payments to be made in each of the next five years, nature of variable portions (if any), and contracted amounts purchased (i.e. take or pay contracts) during the period. It is also recommended, but not required, that effective interest rates be disclosed.[4]

SFAS No.15 requires creditors to disclose troubled debt restructure in all periods that the receivable is outstanding. Troubled debt restructure disclosure includes: aggregate investment recorded, interest income that would have been recorded if the receivables had not been restructured, interest income from restructured receivables, and any commitments to lend additional amounts to debtors with restructured receivables.[5]

The FASB's rationale underlying the major provisions of SFAS No.15 is that when debt is settled in full, a transaction has occurred and a change in assets/liabilities should be recorded. However, when the terms of the debt are modified, the FASB concluded that no transaction has occurred. Thus, no change in assets/liabilities should be recorded, unless future cash flows are less than the carrying value of the debt.[6]

CONGRUENCE OF CONCEPTUAL FRAMEWORK WITH SFAS NO. 15

In this section, each applicable concept of the conceptual framework is analyzed in terms of the provisions of SFAS No.15, to determine whether SFAS No.15 is consistent with the guidelines of the conceptual framework.

Recognition Criteria.

SFAC No.5 developed four recognition criteria, guidance in applying the criteria to the components of earnings, and recognition of changes in assets and liabilities.

The recognition criterion that is applicable to troubled debt restructuring is the measurability concept.[7] Measurability states that assets and liabilities must have a relevant attribute (present value for long-term debt/receivables) that can be quantified in monetary units. The components of earnings that require guidance are revenues/gains and expenses/losses.[8] The guidance for revenues/gains is that they be realized or realizable and earned (though earned is not always as important because some transactions that result in gains do not involve an

earning process). The guidance for determining expenses/losses is the consumption of economic benefits, or discovery of a loss of future economic benefits. Also, changes in assets and liabilities should be recognized and recorded when an event occurs that changes the amount of an asset or liability and that meets the recognition criterion of measurability.[9] There are two types of changes in the amount of an asset or liability: changes in utility or substance, and price changes.

With respect to measurability, the concept states that all long-term debt be recorded at the present value of future cash flows, based on the effective interest rate at the date of issuance. When the debt has been settled in full, there is no future cash flows. Thus, SFAS No. 15 follows the guidance of the conceptual framework when the debt is settled in full. However, carrying restructured troubled debt at its pre-restructure carrying value or at its total future cash flows, when the terms of the debt are modified, instead of the present value of future cash flows is in clear violation of the measurability concept. Therefore, SFAS No.15 is not is line with the conceptual framework.

The second recognition criterion is the guidance in applying the measurability concept to the components of earnings. If the measurability concept is applied to SFAS No.15, then each restructure of troubled debt would result in a gain/loss being recorded. A gain would be recorded by the debtor because the doubter's future cash outflows have been reduced. The gain is

the difference between the present value of future cash flows before and after the restructure. A loss would be recorded by the creditor because the restructuring will result in the loss of future economic benefits. Thus, SFAS No.15 follows the conceptual framework (with regards to measurability) only when there is a full settlement. However, there is an inconsistency with the conceptual framework when debt terms are modified.

The final recognition criterion is the recognition of changes in assets and liabilities. When troubled debt is restructured by full settlement, the changes in assets/liabilities is recorded. However, when a troubled debt is restructured by modification of terms, no change is recorded to recognize the new value of the asset/liability using the measurability concept. Restructured troubled debt consists of both types of changes (in utility and price). Because the cash flows are altered (by a change in face value, interest rate, and/or maturity date), there is a change in utility for both debtor and creditor. According to the measurability concept, a change in the terms will bring about a new price when using present value techniques. Therefore, when the debt is settled in full, SFAS No.15 follows the conceptual framework; but when the terms are modified, SFAS No. 15 does not follow the conceptual framework.

Objectives.

The objectives from SFAC No.1 pertaining to troubled debt restructuring are that financial reporting should provide

information that is useful to present and potential investors and creditors: (1) in investment and credit decisions; (2) in assessing cash flow prospects; (3) and in determining the resources, claims to the resources, and changes in resources of a business enterprise.

