STAFF PAPER

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Project	Goodwill and Impairment		
Paper topic	Value in use—cash flows from a future restructuring or a future enhancement		
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Purpose of this paper

1. In this paper, the staff recommends the Board:
   (a) confirm its tentative decision and include a preliminary view in the Discussion Paper to propose removing the restriction that excludes from the estimation of value in use of an asset (or a cash-generating unit) cash flows expected to arise from a future restructuring or from a future enhancement; and
   (b) in response to concerns about unjustifiably optimistic cash flows associated with future restructurings and future enhancements being included in the estimation of value in use:
      (i) set a 'more likely than not' threshold for the inclusion of cash flow projections associated with future restructurings or future enhancements; and
      (ii) require qualitative disclosures about future restructurings to which an entity is not yet committed and future enhancements of an asset which are yet to occur.

Structure of the paper

2. The paper is structured as follows:

(a) Background (paragraphs 3–13);

(i) Existing requirements (paragraph 3);

(ii) Rationale for exclusion (paragraphs 4–6);

(iii) Board's further considerations in 2004 (paragraphs 7–11);

(iv) Feedback from stakeholders (paragraphs 12–13);

(b) Tentative Board decisions in January 2018 (paragraphs 14–24);

(c) Staff analysis (paragraphs 25–50);

(i) Setting a threshold (paragraphs 32–35);

(ii) 'More likely than not' threshold (paragraphs 36–40);

(iii) Reasonableness of cash flow forecasts (paragraphs 41–42);

(iv) Providing guidance rather than setting a threshold (paragraph 43);

(v) Possible disclosure requirements (paragraphs 44–50); and

(d) Question for the Board.

Background

Existing requirements

3. When calculating value in use, IAS 36 *Impairment of Assets* requires 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 (see paragraphs 33(b) and 44 of IAS 36). Once an entity becomes committed to a restructuring or the entity incurs the cash flows that improve or enhance the asset's performance, its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring or enhancement (see paragraphs 47 and 48 of IAS 36)[1]. An entity determines when it is committed to a restructuring using guidance set out in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

[1] These requirements are applied in accounting for the impairment of not only goodwill but also all assets within the scope of IAS 36.

Rationale for exclusion

4. The International Accounting Standards Committee (IASC), the Board's predecessor, decided in developing IAS 36 in 1998 to exclude cash flows from a future restructuring or enhancement from the calculation of value in use. The IASC stated that these requirements were consistent with the requirement that future cash flows should be estimated for an asset in its current condition and consistent with the direction of the IASC's project on Provisions[2].

5. Illustrative Examples 5 and 6 accompanying IAS 36 illustrate how to treat a future restructuring and a future enhancement in determining value in use. These examples highlight the IASC's desire for consistency between the recognition of the benefits from a restructuring in the determination of value in use and the recognition in accordance with IAS 37 of a provision for the costs of the restructuring.

6. It is unclear whether the IASC had an underlying concern that unjustifiably optimistic inputs could be used in estimating value in use if it had not restricted the inclusion of those future cash flows arising from a future restructuring and a future enhancement. There is no mention of this in the Basis for Conclusions on IAS 36, but it is possible the IASC considered this factor in reaching its conclusions.

Board's further considerations in 2004

7. When the Board revised IAS 36 in 2004, the Board considered a concern raised by respondents.

8. The concern was about a cash-generating unit for which the acquisition price reflected a major future restructuring expected to result in a substantial increase in the net cash inflows. If the net cash inflows arising from the restructuring were not reflected in the unit's value in use, the acquirer might be required to recognise an impairment loss immediately after the acquisition.

9. The Board observed that if the unit's fair value less costs of disposal (FVLCD) were to be estimated, it would reflect the market's assessment of the expected net benefits that any acquirer would be able to derive from restructuring the unit or from future capital

[2] IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* was issued by the IASC in 1998.

expenditure on the unit. Therefore, other things being equal, the unit's recoverable amount in those cases would often be its FVLCD, rather than its lower value in use.

