Swire Pacific

By airmail and email

Swire Pacific Limited
Corporate Finance
35/F, Two Pacific Place, 88 Queensway, Hong Kong
Telephone: (852) 2840 8818
Facsimile: (852) 2946 8534
e-mail: jrg@swirepac.com
Date: 11 April 2003

CL 104

To: **International Accounting Standards Board**
30 Cannon Street London
EC4M 6XH
United Kingdom

E-mail <CommentLetters@iasb.org.uk>

From: **J Robert Gibson**

c.c.: Simon Riley HKSA; Paul Winkelmann PwC

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Exposure Draft of Proposed Amendments to IAS 36 Impairment of Assets response to Question 3 (c)

I believe the standard should require discount rates used for impairment calculations to be set as follows:

1. If a business expects to sell a Cash Generating Unit 'CGU' then it should impair it down to the value of its future cashflows discounted at the WACC appropriate to its asset/project type -- this being the best estimate of the sale price of the CGU.
2. If a business expects to continue to operate a CGU as a GOING CONCERN then it should impair by the amount of future accounting losses expected. That is based on the future cashflow discounted at its cost of debt. To avoid variability in accounting the standard should require all businesses to calculate these losses on the basis that a CGU is 100% debt financed at their prospective cost of debt.

Reasons for this view:

1. Per economic theory, if a business makes a higher rate of profit than the WACC for its industry then new competitors will enter its industry until the profit rate is driven down to this WACC. In a 'perfect' market all firms make exactly the WACC for the industry. In practice it is likely that half make more than this WACC and half less. Therefore if impairment provisions are made based future cashflow discounted at WACC this will lead to 50% of CGUs requiring impairment provisions.
2. If an impairment provision for a going concern is made based future cashflow discounted at WACC and this cashflow subsequently occurs then the business will be releasing the impairment provision to profit to the extent of the difference between its WACC and borrowing cost.
3. The large number of provisions that must be made and subsequently reversed will add 'noise' to the accounts which will make them significantly more difficult to interpret.
4. The very subjective judgments that must be made to calculate WACC will make the accounts vulnerable to manipulation and error. (NB: The Financial Times Lex article of 24th March Financial Times gives a good summary of some of the difficulties in calculating WACC. For instance the lowering of utility Betas caused by the TMT blowout.)

J Robert Gibson
General Manager Corporate Finance