Information that is useful in making investment and credit decisions include all items that would help those who have a reasonable understanding of business activities to make a rational decision.[10] Information concerning cash flow prospects include the amounts, timing, and uncertainty of prospective cash receipts from interest and proceeds from the extinguishments of debt.[11] Information about the enterprise's resources, claims to resources, and changes in resources is included to provide an evaluation of the enterprise's performance during a period.[12]

The first objective of the conceptual framework is that financial reporting should disclose information that is useful to present or potential user in making investment and credit decisions. The disclosures required of debtors, who have restructured troubled debt, is the information that is provided to the users. When the debt is settled in full, the disclosure requirements provide all the information that the users need. The disclosure requirements, when the terms of the debt are modified, for the period of restructure includes all the information a user could use except one. The new effective interest rate is not required to be disclosed in the first period or any other period. Also for periods after the period of

restructure, there is no additional disclosure requirements concerning troubled debt restructuring. This does not seem to provide the information that is needed by the users to make rational decisions. Although the debtor must disclose the type and terms of the debt, and the payments in each of the next five years, they are not required to disclose the portion of the interest payments used to reduce the carrying value of the debt. Also, by placing the restructured debt with the other debt, in periods after restructuring and without the necessary disclosures, the fact that the debtor has had trouble meeting its obligations in the past is hidden. The disclosures required for creditors is the same for all periods that the receivable is outstanding. The disclosures include all information pertaining to receivables that have been restructured, except the new effective interest rate. When the debt is settled in full the required disclosures appear to satisfy the conceptual framework. However, it seems that the disclosures required by SFAS No.15 do not provide the information that is called for by the conceptual framework, when the debt is modified.

The second objective is that is that financial reporting should provide information that is useful in assessing cash flow prospects. The information needed in assessing cash flows is closely tied to the information needed to make rational investment and credit decisions. The disclosures required provide insufficient information concerning future cash flows, when the debt is modified. If the portion of the interest

payments that reduces the carrying value of the debt is not disclosed by the debtor, it could mislead the user as to when cash will be needed to satisfy the debt. The same deficiency can be applied to the creditor if the disclosures do not identify what portion of the interest received reduces the carrying value. Since their are no future cash flows when the troubled debt is restructured by a full settlement, the information provided for these situations is sufficient. The missing disclosure, by both debtor and creditor, of the amount of the interest payments that is used to reduce the carrying value of the debt, shows that SFAS No.15 does not meet the requirements of the conceptual framework when the debt is modified and does meet the requirements when the debt is settled in full.

The third objective is that the information provided be useful in determining an enterprise's resources, claims to resources, and changes in resources. If a troubled debt is restructured, but the carrying value is not changed, then their is a misrepresentation concerning the resources, claims to resources, and changes in resources. The misrepresentation occurs because the future cash flows have changed, but the present value of the future cash flows have not been recorded. Instead, the total future cash flows or the pre-restructure carrying value has been recorded as the carrying value. Because SFAS No.15 does not provide information on restructured troubled debt that reflects the proper value of resources, claims to resources, and changes in resources; it does not follow the guidance of the conceptual framework.

Qualitative Characteristics.

The qualitative characteristics from SFAC No.2 that are relevant to troubled debt restructuring are (1) representational faithfulness,(2) comparability, and (3) consistency.

Representational faithfulness simply means that the information represents what it says it represents.[13] Comparability requires that information of one enterprise be comparable to the information of other enterprises, or comparable to the information of the same enterprise in a different time period.[14] Consistency requires that the same accounting principles be used over a span of time with infrequent changes.[15]

The first qualitative characteristic is representational faithfulness. When restructured troubled debt is placed on the balance sheet with other long-term debt, it is represented as if it were similar to the other debt. Because the other debt is presented at present value, and the restructured troubled debt is not, the restructured troubled debt is not represented faithfully. Therefore SFAS No.15 is not in accordance with the conceptual framework.

The second qualitative characteristic is comparability. In order for restructured troubled debt to have comparability, it must be comparable to information from other enterprises or to information from the same enterprise in a different period. When comparing the pre-restructure carrying value of one debt to the restructured carrying value of the same debt, the pre-restructure carrying value represents the present value of future cash flows,

while the restructured carrying value represents the total future cash flows. These two carrying values of the same debt are not comparable. The same result is reached if a comparison is made within one balance sheet between the carrying value of a "normal" debt and the carrying value of a restructured debt. Because restructured troubled debt is not comparable to other debts, SFAS No.15 does not follow the conceptual framework.

