STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

Project	**New items for initial consideration**		
Paper topic	IAS 36—Recoverable amount and carrying amount of a cash-generating unit		
CONTACT(S)	Denise Durant	ddurant@ifrs.org	+44 (0)20 7246 6469

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify the application of paragraph 78 of IAS 36 *Impairment of Assets*. This paragraph sets out the guidance for considering recognised liabilities for determining the recoverable amount of a cash-generating unit (CGU) within the context of an impairment test for a CGU.[1]

2. The submitter observes that many have struggled with the practical application of paragraph 78 of IAS 36. The submitter requests the Interpretations Committee to review this paragraph and provides some suggestions on how this paragraph could be improved.

3. We performed outreach on this topic with the International Forum of Accounting Standard-Setters (IFASS), securities regulators and the global IFRS technical teams of the international networks of the large accounting firms, in order to find out how widespread the issue raised by the submitter is and to what extent significant diversity in practice exists. At this meeting we will orally update the Interpretations Committee on the results of this outreach.

[1] This impairment test, in accordance with paragraphs 66–108 of IAS 36, involves estimating the recoverable amount of a CGU (the higher of the CGU's fair value less costs of disposal and its value in use) and comparing this amount with the CGU's carrying amount. Where the CGU's carrying amount exceeds its recoverable amount, an impairment loss is recognised.

Purpose of the paper

4. The purpose of this paper is to:

   (a) provide a summary of the submission received;

   (b) provide an analysis of the issue raised;

   (c) present an assessment of the issue against the Interpretations Committee's agenda criteria;

   (d) make a recommendation to issue a tentative agenda decision (see **Appendix A**); and

   (e) ask the Interpretations Committee whether it agrees with the staff recommendation.

5. The submission is reproduced in full in **Appendix B** of this paper.

Summary of the submission received

6. The submitter observes that the general principle in paragraph 76(b) of IAS 36 is that liabilities are excluded from the impairment test and that the exception to this general principle is when the recoverable amount of a CGU cannot be determined without consideration of the liability. This paragraph is reproduced below (emphasis added):

> 76 The carrying amount of a cash-generating unit:
>
> (a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and
>
> **(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.**

7. The submitter observes that the application of paragraph 78 of IAS 36 results in the carrying amount of the liability being deducted *both* from the carrying amount of the CGU and from the value in use (VIU) of the CGU. The submitter observes that deducting the same value from both amounts produces a null result and thinks that this cannot be the intention of the Standard. Paragraph 78 of IAS 36 is reproduced below (emphasis added):

> It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the price to sell the assets of the cash-generating unit and the liability together, less the costs of disposal. **To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.**

8. The submitter also asserts that it does not seem to be appropriate to deduct the carrying amount of the liability from the VIU of the CGU, because the approach that is used to measure the present value (PV) of a liability is different from the approach that is used to measure the PV of an asset's/CGU's VIU. More specifically, the submitter notes that under:

    (a) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* practice is to reflect the risks related to the provision in the cash flows and to use a risk-free interest rate as a discount rate; whereas

    (b) practice in IAS 36 is to reflect the risks in the discount rate.

9. The submitter thinks that instead of deducting the carrying amount of the liability from the CGU's VIU, paragraph 78 of IAS 36 should instead require the estimated cash outflows to settle the liability to be included in the projected cash

flows of the CGU, and then discount these net cash flows using a discount rate to give the overall VIU. The submitter thinks that this alternative approach would achieve a 'like with like' comparison between the CGU's carrying amount and its recoverable amount.

Staff analysis

10. We disagree with the submitter's analysis and conclusions because we think the approach in IAS 36 for considering recognised liabilities in accordance with paragraph 78 of IAS 36 is intentional.

11. We also think that the approach in paragraph 78 of IAS 36 is the consequence of applying IAS 36's approach for assessing impairment, as we explain in the following paragraphs.

