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Final Examination on:

**Comparison between IFRS and French GAAP on the Impairment of Asset**

Course: FEAD11 - International Financial Accounting
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Introduction

The purpose of this paper is to compare IFRS and French GAAP on impairment and depreciation of asset. “Impairment is an unexpected decline in the service utility of a capital asset.” (Investor Words). Importance given to impairment demonstrates if an accounting system is willing to report real value of an asset. Regulation gap between IFRS and other GAAP induce a great difference in company valuation. These divergences become obvious when a company is listed in several marketplaces. In that respect, foreign investors should be very cautious to the impairment system of the country they invest.

For International standards, rules concerning impairment are set out by IAS 36 “Impairment of Assets”. Since 2002 and through CRC 2002-10 regulations, French bookkeeping related to impairment is getting closer to IFRS requirements. It reveals a global harmonisation tendency between Europeans GAAP and IFRS. In this document, I will present the most important stages of the impairment process as describe in IAS 36 and for each stage I will highlight the divergences with the French GAAP. Thus I will take the IFRS regulation as the basis of my thesis.

First I will talk about indication that an asset may be impaired. Then I will present the measurement of recoverable amount thanks to the fair value less cost to sell and the value in use. Finally I will converse on the recognition and measurement of an impairment loss for both individual asset and cash generating unit.

I) Identifying an asset that may be impaired

The first step of an impairment process is the recognition of assets that might go through a decrease of value. For financial and time reason, an entity can perfume impairment test on its entire assets. Entity need to select by a fast and cheap manner, which asset may be impaired. An asset may be impaired when its carrying amount exceeds its recoverable amounts. The carrying amount “is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses thereon” (IAS 36). The notion of recoverable amount will be defined in the second part of this paper.

All assets may be impaired; tangible and intangible asset, asset with definite or indefinite useful life. Under IFRS, entity shall assess if an asset needs to be impairment at each balance sheet date.

IAS 36 set out a non exhaustive list of indicators that an asset may be impaired. If one of this indication conditions is fulfilled, the entity is required to measure the recoverable amount and to perform an impairment test. Two types of indicators should be taken into consideration; external and internal indicators.

- External sources of information
  - Significant and unexpected decrease of the market value of an asset.
  - Changes in environment in which the entity operates (technological, market, economic and legal changes) that induce negatives effect on entity performance.
- Increase of interest rate that affects the calculation of an asset’s value in use through a discount rate variation.
- The market capitalisation of an asset is slighter than its carrying amount.

- Internal sources of information
  - Sudden obsolescence or physical damage of an asset.
  - Negative changes in asset’s use caused by unemployment or the reduction of the useful life of an asset.
  - Unexpected fall in asset’s economic performance. Asset net cash flow is significantly worse than expected.

This list devised by IASB is just a tool and a support form firm. Entities may identify other relevant indicators of impairment and proceed to an impairment test thereon. IAS 36 set out an exception concerning the intangible asset with indefinite useful life. For this type of asset, an impairment test has to be performed at least annually whether there is any indication of impairment.

The French regulation undertaken in 2002 (CRC: Règlement 2002-07) is largely inspired by IAS 36. At the end of each reporting period, the entity should check any asset’s indication of impairment. The entity is required to use at least external and internal indications listed in the same regulation. However the French indicators are far less detailed than the IAS ones. On this particular point, the French GAAP is not as relevant and precise as the IFRS.

Due to the lack of information on these external and internal indications, French entities can’t proceed to an indicator’s examination. The French translation of IAS 36 isn’t pragmatic enough.

After this stage, if there is an evidence of an asset’s impairment, the entity shall perform an impairment test.

**II) Impairment test**

Carrying out an impairment test is to compare the carrying value of an asset to its recoverable amount. Thus, the main task is to calculate the asset’s recoverable amount.

IAS 36 defines the recoverable amount as “the higher of an asset’s or cash generating unit’s fair value less cost to sell and its value in use”. The French “Current Value” correspond to the recoverable amount, with the same calculating method. In order to estimate the recoverable amount, entity should compute two different values.

In IFRS regulation the recoverable amount is determined for an individual that are independent from other asset, by generating its own cash inflow. If it’s not the case the recoverable amount is determined for the cash-generating unit to which the asset belongs.

