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STAFF PAPER

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Project	**Goodwill and Impairment research project**		
Paper topic	Value in use: cash flows from a future restructuring or a future enhancement		

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Purpose

1. The purpose of this paper is to ask the Board whether it wishes to consider removing from IAS 36 *Impairment of Assets* the explicit requirement to exclude from the calculation of value in use of an asset (or a cash-generating unit[1]) cash flows that would arise from future restructuring and from future performance enhancement.

Structure of the paper

2. The paper is structured as follows:

    (a) background and introduction (paragraphs 3–9);

    (b) staff analysis and conclusion (paragraphs 10–21); and

    (c) question for the Board.

[1] References to an asset in this paper should be read as also referring to cash-generating units.

Background and introduction

3. The Board is considering whether it can simplify the calculation of value in use in the IAS 36 impairment testing model without making the impairment test less robust.

Current requirements and considerations in IAS 36

4. IAS 36 requires that future cash flows should be estimated for an asset in its current condition when calculating value in use. For that reason, IAS 36 states that estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from a future restructuring to which an entity is not yet committed or from improving or enhancing the asset's performance.

5. Once an entity becomes committed to a restructuring, estimates of future cash flows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring based on the most recent financial budgets/forecasts approved by management. Those cash flows will also include future costs of the restructuring, except to the extent that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires the entity to recognise a provision for a liability to incur those costs.

6. In paragraph BC69 of the Basis for Conclusions on IAS 36, developed when the Board revised IAS 36 in 2004, the Board acknowledged that, all else being equal, the value in use of a newly acquired unit would be less than the price paid for the unit to the extent that the price includes the net benefits of a future restructuring to which the entity is net yet committed. The Board observed then that if the unit's fair value less costs of disposal were to be estimated, it would also reflect the market's assessment of the expected net benefits any acquirer would be able to derive from restructuring the unit or from future capital expenditure on the unit. Therefore, other things being equal, the unit's recoverable amount in those cases would often be its fair value less costs of disposal, rather than its (lower) value in use. The Board acknowledged that using fair value less costs of disposal for a newly acquired asset seemed inconsistent with the objective of recoverable

amount measurement, which is to reflect the economic decisions that are made when an asset becomes impaired—is it better to sell the asset or to keep using it?

7. Nevertheless, the Board concluded in 2004 that including these cash flows in the calculation of value in use would significantly change the concept that value in use is determined for the asset in its current condition. That concept was first included in 1998 when IAS 36 was first issued. The Board decided that such a change to the concept of value in use should be reconsidered only if the Board were to address the broader question of the appropriate measurement objectives in accounting (see paragraph BC72 of the Basis for Conclusions on IAS 36).

Feedback from stakeholders

8. During and after the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*, several stakeholders (mainly preparers) expressed concerns about the costs and complexity of the value in use calculations carried out as part of the impairment test. One of the main concerns about such costs and complexity arises from the restriction that excludes from the calculation of value in use those cash flows that would arise from future restructuring and from future performance enhancement. That restriction is a source of cost and complexity because it means that management should adjust its financial budgets/forecasts to exclude those future cash inflows and outflows.

9. Consequently, those stakeholders have asked the Board to consider removing this restriction to reduce the costs and complexity of applying the IAS 36 impairment test.

Staff analysis and conclusion

10. Arguably, the IAS 36 exclusion of cash flows resulting from the potential for future restructuring or future enhancement arises from one or more of the following:

    (a) a failure to distinguish clearly between an existing potential for restructuring or enhancement and the possible future outcome of that restructuring or enhancement (paragraphs 11–14);

(b) the adoption of one unit of account for fair value but a different unit of account for value in use (paragraph 15);

(c) a desire to be consistent with IAS 37 (paragraphs 16–17); and

(d) a wish to exclude cash flows that, arguably, are subject to an unusually high risk that management will make unjustifiably optimistic assumptions (paragraphs 18–19).

Potential for restructuring or enhancement

11. The staff think the current condition of some assets (or cash generating units) contains a potential to restructure or enhance the asset. A market participant purchasing such an asset would be willing to pay for that potential. Similarly, a market participant selling such an asset would demand to be paid for selling that potential.