The final qualitative characteristic is consistency. Consistency calls for the same accounting principles to be applied over time with infrequent changes. By accounting for "normal" debt using present value of future cash flows and accounting for restructured troubled debt using total future cash flows, accounting principles are not being applied consistently. Consistency not only applies to accounting principles over time, but also within a group of similar items. Accounting principles should be applied consistently to items in a group, such as long-term debt. Because restructured troubled debt is not consistent with the accounting principles of normal debt, SFAS No.15 does not follow the guidance of the conceptual framework.

Transactions.

SFAC No.6 defined transactions and events that change assets and liabilities. The pertinent portion of the definition states that price changes and interest rate changes can constitute a transaction or event that will change assets and liabilities.[16]

When a troubled debt is restructured through modifications of terms, there is a change in the price according to the

measurability concept, due to the change in the effective interest rate of the debt when the terms are modified; thus it should be recognized as a transaction or event and an adjustment made to the assets or liabilities involved. Because transactions or events are not recorded when the terms of the restructured troubled debt are modified, SFAS No.15 is not consistent with the conceptual framework.

CONCLUSION

Of the three major provisions of SFAS No.15, only the provision concerning full settlement of troubled debt is congruent with the concepts in the conceptual framework. SFAS No.15's treatment of restructured troubled debt through modifications of terms is inconsistent with certain recognition criteria, objectives of financial reporting, qualitative characteristics of accounting information, and the definition of transactions that change assets and liabilities of the conceptual framework. Also, the disclosures that are required by SFAS No.15 are inadequate and do not meet the objectives of financial reporting. The inconsistencies of SFAS No.15 can be attributed to the FASB conclusions about when a transaction has occurred and when it has not, in cases involving modification of terms. If the transactions were recognized and the gain/loss recorded when troubled debt is restructured, most, if not all of the inconsistencies would be eliminated and SFAS No. 15 would conform to the conceptual framework.

ASSET IMPAIRMENT

INTRODUCTION

In recent years, restructuring charges have been used to reduce the carrying amounts of fixed operating assets. The companies believed the value of the assets were impaired, and could not fully recover the assets cost. In 1985 and 1986, 54 companies had restructuring charges that included amounts for the impairment of fixed assets.[17] the combined value of these charges were over $26 billion.[18] The more notable companies involved were Monsanto Co.($559 million), Union Carbide Corp. ($1.06 billion), Dart & Kraft ($5 million)[19], and American Telephone & Telegraph ($3.2 billion).[20] Additionally, AT&T wrote-off another $6.7 billion in 1988.[21] Without any authoritative literature, how do companies decide what reasons are necessary to write-off a part of the carrying value of an operating fixed asset, how much to write-off, and if write-offs are allowed under current GAAP? A Survey of 24 companies that took write-offs in 1985 showed that the methods used to determine the amounts varied: 46% used net realizable value, 18% used undiscounted expected future cash flows, 14% used net present values of future cash flows, and the remaining 22% used combinations of these and other methods. This survey, by the

Financial Executives Institute (FEI), also showed that 60% used the probability assessments of SFAS No. 5, Accounting for Contingencies, while 36% used the concept of permanent decline.[22]

The purpose of the asset impairment section of this study is fourfold. First, there will be an evaluation of what method should be used to determine if impairment has occurred. Second, an evaluation of the methods of determining the amounts to be written-off will be made. Third, this section will discuss the proper disclosures of a write-off. Fourth, this section will examine whether or not write-offs of impaired operating fixed assets are within the FASB's Conceptual Framework. The first three parts will be under the assumption that write-offs are within the conceptual framework.

IMPAIRMENT?

In some cases, it is easy to determine whether impairment of an asset has taken place. These are covered by two pronouncements of the Accounting Principles Board (APB). The first instance is where the assets have been damaged by an outside party. According to APB Statement No.4, assets damaged by outside parties should be written down to recoverable cost and a loss recorded.[23] In this case, there is obvious impairment caused by the damage and a loss is appropriately recorded. The other case, as described in APB Opinion No.30, involves the sale or abandonment of a business segment at a loss. The loss is record at the date that managements commits itself to the sale or

abandonment.[24] Under these circumstances, impairment is obvious because of the imminent sale or abandonment of a business segment. However the question of impairment is more difficult for nondamaged operating assets.

There have been predominantly two methods of determining if impairment of an asset has taken place. According to the Emerging Issues Task Force (EITF), through 1984, the dominant method was permanent decline.[25] But as shown earlier, the dominant method since 1985 has been probability assessments.