A) Fair value less cost to sell
This concept “is the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable willing parties, less the cost of disposal.” The common proof of such a value is the asset’s market price, usually the current bid or “the price of the most recent transaction” carried out within the same economic circumstances. IAS 36 set out conditions of an appropriate market also called “active market”. This notion refers to a purely competition market with many buyers and sellers, a total transparency and homogenous goods. Thus the market price of an active market is supposed to be relevant and reliable enough to determine the value in use of an asset.

Without active market, entity shall take into account the price of recent transactions for similar asset between knowledgeable parties, within the same economic sector and with comparable economic conditions. Besides when IAS refer to the “market’s expectation of the future cash flows”, it imply the use of the discounted future cash flow method in Fair value calculation. This method will be explained in the next part.

Nevertheless, if the asset is object to a binding sale agreement signed in a context of “an arm’s length transaction”, the price of this transaction shall be considered as the best evidence of the asset’s fair value. The removal of an asset generates cost has to be deduced from the transaction price. Here IAS 36 refers to direct incremental cost and transactions taxes.

Hence there is a hierarchy of methods to determine asset’s fair value.

1) Price set out in a binding sale agreement.
2) In the absence of binding sale agreement, market price less cost to sell of disposal.
3) In the absence of both binding agreement and an active market, use “the best information available to reflect the amount that an entity could obtain.”

If there is no basis for a reliable estimate of the fair value of an asset, impairment test has to be performed in comparison with the only value in use.

The concept of fair value less cost to sell exists in French GAAP, but its role much more important. Indeed French system introduces a hierarchy among valuation methods while IFRS place fair value and value in use on the same plane. In order to determine asset’s recoverable amount, entity shall calculate the value in use if and only if fair value can’t be determined. Hence, most of time French company simply computes asset’s fair value and give up the value in use.

The second step of the recoverable amount’s measurement is the calculation of the value in use. However, if the fair value less cost to sell exceeds the carrying value, asset may not be impaired. In this case, it’s not necessary to determine the value in use.

B) Value in Use

**Principle**

The value in Use “is the present value of the future cash flows expected to be derived from an asset”. According to IAS 36 the calculation of an asset’s value in use shall reflected:

- An estimate of the future cash flows the entity expects to derive from the asset.
- Expectations about possible variations in the amount or timing of those future cash flows.
• The time value of money, represented by the current market risk-free of interest
• The price for bearing the uncertainty inherent in the asset
• Others factors, such as illiquidity, that market participants would reflect in pricing the
current cash flows the entity expect to derive from the asset

Unlike the French GAAP, IFRS regulations provide basis for estimate future cash flow. Future cash flows determination process is divided in three stages:

1) Entity shall establish its asset’s cash flows projection on reliable economic assumption for the asset’s useful life. The assumption used to establish the forecast data are consistent and constitute an acceptable basis for the determination of such data.

2) Entity shall also base asset’s cash flow projections on management’s most recent financial forecasts. These forecasts shall be restricted to a short period of maximum 5 years. However an entity shall extrapolate the most recent budget’s growth rates to the following periods in a careful way. This growth rate can not be higher than economic and market growth of the sector during the previous periods.

3) Entity shall forecast future cash flow within the asset’s current state, future improvement shouldn’t take into account in the future cash inflows.

The last two steps illustrate the principles of prudence in IFRS, where under-estimation are always prefer to over-estimation. Explanation and reason of entity’s choice in asset calculation method shall be disclosed in annexe of financial statement.

Contrasting with IFRS, French GAAP take into consideration cash outflow related to income taxes. Moreover, both accounting are in contrast when it comes to financial activities treatment. According to French accounting future cash flow include outflow from financing activities, while IFRS exclude these outflows. IFRS vision isn’t argued enough. For instance, when an entity purchase an asset with a loan the future repayment will affect the future cash flows. In this respect, IFRS determine cash flow projection with a market-based view, whereas French GAAP assumes a entity-based view by integrating all cost related to the asset.

