Smith & Williamson response – Disposal of non-current assets and presentation of discontinued operations (FRED 32)

The following sets out our responses to the questions raised by the ASB

We are generally supportive of the convergence of UK and international standards and the IASB's project to remove differences between US accounting and international standards. We are concerned that there are a number of projects on the IASB agenda dealing with major accounting issues, for example share based payments, pensions and revenue recognition and it may therefore be more appropriate for the IASB to concentrate on these rather than standards which are more presentational in nature.

ASB 1 *Do you agree with the proposal to issue a new UK standard on disposal of non-current assets and discontinued operations when the IASB issues its IFRS?*

If the IASB do issue a new standard, then subject to our significant reservations with respect to certain aspects of the detailed accounting we would be in agreement with issuing a standard with respect to the disposal of non-current assets.

We do not, however, consider it would be appropriate to issue any revision to the existing definition of discontinued operations contained within FRS 3 for the following reasons:

- The definition within FRS 3 with its emphasis on material operations ensures that entities report what is generally considered to be a fair review of the performance of the entity. Removing the requirement to consider only material elements could result in companies being able to determine relatively small (and frequently loss making) aspects of the business as discontinued. In addition, removal of the materiality distinction could result in certain types of business presenting discontinued activities annually. This would, in our opinion, significantly dilute the ability to discern the underlying performance of the entity.
- The project on reporting comprehensive income will, we understand, also deal with the accounting for discontinued operations. The ASB have indicated that it is their objective to ease the convergence process as much as possible. To introduce one standard which might be replaced by another in a relatively short period of time would not be consistent with this aim. As any standard on reporting financial performance is likely to be very far reachning, it would be more appropriate to include the presentation of discontinued operations within the discussion coming out of that standard.

The following sets out our responses to the questions raised by the IASB

IASB 1

The Exposure Draft proposes that non-current assets should be classified as assets held for sale if specified criteria are met. Assets so classified may be required to be measured differently and presented separately 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?

In certain circumstances, we consider that the separate classification of assets held for sale would provide the users with additional information. However, the definition draws no distinction between those assets held for sale for which replacement assets will be purchased and those where there will be no replacement. We consider that this is an important distinction.

The principle purpose of the proposed standard is to allow users of the accounts to assess the extent to which the assets and liabilities in the balance sheet will be held for the long term to generate future income for the entity. The identification of, for example, a fixed asset as held for sale when it will be replaced by a new asset does not provide clarity to the reader.

We would suggest that the IASB consider amending the definition to exclude assets where a replacement will be acquired. It would, however, be appropriate to set a time limit within which the asset will be purchased. Twelve months would be consistent with the remainder of the definition.

IASB 2

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.

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

We consider that this measurement basis is inconsistent with other accounting standards.

IAS 36 'Impairment' uses a measurement basis which compares carrying amount with the higher of value in use and net realisable value, whereas this comparison is based on the lower of those two measures. Effectively the non-current asset is being accounted for as if it is a current asset. Whilst we agree that there is a difference to an asset which is merely impaired, the other consequence of this treatment is the earlier recognition of any possible loss on sale – albeit this has yet to be realised.

The above accounting treatment could, therefore, result in anomolies between those companies who have identifiable assets held for sale and those who have sold an asset at a loss without meeting the criteria.

We also consider that the accounting requirements could be detrimental to the entities ability to negotiate the best price for an asset held for sale. In many circumstances accounting principles will result in the value of the asset being recorded at the 'most likely price' which may be below the position that management would like to begin any negotiations.

The non-provision of depreciation is contrary to generally accepted accounting principles. Whilst the calculation of the fair value less costs to sell should result in the same effect in total, it does not take account of the matching of revenue and costs. Where a major asset is held for sale, but continues to generate revenue within two accounting periods, in the absence of charging depreciation, the reported results for both periods will be subject to distortion.

The more appropriate accounting basis would be to record the asset held for sale at its value in use and continue to provide depreciation through to the date of sale.

IASB 3 *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 value of the non-current assets in the disposal group.*

Is this appropriate? If not, why not?

We are in agreement that it is appropriate to classify assets and liabilities which will be disposed of together as a disposal group.

We do, however, have the same reservations over the method of valuation as referred to in the answer to question 2.

IASB 4 *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. It therefore proposes a consequential amendment to [draft] IFRS X* Business combinations *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 fair value as currently required.*

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

We consider that this is an appropriate basis to deal with such assets.

IASB 5 *The Exposure Draft proposes that, for revalued assets, impairment losses arising from the writedown 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.*

Is this appropriate? If not, why not?

We are in agreement with this proposal which is consistent with other accounting standards.

IASB 6 *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.*

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

We do not agree with this proposal. In our view such subsidiaries are, by their very nature, not held to provide long term benefits to the group as a whole and are usually acquired as a consequence of a far larger acquisition. We therefore consider that to include such subsidiaries within consolidated accounts would be inconsistent with the position that should be given by group accounts.

IASB 7 *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.*

Is this presentation appropriate? If not, why not?

We are in agreement with the proposals with respect to the disclosure as separate items with no offset of assets and liabilities, which is consistent with generally accepted accounting principles.

IASB 8 *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.

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 reported 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 to be made, 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 impairment or disposal of long-lived assets'. How important is convergence in your preference?

We consider that it would be appropriate to amend the criteria to one where a discontinued operation is a separate line of business or geographical region. We think that this is essential if financial statements are to present meaningful information about the financial performance of an entity.

Whilst fully supportive of the aims of the IASB with respect to convergence, we do not consider that this should be at the expense of finding the best position for individual sets of circumstances.

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?

We consider that other aspects of the proposed standard are acceptable and consistent with existing accounting practice.

IASB 9 *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. 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?

We favour the analysis of a discontinued operation across the relevant profit and loss headings. This approach provides for greater transparency when considering the impact of discontinued operations on the performance of the business and allows proper computation of financial ratios.