10. The Board however acknowledged that using FVLCD 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?

11. Nevertheless, the Board concluded in 2004 that including these cash flows in the calculation of value in use would significantly change the concept adopted in the previous version of IAS 36 that value in use is determined for the asset in its current condition. 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

12. During and after the Post-implementation Review (PIR) of IFRS 3, several stakeholders (mainly preparers) expressed concerns about the cost and complexity of the value in use estimations carried out as part of the impairment test. One of the main sources of cost and complexity they identified was the restriction on including cash flows arising from a future restructuring or future enhancement. That restriction causes cost and complexity because management has to adjust its financial budgets/forecasts to exclude those future cash flows. In particular, there are challenges in separating forecast capital expenditure between maintenance and expansionary capital expenditure and in determining how this separation impacts subsequent cash flows.

13. 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.

Tentative Board decisions in January 2018

14. In the January 2018 Board meeting, the Board tentatively decided to consider removing the requirement for an entity to exclude from the calculation of value in use those cash flows that are expected to arise from a future restructuring or from a future enhancement.

15. The basis for the staff's recommendation underlying this tentative decision was that the removal of the restriction on the inclusion of these cash flows 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, rather than only those cash flows that will result if the asset remains (and is consumed) in its existing unrestructured and unenhanced condition. See further discussion in paragraph 16;

(b) adopting the same unit of account for value in use as is used for fair value less costs of disposal, and thus ensuring that recoverable amount equals the higher of two different measures of the same asset, rather than the higher of measures of two different assets;

(c) avoiding applying to the determination of value in use a liability recognition criterion that is not pertinent to the measurement of an asset. The value in use (or fair value) of an asset reflects many expected future cash outflows for which the reporting entity has no liability at the measurement date, but that fact does not mean those cash outflows should be excluded from the value in use of the asset. Whether the entity already has a liability determines where those cash flows should be included: in measuring the liability or in measuring the value in use of the asset; and

(d) avoiding applying a rule perhaps intended to avoid unjustifiably optimistic assumptions. That rule excludes some cash flows in a way that is inconsistent with the underlying concepts. Preventing unjustifiably optimistic assumptions would be more appropriately addressed by auditors or enforcers (although see paragraphs 25–50 for further discussion on this issue).

16. The staff have sometimes heard people argue that including cash flows from a future restructuring or a future enhancement would assume that the restructuring or enhancement has already occurred. However, in the staff's view, that argument is invalid. Including those cash flows is means of reflecting a potential already contained within the asset—the potential to restructure or enhance the asset. Indeed, the fair value of the asset would reflect that potential. A fair value measurement would not assume that the restructuring or enhancement has already occurred. If the restructuring or enhancement is not certain to occur, the asset's fair value reflects the probability of its occurrence, perhaps using

expected value techniques, and does not assume the restructuring or enhancement is certain. Similarly, the asset's value in use could also reflect that potential, reflecting the probability of those cash flows, as discussed in paragraph 39.

17. 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 the entity's continuing use of the asset and from its subsequent disposal. If the asset that the entity controls at the measurement date contains the potential for future restructuring or future enhancement, in the staff's view value in use would appropriately reflect, among other things, the cash flows expected to result from that potential.

18. In addition, paragraph 6.20 of the Conceptual Framework for Financial Reporting (Conceptual Framework) explains that fair value and value in use reflect the same factors in their calculations[3]. In terms of these factors, the staff think that the potential of an asset should be reflected in fair value and value in use in the same manner.

19. Removing the restriction on the inclusion of these cash flows would remove the cost and complexity that this restriction causes, as discussed in paragraph 12, although this may be offset by additional cost if there is a need to consider potential variations in the amount of the cash flows. The staff believe removing this restriction could also improve the effectiveness of the impairment test to some extent, by basing the test on cash flow forecasts that are used in the business rather than prepared solely for financial reporting purposes. For these reasons the staff recommend the Board confirm its tentative decision (see paragraph 1(a)).