**Calculation**

So as to calculate Value is Use, IFRS resort a classical technique; the discounted future cash flow given by the following formula:

\[
\sum_{t=0}^{N} \frac{F_t}{(1 + a)^t} + \frac{F'}{(1 + a)^t}
\]

Where Ft: Future cash inflow less cash outflows generating by asset’s use.
F’: Net cash inflows for the disposal at the end of asset’s useful life
a : Discount rate
t : reporting period over asset’s useful life

Then entity applies an appropriate discount rate to those future cash flows. The formula of this discount rate is:

\[\text{Inflation rate} \times \text{risk on non adjusted estimate}\]
This rate correspond to the return expect by investors in a current market transaction. The risk rate corresponds to “the price for bearing the uncertainty inherent in the asset”. By regulating future cash flow estimations, IAS 36 tries to avoid manager’s discretionary choices. Despite all these basis there is still a part of uncertainty in each cash flow projection.

The French value in use computes futures cash flow expected to derive from the use of an asset. If expected cash flows aren’t relevant enough for describing an entity, other indicators shall be selected.

It is important to point out that the French GAAP doesn’t take into consideration discount rate for calculating future cash flows. Computing value in use is simpler following the French manner:

\[
\text{Future cash inflows} - \text{future cash outflows for generating cash inflows} + \text{Net cash inflows for the disposal at the end of asset’s useful life}
\]

With this method Value in Use is higher than the IFRS’s Value in Use. French GAAP is less accurate because future cash inflows are account with their nominal value. Such factors as inflation or investment risk are forgotten. As a result, impairment test are often negative. Without discounted cash flow projections, Value in use is often higher than the carrying amount. French regulation isn’t willing to accept discounted cash flow method for fiscal reason. Indeed impairment loss can be deducted from income taxes. Impairments are more frequent in IFRS, but above all they are reflecting more precisely the loss of value of an asset.

When an entity calculates the Value in Use, it has to find at which level cash flow is generated. If the asset doesn’t generate independent cash inflow, entity should identify the cash generating unit to which the asset belongs.

C) Cash Generating Unit

According to IAS 36, a Cash Generating Unit “is the smallest identifiable group of asset that generates cash inflows that are largely independent of the cash inflows from other asset.” When it is not possible to estimate the recoverable amount of an individual asset, an entity shall determine the recoverable amount of asset’s Cash Generating Unit.

IAS 36 set out a principle ; a group of assets shall be identity as a CGU if their output can be sell to an active market. “This is because the group of assets could generate cash inflows that would be largely independent of the cash inflows from other groups of assets.”

Entity should asses CGU’s independence considering two factors:

- Management monitoring of entity’s group of assets. Are headings managing the CGU as an independent profit centre?
- Management policy about continuation and disposal of entity’s assets.

However identifying CGU involves a subjective and judgmental process that required a good knowledge of the organization of the company. It can induce abusing compensation between impairment gain and loss of different component of the CGU. In order to prevent misuse of CGU, IAS 36 put the emphasis on consistent identification from period to period.
This concept of CGU is not defined by the French GAPP. The fact that Value in Use is rarely determined by French entities explains why CGU is not taken into consideration. Thus, French entities aren’t able to calculate recoverable amount of some specific assets, when these assets don’t generate independent cash inflows. This is a case of internally generated asset with an internal use, such as a patented technology which is used only within the entity’s production process. IAS 36 offers an example of a private railway owned by a mining firm. “It is impossible to estimate the recoverable amount [...] because its value in use cannot be determined and is probably different from scrap value.” In these cases, entities use to define an overall UGT (frequently the enterprise itself) for which it’s possible to determine its fair value.

III) Measuring an impairment loss

IAS 36 implements different treatments of impairment loss for individual asset and Cash Generating Unit.

A) Individual asset

An impairment loss shall be recorded if carrying value is higher than asset’s recoverable amount. The asset’s book value shall be reduced to its recoverable amount. Impairment loss has to be simultaneously recognised as a loss on the entity’s income statement.

When it comes to a revalued asset, impairment loss shouldn’t be disclosed as a loss. Reduction of carrying value shall be accounted as a revaluation decrease. A loss can be recognised if and only if the reduction is higher than the revalued amount. In this case, the difference between reduction and revaluation impacts the income statement.

Finally, entities shall report impairment loss on their amortisation plan. “The depreciation charge for the asset shall be adjusted in future period to allocate the asset’s revised carrying amount.”

For instance: An entity acquires a car for 1000 SEK, with a useful life of 5 years. At the end of the first period, the recoverable amount of this asset is evaluated at 600 SEK, an impairment loss of 200 SEK is recognized.