The concept of permanent decline (or impairment) of assets was derived from the concept of permanent decline that is used in accounting for noncurrent marketable equity securities. Under SFAS No.12, Accounting for Certain Marketable Securities, any decline that is other that temporary will be realized as a loss currently, instead of establishing a valuation account.[26] This concept requires that a judgment be made that the current value, or other method of valuation will not return to its original amount or subsequent carrying amount.

The other method, probability assessments, was taken directly from SFAS No.5; the assessments are defined below:

> Probable. The future event or events are likely to occur.
>
> Reasonably Possible. The chance of the future event or events occurring is more than remote but less than likely.
>
> Remote. The chance of the future event or events occurring is slight.

Under these assessments, only impairments that are probable would be recorded as losses. Reasonably possible impairments would be disclosed in the footnotes to the financial statements.

The criteria used in this study to in evaluate which method to use, is based on 1) restrictiveness of use and 2) the inability of future write-ups. According to the EITF, under the concept of permanent decline, write-offs have been made only in unusual situations. Also stated is that the potential for abuse is small because of the difficulty of estimating the amounts.[28] Conversely, the AICPA, in an issue paper dated 1980, felt that the probability assessments were easier to apply and would allow more write-offs.[29] Additionally, the AICPA felt that since permanent decline meant forever, it would be unduly restrictive and difficult to determine.[30]

The EITF maintains that under the concept of permanent decline, write-ups would not be allowed.[31] This position is consistent with principles followed in inventory and noncurrent marketable securities write-offs. However, the AICPA feels that using probability assessments will allow recoveries to be made in a manner parallel to recoveries made on current marketable securities and accounts receivable.[32]

This study finds that based on how these two methods can be used, the more restrictive method is permanent decline. Also, the position taken in this study is consistent with certain opinions expressed in the AICPA Issue Paper. These opinions state that under the probability assessments, future recoveries

could be abused and contribute to a "yo-yo" effect on the carrying amounts of assets, and have a smoothing effect on income.[33] Therefore, the preferred method of determining impairment is permanent decline.

DETERMINING THE AMOUNTS

This study has determined that there are basically two methods to write down the carrying amounts of fixed assets: Direct and Indirect. The direct method involves determining the value of the asset and the loss is the difference between the carrying amount and that value. Once an asset is judged to have suffered a permanent decline, the value of the asset must be estimated.

The AICPA listed nine possible measurement methods for fixed assets. Theses nine methods with descriptions are listed:

> 1. Current reproduction cost. Cash expected to be needed to purchase identical asset (if new, allow for depreciation).
>
> 2. Current replacement cost. Cash expected to be needed to buy best asset to do some function (if new, allow for depreciation).
>
> 3. Net realizable value. Net cash expected to be received for sale of assets.
>
> 4. Net present value of expected future cash flows. Expected net cash inflows attributed to the asset discounted to a present value.
>
> 5. Current cost. Current replacement cost adjusted for advantages or disadvantages of service potential of the asset that is owned.

6. Recoverable amount. Net realizable value (if asset is to be sold) or net present value of expected cash flows (if asset is not to be sold).

7. Value to the business. Lower of current cost and recoverable amounts.

8. Fair value. Cash expected to be received in a non compulsion, short time sale.

9. Gross value of expected future cash flows. See 4 without being discounted.[34]

There are inherent difficulties in a number of the estimate methods. First, if an asset is impaired but not damaged, the cost of another asset (see 1 and 2 above) should be similar or more than the carrying value, unless the cost of a new asset has decreased substantially. In this case, the impairment is questionable because it seems to be based on the decreased cost of a new asset. Secondly, it is difficult to assign cash flows (see 4 and 9 above) to fixed assets, particularly production assets. Next, the adjustments for current cost would seem to be judgmental; additionally, it would seem hard to estimate the value to attached to individual advantages or disadvantages of the assets. Finally, the discount rate (4 above) could be manipulated easily to produce larger losses.

Considering these difficulties, net realizable value and fair value should be more attainable, based on like-assets sold (by other companies) and estimates of selling cost. If selling cost are estimatable, net realizable value is preferable based on the constraint of conservation. If not estimable, fair value

should be used. When a direct write-off is used (loss recognized, and asset account adjusted), net realizable value should be used to determine the loss (if selling costs are estimatable, fair value if they are not).

