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Recognition of asset impairment: A Comparison of Recognition Criteria

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RECOGNITION OF ASSET IMPAIRMENT: A Comparison of Recognition Criteria

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ABSTRACT (100-200 WORDS):

This report examines the accounting for the impairment of long-lived assets and identifiable intangibles as discussed in the Financial Accounting Standards Board Discussion Memorandum No. 098-B. This report specifically analyzes the recognition criteria to be used in determining when an impairment exists. The economic, permanence, and probability criterion are compared and contrasted to ascertain which method is the most feasible. The relevant information for this study came from the discussion memorandum, Big Six accounting firms, published literature, and a national student seminar on the topic.

The study revealed a great deal of ambiguity in accounting for assets whose value has diminished due to corporate restructuring. This uncertainty has lead to confusion and mistrust among financial statement users. There is, however, a solution to this problem. The use of the probability criterion in recognizing and recording impairments provides adequate disclosures and timely information.

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RECOGNITION OF ASSET IMPAIRMENT:
A Comparison of Recognition Criteria

In December of 1990, the Financial Accounting Standards Board (FASB) issued a Discussion Memorandum (DM) entitled Accounting for the Impairment of Long-Lived Assets and Identifiable Intangibles. This DM was the direct result of pressure from other accounting bodies. The Accounting Standards Executive Committee (AcSEC) of the AICPA, the Emerging Issues Task Force (EITF) of the FASB, the Financial Accounting Standards Advisory Council (FASAC), the Financial Executives Institute (FEI), and the National Association of Accountants (NAA) all examined the issue of asset impairment prior to the FASB's study of the issue. After several recommendations by the FASAC, the FASB added impairment of long-lived assets and identifiable intangibles to its agenda in of November 1988.

One of the reasons for this project is lack of professional guidance and a wide variety of accounting methods which are used in practice that lead to a lack of comparability between financial statements. The DM addresses several aspects of accounting for impairment such as measurement, recognition, and disclosure. The purpose of this report is to analyze the three recognition criteria examined in the discussion memorandum. This report offers first a brief background on asset accounting and impairment; then it presents, in complete detail, the three recognition criteria being considered as the proper one to recognize impaired assets.

The original discussion memorandum was read in its entirety and each issue was assessed as to its significance in relation to the main issue of asset impairment. It was ascertained that the central issue was what criterion should determine whether the difference between the carrying amount and the measurement attribute should be recognized as a loss? After deciding on the central issue, Big Six accounting firm responses to the DM were analyzed. Various journal articles dealing with asset impairment were also studied. In addition, information was obtained through a Beta Alpha Psi (National Accounting Fraternity) seminar/discussion on the issue of asset impairment. After consulting all the above sources, a conclusion was reached as to the most appropriate criterion to be used for recognizing and/or recording when an asset impairment exists.

BACKGROUND

"With so many managers stretching or obscuring the truth, getting to the bottom of the bottom line is more difficult than ever."[1] This dominant attitude refers mainly to the way assets are valued, depreciated, and written-down. One of the most common abuses cited is "big bath" accounting. "Big Bath" refers to taking a huge loss in one quarter to write-down long-lived assets that are no longer performing or producing the results as expected. As one commentator stated, "the big bath represents the corporate equivalent of two weeks at a fat farm. It rids the company of excess expenses and may eventually firm up profits."[2]

Accountants are being targeted as the source of the "big baths". The criticism is aimed at Generally Accepted Accounting Principles (GAAP) which many claim are too vague and do not give accountants or auditors sufficient guidance. Guidance is provided, however, in regard to defining assets and the allocation of depreciation to those assets. Long-lived assets are those which "... have a limited life, at the end of which they must be abandoned or replaced. This life may be an estimated number of years determined by wear and tear caused by the elements, or it may be variable, depending on the amount of use and maintenance."[3] Life span is estimated at the date of acquisition and used as the period over which the asset is depreciated. Depreciation is most commonly described as "... a systematic and rational method of allocating costs to periods in which benefits are received."[4] Although, there is some concern over the manipulation of income by changing depreciation methods, the biggest problem is what to do once depreciation does not accurately match benefits with expenses.

This matching problem arises when long-lived assets and/or identifiable intangibles become impaired. The American Heritage Dictionary defines impairment as diminishing in value. It is this definition which should be used in judging whether or not an asset is impaired. An impaired asset is one whose value has declined below its depreciated or amortized value. Typically, management is given the power to judge when, or if, an impairment exists.