<table>
<thead>
<tr>
<th>Before Impairment Recognition (Year N):</th>
<th>After Impairment Recognition (Year N+1):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortisation charge:</td>
<td>Carrying amount:</td>
</tr>
<tr>
<td></td>
<td>=Acquisition cost – Amortisation - Impairment</td>
</tr>
<tr>
<td></td>
<td>=1000 – 200 – 200 = <strong>600 SEK</strong></td>
</tr>
<tr>
<td>Entity will perform an amortisation of 200 during 5 years.</td>
<td>Amortisation charge:</td>
</tr>
<tr>
<td></td>
<td>=600 / 4 = <strong>150 SEK</strong></td>
</tr>
<tr>
<td></td>
<td>For the remaining 4 years, impairment loss reduces amortisation charge of 50 SEK.</td>
</tr>
</tbody>
</table>

In French GAAP, an impairment loss reduces asset’s book value and is also recognized in profit or loss. Nevertheless, revaluation is strictly forbidden. Indeed, according
to the principles of prudence French accounting doesn’t take into account unrealized gains. Unlike IFRS, in French GAAP the principle of prudence is more important than the principle of relevancy. Hence impairment loss leads to a decrease of income without exception.

However, an impairment loss may be adjusted in future periods. Thus, if at the end of the following year the impaired asset’s recoverable amount is higher than the carrying value, entity shall perform a decrease of the previous impairment loss. It’s the only case where asset’s carrying value is revaluated to the extent that the revaluation doesn’t exceed the previous impairment loss.

Example on French system:

An entity own 50% of the shares of the company Beta. These shares were acquired in N-1 for 1000 SEK.

At the end of year N, the market value of these shares is 800 SEK, an impairment loss shall be accounted by the entity:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial loss</td>
<td>200</td>
</tr>
<tr>
<td>Impairment on asset</td>
<td>200</td>
</tr>
</tbody>
</table>

On the balance sheet we will see:

<table>
<thead>
<tr>
<th>31/12/N</th>
<th>Historical cost</th>
<th>Impairment</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiaries</td>
<td>1000</td>
<td>200</td>
<td>800</td>
</tr>
</tbody>
</table>

At the end of N+1 the market value of Beta’s capital share is 1200 SEK. According to French accounting system entity shall perform a recovery of impairment:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment on asset</td>
<td>200</td>
</tr>
<tr>
<td>Financial gain</td>
<td>200</td>
</tr>
</tbody>
</table>

On the balance sheet, we will read:

<table>
<thead>
<tr>
<th>31/12/N+1</th>
<th>Historical Cost</th>
<th>Impairment</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiaries</td>
<td>1000</td>
<td>0</td>
<td>1000</td>
</tr>
</tbody>
</table>

We can see that the unrealized gain isn’t accounted because book value equal acquisition cost. Until the asset’s removal, gross value or historical cost appears on balance sheet next to the carrying value. All along the useful life of the asset, this value remains a reference. This system stems from the French contract law, which has a great importance in accounting regulations. Rooted by contract law, price fixed since the agreement of two contracting parties is the best evidence of asset’s value.

Although unrealized losses are impaired, unrealized gains are not taken into consideration. It’s a lack of relevance of the French Standards.
B) Cash Generating Unit:

The principle is similar to the one use with individual assets. An impairment loss shall be accounted if the carrying amount of CGU is higher than the recoverable amount. The impairment loss shall be allocated among the different asset of the CGU. This allocation has to be done according to a specific order regulated by IAS 36:

- “First, to reduce the carrying amount of any goodwill allocated to the CGU”. Goodwill is an intangible asset which represents excess on purchase price over the net book value of an asset.
- “Then, to the other asset of the unit pro rata on the basis of the carrying amount of each asset in the unit.” However, the carrying value of each asset shall not be reduced below the highest of theirs proper fair value less cost to sell and value in use.

If the value in use of an individual asset is not determinable, no impairment loss is recognised if the CGU to which this asset belongs is not impaired. And so, even if the asset’s carrying amount is higher than the value in use.

Moreover for a particular asset of the unit, when the impairment loss is too high for being entirely allocated, the excess shall be shared pro rata to the other asset of the unit. In some case, at the end of this allocation process there is still a non allocated amount of impairment loss. This remaining impairment loss shall be accounted as debt only if it is required by a other international standard, otherwise this shall will not be accounted.