20. Agenda Paper 18B for the January 2018 Board meeting provides a detailed analysis of the issue and the arguments in support of the Board's tentative decision.

21. When the Board reached its tentative decision, some Board members were concerned that simply removing the existing restriction could risk an increase in the use of unjustifiably optimistic inputs in estimating value in use.

22. Similar concerns were expressed in the April 2019 Accounting Standards Advisory Forum (ASAF) meeting. At that meeting, a representative of the Australian Accounting Standards Board (AASB) presented research on IAS 36. One of the recommendations presented was

[3] These factors are also consistent with those described in paragraph 30 of IAS 36.

to remove the restriction on future restructurings and asset enhancements when using value in use, but to include guidance on when it would be reasonable to include such cash flows. The research noted that some analysts disagreed with removing the restriction because of fears that estimates of the cash flow impact of the restructuring could be unrealistically positive.

23. During the ASAF meeting, some ASAF members also noted that removing the existing exclusion would add further management judgement to the estimation of value in use.

24. The staff consider a number of alternative suggestions that might be able to address these concerns in the next section.

Staff analysis

25. If the restriction on the inclusion of cash flows from a future restructuring or from a future enhancement was removed without any further amendments to IAS 36, those cash flows would be required to be based '…on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset.' (paragraph 33(a) of IAS 36) and '…on the most recent financial budgets/forecasts approved by management,..' (paragraph 33(b) of IAS 36).

26. The feedback from the PIR of IFRS 3 indicated concerns about the high degree of subjectivity in the assumptions used in the estimation of value in use and a number of respondents reporting those concerns were concerned with management optimism. The staff have also heard that some stakeholders think that because some entities set their budgets/forecasts as 'stretch targets' to drive behaviour within the entity to meet challenging targets, there may sometimes be some doubt about whether the budgets/forecasts used in impairment tests reflect an unbiased estimate of what will happen.

27. There is also academic research that provides evidence of management discretion in the timing of recognition of impairment losses. Although this includes evidence of income smoothing and 'big bath' behaviour, there is also evidence of the impact of management incentives and CEO tenure on the timeliness of impairment recognition (see Agenda Paper 12A for the December 2014 Board meeting).

28. The AASB's research paper on IAS 36 presented to the April 2019 meeting of the ASAF included a section on international corporate reporting enforcement focus areas and audit quality issues. This summary highlighted concerns about inappropriate assumptions used in cash flow forecasts as a regular enforcement focus area and audit quality issue.

29. Concerns about inappropriate assumptions could be viewed as a matter more for auditors and regulators than for accounting standard-setters. Nevertheless, although users of financial statements would benefit from inclusion of the cash flows from future restructurings or future enhancements, that benefit will be limited if users of financial statements have concerns over the reasonableness of the associated cash flow forecasts.

30. The staff explore below some possible suggestions, or clarifications, to address the concerns of unjustifiably optimistic forecasts of cash flows that will arise from future restructurings and future enhancements. Some of these suggestions or clarifications could be extended to the projections of other cash flows included in the impairment test, potentially making the test more effective.

31. The staff have considered:

(a) setting a threshold;

(b) 'more likely than not' threshold;

(c) reasonableness of cash flow forecasts;

(d) providing guidance rather than setting a threshold; and

(e) possible disclosure requirements.

Setting a threshold

32. The staff think that setting a threshold may address some stakeholders' concerns about the reasonableness of management's assumptions in relation to whether a future restructuring or future enhancement will occur. Setting a threshold would, in the staff's view, also be consistent with the use of budgets/forecasts, which the staff think would generally only include items whose probability of occurrence is over some threshold.

33. However, if a threshold was set, some existing potential in an asset may not be recognised in a value in use calculation (because its probability is under the threshold) even though a market participant purchasing the asset might well be willing to pay for that potential and, in addition, a market participant selling the unit or asset might well demand to be paid for the potential. Continuing to exclude some of that existing potential would retain an

inconsistency between fair value and value in use, and would arguably mean that fair value and value in use are applied to different units of account, as argued against in paragraph 15(a) and 15(b).