12. Thus, the fair value of such an asset would include value attributable to that potential. That value would reflect the potential that exists at the measurement date. It would not assume that the restructuring or enhancement has already occurred. For example, if the restructuring or enhancement is not certain to occur, the fair value would reflect the probability of its occurrence—perhaps using expected value techniques—and would not assume that the restructuring or enhancement is certain. This is somewhat similar to how fair value of a financial instrument that includes an embedded derivative reflects the value of the host and both the intrinsic value and time value of the embedded derivative.

13. Although IAS 36 currently takes a position that, in effect, excludes the value of that potential from the determination of value in use, in the staff's view that is not a necessary consequence of the concept of value in use. The discussion of value in use in IAS 36 is clear that the underlying principle is that the measurement reflects all cash flows expected to arise from use of the asset and from its subsequent disposal. In the staff's view, if the asset that the entity controls at the measurement date already contains the potential for future restructuring or future enhancement, value in use would appropriately reflect, among other things, all cash flows expected to result from that potential.

14. In some cases, it may be difficult in practice to distinguish between an existing potential, already contained within an asset, to enhance that asset, and the possible future acquisition of a different asset.

Unit of account

15. As noted above, fair value reflects an asset's existing potential for restructuring or enhancement, but value in use, as specified currently in IAS 36, does not reflect that potential. Arguably, that difference arises from the adoption of one unit of account for fair value (one that includes the potential for restructuring or enhancement) but a different unit of account for value in use (one that excludes that potential). However, the impairment model in IAS 36 determines recoverable amount by comparing two different measures of the same asset. In the staff's view, adopting two different units of account for those two measures would provide neither a faithful representation of what recoverable amount purports to depict, nor an understandable outcome.

Consistency with IAS 37

16. Some argue that excluding cash flows that relate to an uncommitted restructuring is necessary for consistency with the requirements in IAS 37 on restructuring provisions. In summary, IAS 37 does not permit an entity to recognise a restructuring provision if the reporting entity is not committed to the restructuring.

17. In the staff's view, that argument is not valid. The value in use of an asset (and, indeed, the fair value of the same asset) reflects, among other things, many expected future cash outflows for which the reporting entity has no liability at the measurement date. That does not mean those cash outflows should be excluded from value in use. Whether the entity already has a liability determines whether the resulting cash flows should be included in the measurement of a liability, rather than in the measurement of the recoverable amount of the asset. It should play no role in determining whether it would be appropriate for the value in use of an asset to reflect future cash flows for which no liability exists yet.

Optimistic assumptions

18. Arguably, the IAS 36 restriction discussed in this paper is based on the perspective that management might sometimes be motivated to establish more optimistic cash flow forecasts than if management were estimating what cash flows other market participants would derive from the asset. From this perspective, placing restrictions on estimates of future cash flows is necessary to prevent management from making unjustifiably optimistic assumptions about the effectiveness of a future restructuring or enhancement, even though no similar restriction is placed on estimates of fair value.

19. In the staff's view, restraining unjustifiably optimistic assumptions is more a matter for auditors and regulators than for accounting standards.

Staff conclusion

20. The staff think that removing the restriction that excludes cash flows from future restructuring and from future performance enhancements would not lead to a significant change in the concept of value in use. Rather, it would eliminate an inconsistency in IAS 36, by:

    (a) capturing within value in use the cash flows that result from an existing potential to restructure or enhance an existing asset, as is also the case for fair value;

    (b) adopting the same unit of account for value in use as is done for fair value less costs of disposal;

    (c) avoiding applying to the determination of value in use a liability recognition criterion that is not pertinent to the measurement of an asset; and

    (d) avoiding applying a rule that excludes some cash flows to avoid unjustifiably optimistic assumptions, but that is inconsistent with the underlying concepts and would be more appropriately addressed by auditors or enforcers.

21. IAS 36 anchors the estimates of future cash flows in management's budgets and forecast. The IAS 36 restriction on the cash flows means that the budgeted or

forecast cash flows need to be split into two components, for example to separate forecast capital expenditures between maintenance capital expenditures and expansionary capital expenditures. Arguably, that exclusion is arbitrary, produces information that is less likely to be useful to users of financial statements and imposes costs on preparers. Removing that restriction would eliminate unnecessary costs and complexity.

Question for the Board

Does the Board wish to consider removing from IAS 36 the requirement for an entity to exclude from the calculation of value in use those cash flows that would result from a future restructuring or from a future enhancement?