TECH 32/03

NON-CURRENT ASSETS AND DISCONTINUED OPERATIONS

Memorandum of comment submitted to the International Accounting Standards Board in October 2003 concerning Exposure Draft 4, 'Disposal of Non-current Assets and Presentation of Discontinued Operations', published by the Board for comment in July 2003

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the International Accounting Standards Board (the Board) regarding the proposals in Exposure Draft 4, '*Disposal of Non-current Assets and Presentation of Discontinued Operations*', published by the Board for comment in July 2003.

2. We have reviewed the exposure draft and set out below a number of comments and suggestions. In particular, we explain why the proposals should not be implemented in the near term: they impose additional burdens on companies migrating to International Financial Reporting Standards (IFRS) in 2005, yet overall would not improve the quality of financial reporting. We deal first with this and other major points before answering the questions specifically raised by the Board.

MAJOR POINTS

US Convergence: Timing Issues

3. In principle, we support the taking of early, small steps by the Board in the direction of convergence, but consider that this process is a low priority compared with the pressing need to ensure that a suitable set of IFRS is available in good time for adoption in 2005. Recent controversies in Europe and delays cast doubt on the advisability of diverting any significant IASB resources to the US convergence project, which is highly desirable in principle but inevitably longer-term in nature.

4. The proposals in ED 4 represent a significant change to current IAS, but not a significant improvement from the existing standard IAS 35. EU listed companies - already facing major challenges in migrating to IFRS - should not be obliged to implement these further changes in 2005 solely in the interests of advancing convergence with US GAAP.

Convergence: the IASB Approach

5. The issue of ED 4 provides the first opportunity for respondents to comment on the convergence programme. We support the 'Norwalk Agreement' between the Board and the US Financial Accounting Standards Board (FASB) and the principle of early convergence between IFRS and US GAAP. However, convergence should lead only to the highest quality accounting solutions. This necessitates the careful selection of the best elements of IAS, US and other national GAAPs. It is not apparent that, in developing ED 4, the Board has considered the merits of relevant GAAP other than SFAS 144, '*Accounting for the Impairment or Disposal of Long-Lived Assets*'.

6. In paragraph BC4, the Board explains that where a topic has recently been considered by the Board or by FASB, there is an expectation that the board that has more recently deliberated it 'will have the higher quality solution'. This

expectation is not consistent with recent statements by FASB on the merit of moving towards more principles-based standards, reinforced by the publication by the SEC in July 2003 of a study that calls on FASB to adopt a principles-based approach to developing future standards and to address existing standards that are more rules-based. SFAS 144 reflects an unmodified rules-based approach to standard-setting. It is therefore inappropriate for the Board to use this standard as a model for convergence.

7. SFAS 144 is a recent standard, and its effectiveness is therefore still largely untested. In contrast, IAS 35, '*Discontinuing Operations*', appears to have generally worked well. The lack of a comparative analysis in the exposure draft of the merits of the two standards - and others around the world - is a major omission that hinders assessment of the proposals. On the basis of the evidence available, we are not convinced that ED 4 would improve the quality, and in particular the reliability and consistency, of financial reporting under IFRS. The Board should work with FASB and other standard setters to identify a more appropriate global solution.

A Robust, Principles-Based Approach

8. An approach to standard-setting that as far as possible avoids introducing different definitions, trigger points and measurement rules reduces complexity, minimises the likelihood of inconsistency between standards and between preparers, and is more compatible with a principles-based approach to standard-setting. In a number of respects ED 4 does not embody such an approach. For example:

- designation as "held for disposal" is by reference to criteria different from those used in IAS 37, which describes commitment to a course of action in terms of obligation. The designation of ED 4 is based on management intent which risks abuse through selective application. For example, management may designate a loss-making unit as a disposal group, but not a profitable unit;

- taken together with current thinking regarding the reporting of comprehensive income, the classification of discontinued activities effectively reintroduces a concept of "after-tax net reporting" at the same time as extraordinary items are being removed from IAS 1; and

- the one-sided valuation basis (lower of carrying value and fair value less disposal costs) introduces a measurement basis that is not consistent with financial assets held-for-sale under IAS 39 (fair value), investment properties held for sale under IAS 40 (fair value), or impaired assets under IAS 36 (recoverable amount).