The plethora of corporate restructurings that took place during the mid-80's created the perfect opportunity for management to judge assets as impaired. These write-downs and subsequent similar devaluations have caused investors to look to accountants for the reasons behind managements control over the bottom line. Accountants claim they're doing their best. They are evaluating and reviewing depreciation but it is "... difficult to pass judgement on how much value can be squeezed from the assets."[5] For this reason, auditors generally go along with management if their estimates are reasonable. The inability to pass judgement on management's evaluation has led to the request for detailed accounting standards on impairment.

Between 1986 and 1988 an unbelievable $10 billion in write-downs took place among Dow Jones firms.[6] With $10 billion flex in the financial statements, reliability is significantly impaired. If billions of dollars can simply disappear with the stroke of a pencil, data contained in the financial statements becomes suspicious and subject to disbelief. In addition, many of these write-downs took place in the fourth quarter. The fourth quarter was "the quarter when the bottom fell out of corporate profits."[7] These fourth quarter write offs took many shareholders by surprise.

Earnings for the first three quarters looked profitable and then the bomb hit in the fourth quarter. Thus, management has the ability to manipulate the quarterly financial statements and deceive shareholders.

ISSUES

The DM issued by the FASB is an attempt to create standards that will control the reporting of impairment. Consequently, the discussion memorandum addresses several issues involved in the valuation of assets whose worth has declined. The three main topics are measurement, recognition, and disclosure. Each of these is further broken down into sub-issues.

MEASUREMENT. Measurement is broken into three questions:

* How should asset impairment be measured?
    a. current cost
    b. current market value
    c. net realizable value
    d. present value of future cash flows
    e. sum of future cash flows
* How should assets be grouped to determine if impairment exists?
    a. business segment
    b. other business unit
    c. individual asset
    d. lowest level that constitutes a form of

business operation (that has identifiable cash flows)

* At what intervals should assets be evaluated to determine if an impairment is present?
  a. every reporting period
  b. when events or circumstances indicate
  c. annually[8]

RECOGNITION. Three questions also must be asked when recognition of an impairment is considered. These questions are the following:

* When should the impairment of an asset be recognized?
  a. economic criterion
  b. permanence criterion
  c. probability criterion
* How should a recognized impairment be shown on the company's income statement?
  a. separate line item in continuing operations
  b. separate line item outside continuing operations
  c. separate disclosure of the amount of the write-down in the notes to the financial statements

* If the asset increases in value after a prior write-down, should that subsequent increase be recognized?[9]

DISCLOSURE. The following disclosure issues should also be given consideration:

* What information should the footnotes contain regarding write-downs?
  a. no additional information
  b. descriptions of the impaired assets
  c. descriptions of the events and circumstances related the impairment
  d. descriptions of the measurement assumption
* How long should these disclosures be included in the financial statements?
  a. year of impairment only
  b. all years for which the year of impairment is presented
* Should any disclosure be required for impending impairments?
* If so, what information should such disclosures include?
  a. no disclosure
  b. the excess of the carrying amount over a measurement attribute
  c. description of the assets for which the

carrying amount exceeds the measurement attribute

d. description of the events and circumstances related to the assets for which the carrying amount exceeds the measurement attribute

e. description of the measurement assumptions

* If a future increase is recognized, to what extent should the increase be made?

a. impairment taken

b. fair value[10]

RECOGNITION

The most important issue talked about in the discussion memorandum is when should the impairment of an asset be recognized? No matter what measurement criteria is used, how the assets are grouped, or what disclosures are required, the primary question that must be resolved is how the impairment should be recognized. There must be a recognized standard for asset impairment that indicates when and to what extent an impairment should be quantified. Currently, there are three bases for recognition criteria which can be utilized.

Economic Criterion. The economic criteria requires the immediate recognition of a loss when the carrying value is greater than the measurement attribute. The measurement attribute could be any of those listed previously. At this point, no particular attribute is required. Net realizable value, however, is the one most prevalently used in practice.[11]

Permanence Criterion. The permanence criterion requires the write-down of an asset's value only when the impairment condition is judged to be permanent. If the impairment is not absolute, no recognition or disclosure is shown in the financial statements.

Probability Criterion. The probability criterion bases loss recognition on the principles of Statement 5. This criterion classifies the measurement of impairment into the following three categories:

1. It is probable that the carrying amount cannot be recovered fully.
2. It is reasonably possible that the carrying amount cannot be recovered fully.
3. It is remotely possible that the carrying amount cannot be recovered fully.