The indirect write-off methods are covered by authoritative literature. The methods of indirect write-offs are 1) change in the estimated life, 2) change in the estimated salvage value, and 3) change in depreciation method (to a more accelerated method). Changing (lowering) the estimate life and/or salvage value is covered by APB Opinion No. 20 and states that the changes are handled presently and in the future.[35] There would not be any restatement or cumulative effects. The change would have to be disclosed in the footnotes. The effect would be to increase depreciation expense over remaining life of the impaired asset. A change in depreciation method is also covered by APB Opinion No. 20. This opinion requires that the current income statement show the effect by having a "Cumulative Effect of Accounting Change" before extraordinary items and net income, and if prior income statement are shown, for comparison, they are shown as they were originally reported.[36] In a separate section, selected information is presented in a pro forma format, that shows the results as if the new depreciation method had always been used. Finally, APB No. 20 requires that the change be justified in the disclosures. The effect of a change in depreciation method (to a more accelerated method) will reduce the carrying amount of the impaired asset and reduce net income in the year of the charge.

But depending on how much of the estimated life has elapsed, the depreciation expense may be higher or lower in the future than under the old method. Because the indirect method is covered by GAAP, it is preferable over the direct method. All three indirect write-off methods are acceptable and the net realizable value and fair value are acceptable for direct write-offs.

While GAAP does not have any pronouncements on which methods to use, the SEC has stated that a loss should be recognized whenever the net realizable value is less than the carrying amount for all registrants.[37] This is to be applied only when facts and circumstances indicate that impairment has occurred.[38] The following may be indicators of possible impairment:

1. Forecast indicate lack of long term demand for product and production assets are specialized.

2. Changes in the external environment. (i.e. new laws, tax cut backs in government spending, economics changes in dollar strength).

3. Unfavorable operating statistics compared to competitors.

4. Reduction in plant utilization.

5. Substantial decline in product market value.

6. Significant new competition.

7. Actual cost of not-yet-operational asset is significantly higher than expected.[39]

HOW DISCLOSED

There are no specific GAAP requirements for disclosure of direct write-offs. While the SEC has made disclosure requirements of registrants, GAAP has only provided general guidelines for disclosure. The SEC requires the loss be included in income from operations and a part of operating expenses. There can be no income subtotals (captioned or not) before the loss is captioned if material.[40] The EITF has suggested that the loss be disclosed as either an operating expense, or an unusual or infrequent item determined by application of APB Opinion No. 30.[41] A survey of the 54 companies that took write-offs in 1985-86 showed that 79% did not include the charges in operating income, while 8% included the charges as a component of operating income and 13% include the charges in "other items" which was a component of operating income.[42] The current practice (outside of SEC filings) is not to include the charges in operating income.

The general guidelines provided by GAAP came from SFAC No. 5, No. 6, and APB Opinion No. 30. SFAC No. 5 states that items with similar characteristics should be grouped together to enable analysis of predicting the amounts, timing, and uncertainty of cash flows in homogeneous groups.[43] SFAC No. 6 defines gains/losses and distinguishes between operating/nonoperating. Gains/losses are defined as increases/decreases in equity from peripheral or incidental transactions and all other transactions, events, or circumstances, excluding revenues, expenses and

ownership transactions.[44] The classification of operating or nonoperating depends on how the loss relates to the central operations of the business. [45] APB Opinion No. 30 states that losses in connection with the sale of abandonment of operating assets are not extraordinary items, but unusual or infrequent items.[46].

Using these guidelines, the losses should be disclosed as operating losses after operating income and before income from continuing operations. These losses should not be included in operating income because they are not recurring and would inhibit predicting the amounts, timing, and uncertainty of cash flows. Also, the losses should be considered operating because they normally involve operating assets. Finally, the indirect write-offs should be disclosed as discussed in the previous section.

IMPAIRMENT ALLOWABLE UNDER GAAP

The assumption used in the first three sections of this study was that recording losses based on impairment of operating assets is acceptable under GAAP. This last section will evaluate whether these losses are acceptable under GAAP. While there is a lack of authoritative pronouncements on the subject of direct write-offs, the FASB has at least twice disclaimed addressing this subject while addressing related topics. In SFAS No. 5, the FASB wrote,

> In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected

> to be recoverable through future use of that asset even though there has been no physical loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.[47]

and again in SFAS No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, the FASB stated,

> The question of whether to write down the carrying amount of productive assets to an amount expected to be recoverable through future use of those assets is unsettled under present generally accepted accounting principles.[48]

The only positive guidance was issued by the APB. In Statement No. 4 the APB said,

> In unusual circumstances, persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover costs.... The amount at which these facilities are carried is sometimes reduced to recoverable cost.[49]

The only problems is, "sometimes" was never defined nor guidance provided for the use of "sometimes."