9. We discuss these issues further below in paragraphs 11-12, and again in the context of proposals relating to measurement (paragraph 14) and to the concept of a 'disposal group' (paragraphs 17-18).

ANSWERS TO IASB QUESTIONS

Question 1 - Classification of Non-current Assets Held for Sale

The Exposure Draft proposes that non-current assets should be classified as assets held for sale if specified criteria are met. (See paragraphs 4 and 5 and Appendix B.) Assets so classified may be required to be measured differently (see question 2) and presented separately (see question 7) from other non-current assets.

Does the separate classification of non-current assets held for sale enable additional information to be provided to users? Do you agree with the classification being made? If not, why not?

10. Designation of non-current assets as held-for-sale provides additional information regarding directors' late-stage intentions. This should assist users seeking to assess the timing and amount of future cash flows. In principle, we therefore support additional disclosure through separate classification.

11. Appendix B, paragraph B1(a), requires management to 'commit itself to a plan to sell', but does not go on to define 'commitment'. As discussed above, this requirement is not sufficiently robust, notwithstanding the inclusion in sub-paragraphs (b) to (f) of additional criteria for designation. The proposals introduce an unacceptable degree of management intent into the accounting, which is likely to result in situations where the designation is selectively applied (for example, loss making units are designated as disposal groups, but not profitable units), and may be reversed the following year, for example following a change of management. The need to include additional criteria in sub-paragraphs (b) to (f) also results in an excessively rules-based and prescriptive approach. This is unlikely to prove effective.

12. A more appropriate solution to the definition of commitment to a disposal would be reference in the new standard to the existing, well-understood and more demanding provisions of IAS 37, '*Provisions, Contingent Liabilities and Contingent Assets*', particularly paragraphs 72-74 on constructive obligations relating to restructuring. We understand that these paragraphs of IAS 37 are also being reviewed as part of the convergence process, and that any change is likely to tighten the classification further. As discussed above, an approach to standard-setting that as far as possible avoids introducing different definitions, measurement rules and trigger points reduces complexity, minimises the likelihood of inconsistency between standards and is more compatible with a principles-based approach.

13. Our concern over the scope for management discretion in ED 4 is increased by the proposal that non-current assets to be exchanged for other non-current assets should also be classified as held-for-sale. Companies might be able to designate as held-for-sale substantial loss-making groups of assets by arranging mutually-beneficial swaps with third parties.

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Question 2 - Measurement of Non-current Assets Classified as Held for Sale

The Exposure Draft proposes that non-current assets classified as held for sale should be measured at the lower of carrying amount and fair value less costs to sell. It also proposes that non-current assets classified as held for sale should not be depreciated. (See paragraphs 8-16.)

Is this measurement basis appropriate for non-current assets classified as held for sale? If not, why not?

14. A new measurement basis is proposed for non-current assets that are designated as held-for-sale: the lower of carrying amount and fair value less costs to sell, with no subsequent depreciation charge. We do not accept that this new approach is superior to the existing basis, impaired cost. On the contrary, the proposal runs counter to our preferred approach to standard-setting, explained above: the unnecessary introduction of a new measurement basis risks complexity, increases the likelihood of inconsistency between standards and is not compatible with a principles-based approach. There is no compelling case for changing the way in which assets subject to ED 4 are measured.

15. If a move towards market-based measurement were made in a standard based on ED 4, it would be more logical for all assets affected to be held at fair value less costs to sell, which might be higher or lower than carrying amount. This treatment would be more consistent with accounting prescribed for example in IAS 39, '*Financial Instruments: Recognition and Measurement*' and IAS 40, '*Investment Property*'. It would also provide more relevant information regarding assets held-for-sale. Our support for this option would be conditional on a reduction in the scope for management discretion (see paragraph 11 above) and the availability of reliable fair values in each specific case.