The approach in paragraph 78 of IAS 36 is the consequence of applying IAS 36's approach for assessing impairment

12. We observe that the submitter disagrees with the approach in paragraph 78 of IAS 36 because the submitter observes that it creates a null result.

13. We observe that in testing for impairment, consistency is a relevant principle in IAS 36, because an entity should make sure that the carrying amount of the CGU is consistent with how the recoverable amount of a CGU is determined. In this respect we observe that paragraph 75 of IAS 36 states that (emphasis added):

> 75 **The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount** of the cash-generating unit is determined.

14. We observe that paragraph 78 of IAS 36 allows an entity to consider a recognised liability as part of the recoverable amount of the CGU when 'the disposal of a cash-generating unit would require the buyer to assume the liability' and in such case the fair value less costs of disposal (FVLCOD) of the CGU would be 'the price to sell the assets of the cash-generating unit and the liability together, less the costs of disposal".

15. We observe that if the recoverable amount of a CGU (the higher of FVLCD or VIU) considers any recognised liability, then so too must the carrying amount of the CGU consider any recognised liability. This is so that the comparison between the CGU's carrying amount and recoverable amount is made on a consistent basis. Consequently, in circumstances where the CGU's FVLCD includes the liability, paragraph 78 of IAS 36 requires an entity to deduct the recognised liability from:

    (a) the CGU's VIU when determining recoverable amount; and

    (b) the CGU's carrying amount when comparing this with the CGU's recoverable amount.

16. We observe that the approach in paragraph 78 of IAS 36 for considering recognised liabilities does create the 'null result' that the submitter mentioned, because the same amount (ie the carrying amount of the recognised liability) is deducted from the carrying amount of the CGU and from its VIU. However, in our view this 'null result' is appropriate, because the carrying amount and the VIU are adjusted for comparison with the FVLCD (and not for comparison with each other). This ensures that all the measures involved in the determination of impairment are consistent.

17. We observe that an alternative approach to make all the measures comparable could have been to increase the FVLCD by the amount of the liability (ie to measure the FVLCD considering only the assets of the CGU) instead of adjusting the CGU's carrying amount and VIU (as required by paragraph 78 of IAS 36).

18. However, we think that the approach in paragraph 78 of IAS 36 would not be required when an entity uses VIU as the recoverable amount (eg when it is not possible to measure the FVLCD). In accordance with paragraph 20 of IAS 36 an entity uses the VIU as the recoverable amount when 'there is no basis for making a reliable estimate of the price at which an orderly transaction to sell the asset would take place between market participants at the measurement date under current market conditions'.

19. We observe that if an entity uses its VIU as its recoverable amount, then it would be unnecessary to adjust both the VIU and the CGU's carrying for the liability. We observe that these two measures would already be comparable because:

    (a) the determination of the recoverable amount based on VIU is possible without needing to include the liability. This is because the calculation of the VIU of the CGU would consider the future net cash inflows to cover the purchase price and any other costs; hence an entity would not need to deduct from the VIU the future cash outflows necessary to cover the recognised liabilities; and

    (b) the carrying amount of the CGU would consider the purchase price of the assets of the CGU and any costs necessary to keep the assets of the CGU in operation, as well as an estimate of dismantling and removal costs and restoration of the site on which the assets of the CGU are located[2].

The approach in paragraph 78 of IAS 36 for considering liabilities should not be changed

20. We further observe that the submitter suggests that instead of deducting the carrying amount of the liability from the VIU, paragraph 78 of IAS 36 should require the estimated cash outflows to settle the liability to be included in the projected cash flows of the CGU, and then discount these net cash flows using a discount rate to give the overall VIU.

21. We observe that both IAS 36 and IAS 37 allow the risks of the cash flows to be reflected either in the cash flows or in the discount rate. In this respect we observe that:

    (a) paragraph 36 of IAS 37 states that the 'amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. Paragraph 42 of IAS 37 goes on to state that the 'risks and uncertainties that

[2] We based this analysis on paragraph 16 of IAS 16, *Property, Plant and Equipment*.

inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision'.

