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**ASSET IMPAIRMENT:
A Comparison of Recognition Criteria**

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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 November of 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 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 criteria 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. After consulting the above sources, a conclusion was reached as to the most appropriate criteria to be used for recognizing and/or recording the existence of an asset impairment.

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 expected results. 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 allocating depreciation of 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 restructuring 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 management's control over the bottom line. Accountants claim they are doing their best. They are evaluating and reviewing depreciation, but it is "... difficult to pass judgment 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 judgment

on management's evaluation has led to the request for detailed accounting standards on impairment.

Between 1986 and 1988 an astonishing \$10 billion in write-downs took place among Dow Jones firms.⁶ With \$10 billion flex in the financial statements, their 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 until a bomb hit during the fourth quarter. Thus, shareholders feel that management has the ability to manipulate quarterly earnings.

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 can be further segmented into sub-issues.

MEASUREMENT. Measurement is broken down 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:

* When should the impairment of an asset be recognized?

- a. economic criteria?
- b. permanence criteria?
- c. probability criteria?

* 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 to 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 timing of the recognition of the asset impairment seems to be the most important issue talked about in the discussion memorandum. 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 when the impairment should be recognized. A recognized standard must exist for asset impairment that indicates when and to what extent an impairment should be quantified. Currently,

three bases for recognition criteria can be utilized.

Economic Criteria. Economic criteria require 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 Criteria. Permanence criteria require 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 Criteria. Probability criteria base loss recognition on the principles of Statement 5. These criteria classify the measurement of impairment into 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, while no action would be necessary if the impairment is remotely possible.

ARGUMENTS

Economic criteria promote timeliness, since losses are recognized immediately. This recognition gives financial statement users the best information on which to make decisions. Immediate recognition, however, does not consider whether or not the impairment is temporary. Thus, using economic criteria 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 action could lead to great fluctuations in the financial statements and an enormous abuse of the historical cost principle. Economic criteria are very black and white and leave no room for shades of gray.

Coopers & Lybrand opposes economic criteria as an arbitrary approach. "Any consistency suggested by such criteria is illusory because the need for judgment 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 exceeds the net sum of the estimated undiscounted future cash flows of that asset, ('economic criteria') appear appropriate."¹³

Permanence criteria eliminate the problem with economic criteria 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, these criteria best preserve the historical cost method of accounting. Permanence criteria prohibit discretionary write-downs and help to reduce "big bath" accounting. From an international

perspective, permanence criteria are predominantly used. (See Appendix A for a discussion of foreign accounting practices for asset impairment.) Adoption of permanence criteria would, therefore, aid the increasing globalization of business.

Permanence criteria, however, have their 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 believes permanent simply relates to those situations in which carrying value is deemed unrecoverable.¹⁴ As a spokesman for one energy company states, "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 company's 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, "... permanence criteria is too restrictive, ... it limits delays of 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.

Probability criteria help solve the problem of timeliness. With three stages of

disclosure or recognition, probability criteria help warn of impending impairment. These criteria support a gradual, rather than immediate, move to recognition. They provide a continuum on which to place the shades of gray that are inherent within accounting. Probability criteria also help 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 combining the best aspects of the other two criteria, probability criteria have their opponents. The argument against probability criteria states that it is harder to apply than the other criteria. Opponents contend that probability criteria are too subjective because they first subject the asset to a judgment as to whether or not impairment exists. Once impairment is deemed present, the measurement is further subjected to a judgment of probability. This causes an overabundance of perception to be included in the logic behind probability criteria.

CONCLUSION

Probability criteria appear to be the best method 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 Probability criteria

preserve the historical cost principle while providing financial statement users with timely information. Probability criteria alert 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 determined whether or not the decline in value will be long-term. Thus, probability criteria solve the problems of the other two criteria 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 advocates the use of probability criteria but feels that additional guidance is needed in regard to the definition of probable.¹⁸ Deloitte & Touche states that probability criteria should be used in recognizing impairment. "Probability criteria should be applied first to the measurement attribute to determine if an asset or group of assets may be impaired."¹⁹ Arthur Anderson supports probability criteria on the grounds that 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

Probability criteria are the most effective at eliminating the surprise "big bath" fourth quarter write-offs. According to Business Week, more than \$4.8 billion in write-offs took place in 1985.²¹ To eliminate "surprise" write-offs of this magnitude, adopting probability criteria would be the best alternative for timely recording of 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 permanence criteria.²² Thus, the probability method seems to be favored in practice.

The probability method was also the only method 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 that the permanence method was not appropriate.

APPENDIX A
FOREIGN ACCOUNTING PRACTICES
ASSET IMPAIRMENT

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 serve as suggested guidelines. The IASC suggests impairment should be recognized immediately when the carrying amount of the asset falls below book value. The following rules govern 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 at that value 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.

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