16. We acknowledge that the proposed cessation of depreciation of held-for-sale non-current assets would be consistent with the proposal that residual value should be reassessed at each balance sheet date (a proposal that we did not support), set out in paragraph 46 of the draft revised version of IAS 16, '*Property, Plant and Equipment*'. However, we believe that is conceptually wrong simply to cease depreciation when an asset or disposal group is still in active use in the business, even if the impact of revised IAS 16 is to curtail significantly the depreciation charges. This would be inconsistent with the treatment of all other related costs and income - which would still be reflected in the income statement - and could be open to management abuse.

Question 3 - Disposal Groups

The Exposure Draft proposes that assets and liabilities that are to be disposed of together in a single transaction should be treated as a disposal group. The measurement basis proposed for non-current assets classified as held for sale would be applied to the group as a whole and any resulting impairment loss would reduce the carrying amount of the non-current assets in the disposal group. (See paragraph 3.)

Is this appropriate? If not, why not?

17. Paragraph 3 of ED 4 explains that a 'disposal group' may be a group of cash-generating units, a single cash-generating unit or part of a cash-generating unit. We do not support the introduction without good reason of a new way of grouping assets or net assets - the disposal group - to sit alongside existing groupings such as 'subsidiary', 'portfolio' and 'cash-generating unit'. This again runs counter to our preferred approach to standard-setting, as articulated above. We suggest use in this context of the existing concept of a cash-generating unit, as defined in IAS 36, '*Impairment of Assets*'.

18. Paragraph 14 of the exposure draft requires certain non-current assets (including goodwill) forming part of a disposal group to be measured in accordance with other applicable IASs, with any impairment loss on the value of the disposal group allocated only against the carrying amount of those non-current assets that are within the scope of the standard. The proposals and explanation in paragraphs BC 27-29 are unclear, differ from IAS 36 (which would not apply to assets subject to ED 4 by virtue of paragraphs C8-C9) and may produce misleading results. Impairment should be addressed in any new standard based on ED 4 solely by reference to the existing requirements of IAS 36.

Question 4 – Newly Acquired Assets

The Exposure Draft proposes that newly acquired assets that meet the criteria to be classified as held for sale should be measured at fair value less costs to sell on initial recognition (see paragraph 9). It therefore proposes a consequential amendment to [draft] IFRS X Business Combinations (see paragraph C13 of Appendix C) so that non-current assets acquired as part of a business combination that meet the criteria to be classified as held for sale would be measured at fair value less costs to sell on initial recognition, rather than at fair value as currently required.

Is measurement at fair value less costs to sell on initial recognition appropriate? If not, why not?

19. If the Board includes measurement requirements in a standard based on ED 4, we accept that for consistency all assets (and disposal groups) classified as held-for-sale should be measured at fair value less costs to sell. For newly-acquired assets (and disposals groups), this measurement approach would be applied on initial recognition. However, we have concerns regarding the recognition of management intent implicit in this accounting treatment, and as explained above, we do not consider it necessary to provide new measurement rules for this category of assets.

Question 5- Revalued Assets

The Exposure Draft proposes that, for revalued assets, impairment losses arising from the write-down of assets (or disposal groups) to fair value less costs to sell (and subsequent gains) should be treated as revaluation decreases (and revaluation increases) in accordance with the standard under which the assets were revalued, except to the extent that the losses (or gains) arise from the recognition of costs to sell.

Costs to sell and any subsequent changes in costs to sell are proposed to be recognised in the income statement. (See paragraphs B6-B8 of Appendix B.)

Is this appropriate? If not, why not?

20. If the Board include measurement requirements in an IFRS based on ED 4, we would accept on pragmatic grounds the proposed treatment of impairment losses for revalued assets. However, the proposed treatment of previously revalued assets is unnecessarily complex and the approach to revaluation increases in paragraph B8 appears inconsistent with the measurement principle set out in paragraph 8 of the exposure draft. As explained above, we do not consider it necessary to provide any measurement rules for these assets.