(b) IAS 36 specifies a measurement threshold by which the asset's/CGU's carrying amount may not exceed its recoverable amount (see paragraph 1 of IAS 36). Estimating the VIU of an asset/CGU involves, in accordance with paragraph 31 of IAS 36:

(i) an estimate of the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

(ii) the application of an appropriate discount rate to those future cash flows.

22. We note that IAS 36 requires the PV calculation to reflect the risks specific to the asset and IAS 37 requires the PV calculation to reflect the risks specific to the liability. In this respect we note that:

(a) paragraph 47 of IAS 37 states that the discount rate used should be a 'pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability';

(b) paragraph 55 of IAS 36 states that the discount rate used should be a 'pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the asset'; and

(c) paragraph 47 of IAS 37 and paragraph 56 of IAS 36 state that either the discount rate or the cash flows being discounted should be adjusted for relevant risks, (but not both, to avoid duplication).

23. We are of the view that the submitter's proposed solution of including the estimated cash outflows to settle the liability in the determination of the VIU, appears to overlook the requirement in IAS 36 to reflect the risks specific to the asset in the PV measurement of the assets in the CGU and the requirement in IAS 37 to reflect the risks specific to the liability in the PV calculation of the liability.

24. Furthermore, we think that the guidance in paragraph 78 of IAS 36 implicitly recognises that it would be difficult to find a discount rate to be used for the combination of the cash flows for the assets of the CGU and for the liability

(because the risks related to an asset could well be different from the risks related to a liability).

25. We are of the view that the approach in paragraph 78 of IAS 36 for considering recognised liabilities provides a relatively straightforward, more cost-effective method to perform a meaningful comparison of the measures involved in impairment testing than the proposal made by the submitter. Consequently, we think that the approach in paragraph 78 of IAS 36 is appropriate and should not be changed.

Agenda criteria assessment

26. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:

Agenda criteria

We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	We will orally update the Interpretations Committee at the next meeting on the results of the outreach that we conducted.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	Not met. We think that the approach for considering recognised liabilities in accordance with paragraph 78 of IAS 36 is intentional and is the consequence of applying IAS 36's approach for assessing impairment. In this respect, we observe that when the CGU's FVLCD considers a recognised liability, paragraph 78 requires adjusting both the CGU's carrying amount and its VIU by the carrying amount of the liability in order to make these measures comparable with the FVLCD. We observe that when the entity uses the VIU as its recoverable amount, the entity need not make an adjustment to the CGU's carrying amount and to its VIU similar to the one required by paragraph 78 of IAS 36, because the carrying amount of the CGU would already be comparable to the VIU of the CGU. We observe that the approach in paragraph 78 of IAS 36 for considering recognised liabilities provides a straightforward and cost-effective method to perform a meaningful comparison of the measures involved in impairment testing.
In addition: Can the Interpretations Committee address this issue in an efficient manner (5.17)	We propose that the Interpretations Committee should issue an agenda decision that would explain that in the light of the existing IFRS requirements the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore decided not to add this issue to its agenda.
Will it be effective for a reasonable time period (5.21)? Only take on the topic of a forthcoming Standard if short-term improvements are justified.	Not applicable.

Staff recommendation

27. On the basis of our analysis and the analysis of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda.

28. We have set out the proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions to the Interpretations Committee

Questions to the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation?
2. Does the Interpretations Committee have any comments on the drafting of the tentative agenda decision?

Appendix A—Tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 36 *Impairment of Assets*——recoverable amount and carrying amount of a cash-generating unit

The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify the application of paragraph 78 of IAS 36 *Impairment of Assets*. This paragraph sets out the guidance for considering recognised liabilities for determining the recoverable amount of a cash-generating unit (CGU) within the context of an impairment test for a CGU.