In the absence of authoritative pronouncements, this study will look to the Conceptual Framework of the FASB and the methods of determining carrying values. According to SFAC No. 5 fixed assets are reported at historical cost and may be adjusted for amortization (depreciation).[50] Additionally stated is that expenses or losses are generally recognized when a previously

recognized asset is expected to provide reduced or no further benefits. Another underlying principle, found in SFAC No. 6, is that losses are recognized by transactions, events, or circumstances that affect the assets.

With respect to historical cost and recognizing losses on previously recognized assets, the idea of changing the carrying amount of fixed assets is contradictory to the concept of historical cost. It seems inappropriate to measure the value of an asset differently (another method) after a number of years have elapsed. While future cash flows (undiscounted and discounted) may be used in the decision to purchase an asset, the asset is not recorded at those cash flows; and while pay-back period and cost-of-capital may also be used in the decision to buy an asset, the asset's cost is not allocated according to the pay-back period or as a percent of return.

The cost of assets is allocated, according to SFAC No. 6, by a "systematic and rational" procedure.[51] There are a number of acceptable procedures: straight-line, sum-of-the-years, double declining balance and per-unit method. All of these methods use cost, salvage value, and estimated useful life or estimated units produced. These methods do not take into account the value of the asset after purchase, therefore the carrying amount does not purport to be the value of the asset. Consider the following simple example using the net realizable value:

A piece of equipment is purchased for $100 with a three year useful life and no expected salvage value. Additionally, after one year the net realizable value is $25 and after two years the net realizable value is $10. The following losses could be recognized if asset write-offs were allowed:

End of	Net Realizable Value	Carrying Amount (Straight-Line)	Additional Loss After Deprec.	Carrying Amount (Dbl-Declining)	Additional Loss After Deprec.
year 1	25	67	(42)	33	(11)
year 2	10	33	(23)	11	(1)
year 3	0	0	0	0	0

As shown by this schedule, the asset's cost would be allocated in a manner that is neither systematic nor rational. The asset's cost would be allocated in essence by both depreciation expense and operating loss. Also shown by this example is that while generally accepted accounting principles are used to determine the carrying value of the asset (under straight-line, double declining balance, or any other depreciation method),it does not approximate the value of the asset. The reason the carrying value does not approximate the value of the asset is that the cost is not allocated according to the decline in net realizable value. This is also the case for any other measure of value for the asset, since the asset's cost is not allocated by those same measures (i.e. cash flows, decreasing fair value, declining current cost).

Next, SFAC No. 6 requires transactions, events, or circumstances occur in order to recognize a loss. Although

inventories and current marketable securities are written down based on events or circumstances that affect the assets, their sale is imminent. This is not the case with long-lived asset. The impaired assets are usually operating assets, their sale is not imminent, and the cost of these assets is to be recovered through allocation. Because of the violations of historical cost and the problems of recognizing when a transaction of event has occurred, there is little support in the conceptual framework for direct write-offs.

Conclusion

Generally accepted accounting principles are quite clear on the subject of indirect write-offs. They are allowable under GAAP, with the proper disclosures. This study finds that the indirect method of writing-off the carrying amounts of impaired fixed assets is the only method clearly allowed by GAAP. Furthermore, the more acceptable method of determining impairment is permanent decline. However, if the direct method is used, the amounts written-off should be based on net realizable value or fair value. The only exception to theses findings is the requirements of the SEC for companies that file with the SEC. In these situations, if facts indicate impairment of an asset, the asset should be written down to net realizable value.

ENDNOTES

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15. Ibid., para 120-122.

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27. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, March, 1975, para 3.

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30. Ibid., p. 16.

31. Emerging Issues Task Force, Minutes, October, 1984, p. 12.

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33. Ibid, p. 25.

34. Ibid, p. 18-23.

35. Accounting Principles Board, APB Opinion No. 20, Accounting Changes, July, 1971, para 31-32.

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37. Emerging Issues Task Force, Minutes, October, 1984, p. 21.

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