Impairment would be recognized in those situations where it is probable that the loss would not be recovered. Disclosure would be required in the reasonably possible case. No action would be necessary if impairment is remotely possible.

ARGUMENTS

The economic criterion is timely since losses are recognized immediately. This gives financial statement users the best information to make decisions. The immediate recognition, however, does not consider whether or not the impairment is temporary. Thus, the economic criterion could cause problems later if the impaired asset increases in value. At that point, the decision must be made as to whether or not the asset should be written back up. This could lead to great fluctuations in the financial statements and an enormous abuse of the historical cost principle. The economic criterion is very black and white and leaves no room for shades of gray.

Coopers & Lybrand oppose the economic criterion as an arbitrary approach. "Any consistency suggested by such a criterion is illusory because the need for judgement in both the measurement and recognition of impairment is simply unavoidable."[12] Price Waterhouse, on the other hand, endorses "... immediate recognition of a loss whenever the carrying amount of the asset exceed the net sum of the estimated undiscounted future cash flows of that asset (the 'economic criterion') appears appropriate."[13]

The permanence criterion eliminates the problem of the economic criterion recognizing temporary losses by waiting until the impairment is permanent. The permanence concept properly restricts write-downs of long-lived assets to those rare situations in which the inability to fully recover carrying amounts is clear. Thus, this criterion best preserves the historical cost method of accounting. The permanence criterion prohibits discretionary write-downs and helps to reduce "big-bath" accounting. From an international perspective, the permanence criterion is the one predominately used. (See Appendix A for a discussion of foreign accounting practices for asset impairment.) Adoption of the permanence criterion would, therefore, aid the increasing globalization of business.

The permanence criterion, however, is not without its critics. The definition of permanent causes the majority of problems for this method of recognition. What one person or company considers a permanent impairment, another company may not see as permanent. Some accountants believe only irreversible events, such as, a destruction of assets should be considered permanent. Others believe that permanence relates to the loss of use of an asset. Yet a third group believe permanent simply relates to those situation in which carrying value is deemed unrecoverable.[14] As a spokesman for one energy company state "let's face it, company officials take a write-down of assets when it's good for them."[15] Whatever definition of permanence best suits the companies needs at the time will, therefore, prevail.

This broad range of definitions leads to inconsistencies between companies and manipulations which hamper comparability of financial statements. By the time an asset is judged permanently impaired, the information may lose its capacity to influence. According to Coopers & Lybrand, "... the permanence criterion is too restrictive, ... it limits or delays recognition of impairments."[16] Permanent impairment requires such an extensive decision making period to assure the loss is not temporary that the information may no longer be pertinent to financial statement users by the time it is recorded.

The probability criterion helps solve the problem of timeliness. With its three stages of disclosure or recognition, the probability criterion helps warn of impending impairment. This criterion is a gradual, rather than immediate, move to recognition. It provides a continuum on which to place the shades of gray that are an inherent part of accounting. The probability criterion also helps reduce the temptation for management to affect income through write-downs. By requiring disclosure for reasonably possible impairments, it is harder for management to suddenly write-down a long-lived asset.

Despite its combining the best aspects of the other two criterion, the probability criterion has its opponents. The argument against the probability criterion is that it is harder to apply that the other criteria. Opponents contend that the probability criterion is too subjective because it first subjects the asset to a judgement as to whether or not impairment exists. Once impairment is deemed present, the measurement is further subjected to a judgement of probability. This causes an overabundance of perception to be included in the logic behind the probability criterion.

CONCLUSION

The probability criterion appears to be the best criteria to use in recognizing the impairment of long-lived assets and identifiable intangibles. "Such an approach would reduce the undesirable 'surprise' effect in quarterly reports which many shareholders have experienced recently and would lessen the ability of management to smooth ('manage') quarterly earnings by choosing what it perceives as a desirable time to release the bad news."[17] The probability criterion preserves the historical cost principle while providing financial statement users with timely information. The probability criterion alerts financial statement users of potential impairment as soon as the possibility exists. Premature recognition is also prevented through the use of disclosure. Disclosure allows time to lapse during which it can be seen whether or not the decline in value will be long-term. Thus, the probability criterion solves the problems of the other two criterion and is, therefore, the best choice for recognizing impaired assets.