The submitter observes that the approach set out in paragraph 78 of IAS 36 for making the CGU's carrying amount comparable with its recoverable amount produces a null result, because the recognised liability is required to be deducted both from the CGU's carrying amount and from its value in use (VIU). The submitter questions whether an alternative approach should be required.

The Interpretations Committee observed that when the CGU's fair value less costs of disposal (FVLCD) considers some recognised liabilities, paragraph 78 requires adjusting both the CGU's carrying amount and its VIU by the carrying amount of the liability in order to make each of these measures comparable with the FVLCD.

The Interpretations Committee observed that the approach in paragraph 78 of IAS 36 for considering recognised liabilities provides a straightforward and cost-effective method to perform a meaningful comparison of the measures involved in impairment testing. Moreover, it observed that this approach is consistent with the requirement in IAS 36 to reflect the risks specific to the asset in the present value measurement of the assets in the CGU and the requirement in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to reflect the risks specific to the liability in the present value calculation of the liability.

The Interpretations Committee further observed that if an entity uses its VIU as its recoverable amount, an entity need not make an adjustment to the CGU's carrying amount and to its VIU similar to the one required by paragraph 78 of IAS 36, because the carrying amount of the CGU would already be comparable to the VIU of the CGU without such an adjustment.

In the light of the existing IFRS requirements the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore [decided] not to add this issue to its agenda.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

IFRS Interpretations
Committee 1st Floor
30 Cannon
Street
London
EC4M 6XH

6 August 2015

Submission to the IFRS Interpretations Committee

Dear Sirs and Madams,

We are writing in regard to IAS 36 *Impairment of Assets*, paragraph 78 and request your consideration for a proposed change.

Proposal for consideration

The general principle in IAS 36 is that liabilities are excluded from the impairment test. The exception is when the liability cannot be separated from the asset. (IAS 36, para 76(b)) The most common example of this is a decommissioning provision, as illustrated in the example following paragraph 78 in the standard.

Paragraph 78 states *'To perform a meaningful comparison between the carrying amount of the cash generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating units value in use and its carrying amount.'*

This is a particularly challenging area of impairment testing. The referenced paragraph in particular is confusing to many readers (as we explain below). Further, it surfaces certain conceptual issues, as further discussed.

The Issue

A literal reading of paragraph 78 results in the carrying amount of the liability (as calculated under IAS 37) to be deducted from both the carrying amount of the CGU and the recoverable amount of the CGU as determined under IAS 36 value in use approach. Deducting the same value from both amounts produces a null result and cannot be the intention of the standard. Thus, many have struggled with the practical application of this paragraph.

The intent of this paragraph must be to insure the comparison of 'like with like' when the liability is inextricably linked to the related assets.

One method that might achieve this 'like with like' result would be to deduct the carrying of the liability from the CGU and ensure that the VIU calculation appropriately reflected the expected cash outflows to settle the liability. The example which follows paragraph 78 attempts to illustrate this method but ignores the different approach to risk in a VIU approach versus an IAS 37 provision measurement.

Sound valuation practice on measurement of the CGU, even under VIU, incorporates the majority of the risk in the discount rate. An IAS 37 measurement uses a risk free rate and incorporates the majority of the risk in the cash flows. The example therefore confuses the issue rather than offering helpful guidance.

To ensure we compare like with like in it would seem appropriate to take the IAS 37 carrying amount from the carrying amount of the CGU and to take unadjusted cash flows from the value in use. The risk would then be reflected in the discount rate. We would propose to clarify this in an annual improvement. We have included a proposed wording change in the appendix for your consideration.

Appendix — Proposed wording change to paragraph 78 of IAS 36.

78. It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the price to sell the assets of the cash- generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted ~~in determining both the cash generating unit's value in use and its carrying amount~~ **from the carrying amount** of the cash-generating unit. **The cash outflows associated with the liability are then given appropriate effect in determining the cash generating unit's value in use.**