Although French GAAP doesn’t regulated the impairment loss of CGU, the two case stated above collide with French accounting system. Thus this system is based on the prudence principle, where each unrealized loss must be recorded.

For a better understanding of the complex allocation process within a cash generating unit, I will give an example:

A parent company, Omega, consider its subsidiary, Gamma, as a Cash Generating unit. Due to a serious decline in demand for Gamma’ products, Omega conclude that it is necessary to undertake an impairment review. This produce a Value in use of 3000, and given a carrying value of 5 500, an impairment loss of 2 500 shall be allocated to Gamma.

The net assets of Gamma in Omega’s consolidated statements are as follows.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Net book value</th>
<th>Recoverable Amount</th>
<th>Impairment</th>
<th>New Net Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant</td>
<td>1 500</td>
<td>1 000</td>
<td>500</td>
<td>1000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>1 000</td>
<td>0</td>
<td>1000</td>
<td>0</td>
</tr>
<tr>
<td>Patent</td>
<td>5 00</td>
<td>100</td>
<td>400</td>
<td>100</td>
</tr>
<tr>
<td>Factory</td>
<td>2 500</td>
<td>1 900</td>
<td>600</td>
<td>1900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5 500</td>
<td>3 000</td>
<td>2500</td>
<td>3000</td>
</tr>
</tbody>
</table>

Thus after the total impairment of goodwill, the remaining impairment loss, 1 500, should be allocated pro rata of the net value of each asset.

**Allocation table:**
<table>
<thead>
<tr>
<th>Asset</th>
<th>Net book value</th>
<th>Pro rata</th>
<th>Allocation 1</th>
<th>Non-allocated</th>
<th>Allocation 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant</td>
<td>1 500,00</td>
<td>33,33%</td>
<td>500,00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Patent</td>
<td>500,00</td>
<td>11,11%</td>
<td>166,67</td>
<td>233,33</td>
<td></td>
</tr>
<tr>
<td>Factory</td>
<td>2 500,00</td>
<td>55,56%</td>
<td>833,33</td>
<td>233,33*</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>4 500,00</td>
<td>100,00%</td>
<td>1 500,00</td>
<td>233,33</td>
<td></td>
</tr>
</tbody>
</table>

* The theoretical impairment on factory is higher than the difference between carrying value and recoverable amount. After the first allocation stage, the remaining impairment loss shall be allocated entirely on the patent.

In this simple example, the total impairment loss is allocated after 2 allocation steps, for a real company much more allocation stages are needed.

As I said before, when the recoverable amount of an asset can’t be determined, French GAAP consider the Cash Generating Unit not as a group of asset, but as an individual asset. A subsidiary that would be considered as a CGU in IFRS, is viewed as a financial asset in French GAAP. Here the subsidiary Gamma will be impaired in the same manner as an individual asset. We might see in Omega’s balance sheet:

<table>
<thead>
<tr>
<th>31/12/N</th>
<th>Historical Cost</th>
<th>Impairment</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gamma</td>
<td>5 500</td>
<td>2 500</td>
<td>3 000</td>
</tr>
</tbody>
</table>

Once again the French system is simpler but IFRS is more accurate and provide more relevant information about origins and causes of an impairment of a CGU.

**Conclusion:**

Concerning impairment of asset, it is impossible to draw a general rules to distinguish IFRS from French GAAP. In some stage, like identification of impairment need both systems are almost similar. In other stage like recording CGU’s impairment loss, both approaches are opposite. Both accounting system have different understanding of the prudence principle. This divergent imply differing measurement and recording of impairment losses.

Besides we can assert that the international system is more precise and pragmatic than GAAP, knowledgeable entities can use IAS 36 as a guide for their reporting work. French regulation is not clear and detailed enough for being use in that way. When French entities are producing their financial statement, they are totally dependant from the accounting craft, because impairment regulations leave space for interpretation.

Finally, this study shows that both accounting do not attribute the same importance of impairment rules. IFRS aim at regulating all aspects of impairment, in order to monitor entity reporting process. On the contrary, French GAAP influenced by the accounting craft is more elusive and practise-oriented.
Notes:

- Definition of Asset Impairment on: http://www.investorwords.com/6404/asset_impairment.html
- Dominique Rachez, PowerPoint presentation on Impairment, September 2009.