This opinion is shared by five of the Big Six Accounting Firms (all except Price Waterhouse). Coopers & Lybrand advocate the use of the probability criterion but feel that additional guidance is needed in regard to the definition of probable.[18] Deloitte & Touche state the probability criterion should be used in recognizing impairment. "The probability criterion should be applied first to the measurement attribute to determine if an asset or group of assets may be impaired."[19] Arthur Andersen supports the probability criterion on the grounds it "... would promote consistency of application in practice and help discourage 'big bath accounting.' ... The information...allows the users to assess the certainty of future cash flows and provides an 'early warning' for impairment losses."[20]

The probability criterion is the most effective at eliminating the surprise "Big-Bath" fourth quarter write-offs. According to Business Week, more that $4.8 billion in write-offs took place in 1985.[21] To eliminate "surprise" write-offs of this magnitude, adopting the probability criterion would be the best alternative for timely recording the impairment of long-lived assets.

In 1985 the Financial Executives Institute (FEI) surveyed 24 companies on their policies for recognizing impaired assets. The survey found 60% of the write-down decisions were based on a probability test similar to that outlined in FASB Statement 5. Only 36% of the companies used the permanence criterion.[22] Thus, the probability method seems to be favored in practice.

The probability method was also the only one endorsed by the American Institute of Certified Public Accountants (AICPA) in their 1980 Issues Paper on asset impairment. The AICPA "concluded that the concept of permanent decline in values was too subjective and restrictive."[23] They unanimously agreed the permanence method was not appropriate.

APPENDIX A

The International Accounting Standards Committee (IASC) consists of accounting bodies from more than 70 countries. The IASC's purpose is to develop international accounting standards. These standards are not enforceable on any country but are suggested guidelines. The IASC suggests impairment should be recognized immediately when the carrying amount of assets falls below book value. The following are the rules governing long-lived asset impairment in nine major countries:

AUSTRALIA - The value of the long-lived asset is written-down when the impairment is judged permanent.

CANADA - Write-downs are charged to income when it is determined that the net undiscounted future cash flows are less than the carrying value and will remain there permanently.

FRANCE - When an asset becomes permanently impaired, it is written-off to depreciation.

GERMANY - A write-down of long-lived assets is required when a permanent impairment exists.

ITALY - No rules exist concerning the impairment of long-lived assets.

JAPAN -	Write-downs of long-lived assets are due to disasters or accidents. Technological obsolescence is recorded by changing depreciation rates.
MEXICO -	An impairment is recorded as soon as it is noticed. This is due to Mexico's inflationary economy.
NEW ZEALAND -	Any time the carrying amount of a long-lived asset is greater than the estimated recoverable amount, it is written down immediately.
UNITED KINGDOM -	Reductions to long-lived assets are made when the impairment is deemed permanent.

ENDNOTES

[1]Gary Hector, "Cute Tricks on the Bottom Line," Fortune 24 April 1989: 196.

[2]Hector 196.

[3]Eldon S. Hendriksen, Accounting Theory (Homewood, IL: Richard D. Irwin, 1977) 357.

[4]Hendriksen 389.

[5]Dana Wechsler, "Earnings Helper," Forbes 12 June 1989: 150.

[6]Penelope Wang, "You know it when you see it," Forbes 25 July 1988: 84.

[7]Robert Mims, "Write-Off Time: Why The Fourth Quarter Was So Bad," Business Week 17 March 1986: 116.

[8]FASB Discussion Memorandum No. 098-B, "Accounting For The Impairment of Long-Lived Assets and Identifiable Intangibles," 7 December 1990: 5-6.

[9]FASB 6.

[10]FASB 6.

[11]FASB 7.

[12]Coopers & Lybrand, Response to Discussion Memorandum No. 098-B, 26 April 1991: 5.

[13]Price Waterhouse, Response to Discussion Memorandum No. 098-B, 11 June 1991: 5.

[14]FASB 21.

[15]Lee Berton and Gay Sands Miller, "Accountants Debate Tightening Rules For 'Big-Bath' Write-Offs by Companies," The Wall Street Journal 11 Feb. 1986: 3.

[16]Coopers & Lybrand 5.

[17]Jonathan Schiff, "Surprise Losses in Quarterly Earning Reports," Management Accounting July 1985: 53.

[18]Coopers & Lybrand 5.

[19]Deloitte & Touche, Response to Discussion Memorandum No. 098-B, 10 June 1991: 7.

[20]Arthur Andersen & Co., Response to Discussion Memorandum No. 098-B, 31 May 1991: 6.

[21]Elizabeth Ehrlich, "Industry Cleans House," Business Week 11 Nov. 1985: 32.

[22]FASB 97.

[23]FASB 81.

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