34. For example, in an entity with oil and gas interests one of its properties may have contingent resources, whereby some hydrocarbons have been discovered but it is not currently economic to develop and produce them due to a low commodity price environment. Even if it is not probable (ie only possible) that commodity prices will become high enough for a future project to be economically viable, the development potential has a value and a market participant purchasing the asset would be willing to pay for that potential. This development potential is a current condition of the property and is also available to the entity and therefore it would seem reasonable to include it in the value in use calculation. If a threshold is set, the value of this development potential would not be included in value in use if the probability is below the threshold set.

35. Although setting a threshold may not fully address the feedback received during the PIR of IFRS 3, described in paragraph 12, about cost and complexity, the staff think it may be an acceptable balance between providing some assurance to stakeholders over the reasonableness of the cash flow projections for future restructurings or future enhancements and improving the calculation of value in use by including the value of existing potential of assets (or a cash-generating unit) that is available to the entity. The staff believe that likely stakeholder concern over the reasonableness of management's assumptions specifically in relation to future restructurings or future enhancements, warrants such a response.

'More likely than not' threshold

36. The staff do not think it would be appropriate to exclude from value in use the effects of all future restructurings and future enhancements that are not certain to occur. The outcome of adopting this criterion is likely to be very similar to the position today. In order to conclude that a restructuring is certain it is likely that the criteria for recognising a provision for the restructuring event under IAS 37 will have been met. Similarly, it is likely that, in most cases, it will not be possible to conclude that an enhancement is certain until shortly before the expenditure on the enhancement is incurred.

37. A threshold could be set that requires a future restructuring or enhancement occurring to be 'more likely than not' to occur for its effects to be included in value in use.

38. When the threshold is not passed, an entity would have to separate future cash flows arising from these events from its budgets/forecasts. For this reason, the staff also rejected using a threshold higher than 'more likely than not' (eg 'highly probable') since the staff believe this would not address the cost and complexity issue described in paragraph 12 sufficiently.

39. In considering whether to set a threshold, and what threshold to set, it is worth considering the interaction of a threshold with the treatment of uncertain cash flows in determining value in use. IAS 36 requires estimates of value in use to reflect expectations about possible variations in amount or timing of future cash flows. It states that those expectations are reflected by making adjustments to either the future cash flows or the discount rate. It states that whichever approach an entity adopts to reflecting those variations, 'the result shall be to reflect the expected present value of the future cash flows, ie the weighted average of all possible outcomes'.[4] As a result of those requirements, a 'more likely than not' threshold would have the following consequences:

    (a) If there is a 60% probability that a restructuring will occur, value in use will reflect 60% of the incremental cash flows that would be caused by the restructuring.[5]

    (b) If there is a 40% probability that a restructuring will occur, value in use will not reflect the restructuring. In contrast, if there was no threshold, value in use would reflect 40% of the incremental cash flows that would be caused by the restructuring.

40. Hence setting a threshold does not prevent an expected present value being calculated, it simply means some existing potential of the asset would not be included in that expected present value calculation.

Reasonableness of cash flow forecasts

41. Some stakeholders may have concerns forecasts of cash flows arising from future restructurings and enhancements may be more subjective, and sometimes perhaps subject

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[4] See paragraph 32 of IAS 36.

[5] In accordance with paragraph 30(d) of IAS 36, the value in use would also need to reflect the price for bearing uncertainty inherent in the asset. As explained further in paragraphs 6.14 and 6.93-6.94 of the *Conceptual Framework*, that future adjustment is needed because it is not already captured in the expected present value.

to greater measurement uncertainty, than the cash flow forecasts of cash flows that would arise without the future restructuring or future enhancement. However, the staff think it is not possible to consider developing suggestions to address concerns over the reasonableness of the cash flows associated with future restructurings and future enhancements without considering all requirements on cash flow projections used in estimates of value in use. The staff think that considering those requirements is outside the scope of the current objectives for the project. Feedback on the Discussion Paper can be used to determine whether further work should be performed in this area.