Question 6 - Removal of the Exemption from Consolidation for Subsidiaries Acquired and Held Exclusively with a View to Resale

The Exposure Draft proposes a consequential amendment to draft IAS 27 Consolidated and Separate Financial Statements to remove the exemption from consolidation for subsidiaries acquired and held exclusively with a view to resale. (See paragraph C3 of Appendix C and paragraphs BC39 and BC40 of the Basis for Conclusions.)

Is the removal of this exemption appropriate? If not, why not?

21. If the Board publishes a standard based on ED 4, the removal of the exemption from consolidation for subsidiaries acquired would be an appropriate consequential amendment. The assets and disposal groups held-for-sale within such subsidiaries should be treated consistently with other assets and disposal groups.

Question 7 - Presentation of Non-current Assets Held-for-sale

The Exposure Draft proposes that non-current assets classified as held for sale, and assets and liabilities in a disposal group classified as held for sale, should be presented separately in the balance sheet. The assets and liabilities of a disposal group classified as held for sale should not be offset and presented as a single amount. (See paragraph 28.)

Is this presentation appropriate? If not, why not?

22. We consider the proposed separate presentation of non-current assets held-for-sale to be appropriate, and agree that assets and liabilities should not be offset in the balance sheet.

Question 8 - Classification as a Discontinued Operation

The Exposure Draft proposes that a discontinued operation should be a component of an entity that either has been disposed of, or is classified as held for sale, and:

(a) the operations and cash flows of that component have been, or will be, eliminated from the ongoing operations of the entity as a result of its disposal, and

(b) the entity will have no significant continuing involvement in that component after its disposal.

A component of an entity may be a cash-generating unit or any group of cash-generating units. (See paragraphs 22 and 23.)

These criteria could lead to relatively small units being classified as discontinued (subject to their materiality). Some entities may also regularly sell (and buy) operations that would be classified as discontinued operations, resulting in discontinued operations being presented every year. This, in turn, will lead to the comparatives being restated every year. Do you agree that this is appropriate? Would you prefer an amendment to the criteria, for example adding a requirement adapted from IAS 35 Discontinuing Operations that a discontinued operation shall be a separate major line of business or geographical area of operations, even though this would not converge with SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets. How important is convergence in your preference?

Are the other aspects of these criteria for classification as a discontinued operation (for example, the elimination of the operations and cash flows) appropriate? If not, what criteria would you suggest, and why?

23. We agree that frequent restatement of comparatives is likely under the ED 4 proposals. This will be costly to companies and confusing to users, and risks undermining efforts to restore the credibility of financial reporting and enhance management accountability. We strongly prefer the IAS 35 requirement that a discontinued operation should be a separate major line of business or geographical area of operations. This approach should be retained, even if this does not lead to convergence with SFAS 144 on this issue.

24. We also prefer the concept of 'discontinuing' as used in IAS 35 to that of 'discontinued' as proposed in ED 4. The early reporting of discontinued operations provides more useful information to users of financial statements.

Question 9 - Presentation of a Discontinued Operation

The Exposure Draft proposes that the revenue, expenses, pre-tax profit or loss of discontinued operations and any related tax expense should be presented separately on the face of the income statement. (See paragraph 24.) An alternative approach would be to present a single amount, profit after tax, for discontinued operations on the face of the income statement with a breakdown into the above components given in the notes.

Which approach do you prefer, and why?

25. We agree that revenue, expenses, pre-tax profit or loss relating to discontinued operations and any related tax expense should be presented separately on the face of the income statement. Disclosure only in the notes does not accord sufficient prominence to information about discontinued operations.

26. The outcome of the Board's project on reporting comprehensive income is highly relevant to a proper evaluation of the proposals in ED 4. We recognise that the outcome is still highly uncertain. However, the limited discussion in the exposure draft of the potential implications of the project is unhelpful. Our assessment would be affected by a requirement for discontinued operations to be disclosed as a one-line after-tax figure at the foot of a new statement of comprehensive income, which would provide less transparent information about the performance of the reporting entity and its management during the accounting period.

27. The Board should consider the merit of deferring implementation of any new standard based on the proposals in ED 4 until the shape of the proposals on reporting comprehensive income is clearer.

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