42. Areas that could perhaps be explored include whether to clarify some requirements of IAS 36, such as what is meant by ‘reasonable and supportable assumptions’, ‘management’s best estimate of the range of economic conditions’, and ‘most recent financial budgets/forecasts approved by management’.

Providing guidance rather than setting a threshold

43. Rather than setting a specific threshold, the Board could remove the restriction on including cash flows from a future restructuring or from a future enhancement and add guidance on what sort of evidence would need to be available to make it reasonable to include such cash flows in a calculation of value in use. Feedback whether this is preferable to setting a threshold could be sought in the Discussion Paper.

Possible disclosure requirements

44. Paragraph 5.23 of the Conceptual Framework states that a faithful representation of an asset may need to include explanatory information about the uncertainties associated with the asset or liability’s measurement, or with its outcome—the amount, or timing of any inflow or outflow of economic benefits that will ultimately result from it.

45. Thus, whether or not a threshold is set for the inclusion of future restructurings or future enhancements, the staff believe additional disclosures about the measurement uncertainty associated with estimates of the amount, timing and uncertainty of cash flows arising from future restructurings or future enhancements could provide users of financial statements with:

    (a) useful information; and

    (b) some insight into the reasonableness of estimates of those future cash flows reflected in the entity’s estimate of value in use.

46. The staff think that the following possible disclosures could be useful for investors when value in use includes any estimated future cash flows arising from a future restructuring or a future enhancement:

(a) qualitative information, such as a general description, nature of the benefits, estimated timing, management's assessment of the likelihood of occurrence, a description of factors that will determine whether the future restructuring or the future enhancement will occur and description of the principal risks associated with, the future restructuring or the future enhancement; and

(b) quantitative information, such as the amount of the value in use calculated that is attributable to the future restructuring or future enhancement.

47. However, the staff acknowledge that requiring the quantitative information would require entities to isolate those cash flows from their budgets/forecasts and this would negate one of the key benefits of removing the restriction on including such cash flows as described in paragraph 19. For this reason, the staff do not recommend requiring the disclosure of quantitative information.

48. The staff instead recommend only requiring that qualitative information should be disclosed about future restructurings or future enhancements included in an estimate of value in use. Again, the staff think that likely stakeholder concern over the reasonableness of management's assumptions in relation to future restructurings or future enhancements warrants such a requirement.

49. For cash-generating units containing goodwill, the disclosures required by paragraphs 134(d)(i) [key assumptions] and 134(f) [reasonably possible change in key assumptions] of IAS 36 would provide information that may overlap with the possible requirements discussed in paragraph 46(a) (although the frequency of those disclosures may reduce if the Board decides to provide relief from the mandatory annual quantitative impairment test for goodwill, see **Agenda Paper 18D Relief from mandatory annual impairment test**). However, the possible requirements discussed in paragraph 46(a) would provide clarity:

(a) that assumptions about these events are key assumptions in an estimation of value in use; and

(b) about what information should be provided about these events.

50. The staff recommend that the qualitative disclosure should be required when cash flows arising from future restructurings and future enhancements affected the outcome of the impairment test. Thus, the staff recommend requiring these disclosures when excluding those cash flows:

    (a) would cause or increase an impairment loss; or

    (b) would mean that a reasonably possible change in a key assumption would cause or increase an impairment loss.

Question for the Board

Question for the Board
1. Do you agree with the staff recommendations that the Board: (a) confirm its tentative decision and include a preliminary view in the Discussion Paper and propose removing the restriction that excludes from the estimation of value in use of an asset (or a cash-generating unit) cash flows expected to arise from a future restructuring or from a future enhancement; and (b) in response to concerns about unjustifiably optimistic cash flows associated with future restructurings and future enhancements being included in the estimation of value in use: (i) set a 'more likely than not' threshold for the inclusion of cash flow projections associated with future restructurings or future enhancements; and (ii) require qualitative disclosures about future restructurings to which an entity is not yet committed and future enhancements of an asset which are yet to occur?