Grant Thornton

Accounting

Advisory

Global

Insights into IAS 36

Estimating recoverable amount

IAS 36 'Impairment of Assets' provides the guidance for carrying out impairment reviews of assets (both tangible and intangible). IAS 36 is not a new Standard, and while many of its requirements have been extensively commented on, IAS 36's guidance is detailed, prescriptive and complex in some areas, and therefore frequently challenging to apply in practice.

The articles in our 'Insights into IAS 36' series have been written to assist preparers of financial statements and those charged with the governance of reporting entities understand the requirements set out in IAS 36, and revisit some areas where confusion has been seen in practice.

The next three articles in our 'Insights into IAS 36' series cover Step 4 of the impairment review, namely estimating the recoverable amount.

We cover:

- Recoverable amount and fair value less costs of disposal
- Value in use – estimating future cash inflows and outflows, and
- Value in use – applying the appropriate discount rate.

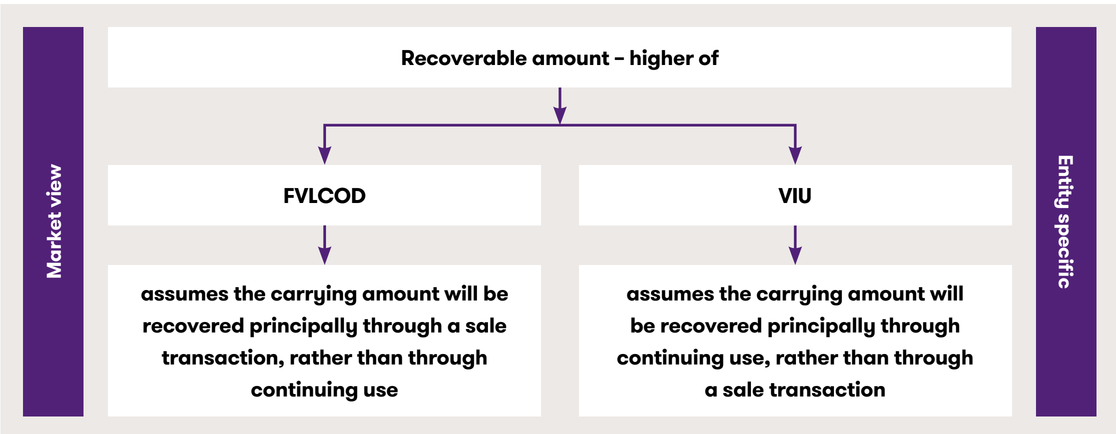
This article covers the definitions of recoverable amount and fair value less costs of disposal (FVLCOD) and provides an overview of value in use (VIU).

Recoverable amount

IAS 36 defines the 'recoverable amount' and related terms as follows:

Term	Definition
Recoverable amount	The recoverable amount of an asset or a cash generating unit (CGU) is the higher of its FVLCOD and its VIU.
Fair Value	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Costs of disposal	Costs of disposal are incremental costs directly attributable to the disposal of an asset or CGU, excluding finance costs and income tax expense.
Value in use	VIU is the present value of the future cash flows expected to be derived from an asset or CGU.

This can be explained in the following diagram:



Therefore, an impairment test involves estimating both FVLCOD and VIU and comparing the higher amount to the asset's carrying amount. However, there are certain circumstances in which it is unnecessary to estimate both FVLCOD and VIU. This is explained in our article **'Insights into IAS 36 – Value in use: applying the appropriate discount rate'**.

Fair value less costs of disposal

The 'fair value' and 'costs of disposal' elements of FVLCOD are discussed in turn below.

Fair value

The FVLCOD component of recoverable amount applies whether or not management currently intends to sell the asset. IAS 36 previously included its own hierarchy of guidance to determine fair value, which was superseded in 2013 by the guidance in IFRS 13 'Fair Value Measurement'. IFRS 13 explains how to measure fair value by providing a clear definition and introducing a single set of requirements for almost all fair value measurements. It clarifies how to measure fair value when there is no active market or when an active market becomes less active. IFRS 13 applies to both financial and non-financial items but does not address or change the requirements on when fair value should be used.

For more information on IFRS 13, refer to our article '**Insights into IFRS 13 – Fair Value Measurement**', which not only summarises the Standard, but also provides detailed commentary on various aspects of applying IFRS 13 from the perspective of a preparer working alongside a valuation expert.

Example 1 – Estimating fair value

An entity operates in the hotels sector. Management is testing a hotel for impairment for which the internal budget and cash flow forecasts include outflows and inflows relating to a significant enhancement planned to start in two years' time. This will involve temporary closure and undertaking a major upgrade from four to five-star status.

Management has determined that fair value and FVLCOD should be estimated using an income approach (ie a discounted cash flow approach).

Management is aware of IAS 36's requirement that, for VIU purposes, an asset's future cash flows should be estimated based on the asset's current condition. Management is considering whether, for the purposes of estimating FVLCOD using an income approach, adjustments are also required to exclude cash flows from the planned upgrade.

Analysis

A fair value estimate takes into account characteristics of an asset that market participants would take into account in pricing the item. Put another way, when estimating fair value and FVLCOD (in the absence of a quoted price), management should aim to use inputs and assumptions consistent with those that prospective buyers would use. Accordingly, although FVLCOD should be based on the hotel's current condition, IAS 36's requirement to exclude cash flows relating to enhancements when estimating VIU does not apply in the same way when estimating FVLCOD. Cash flows relating to the upgrade would therefore be included if market participants would consider these in their pricing decisions. This does not mean management's budget and cash flow forecasts can simply be used without adjustment: various adjustments may be required to ensure the estimates are unbiased and consistent with the assumptions that market participants would make.

Costs of disposal

Costs of disposal are incremental costs directly attributable to the disposal of an asset or CGU, excluding finance costs and income tax expense (and any other costs that have already been recognised as liabilities in the statement of financial position). Potential examples of costs of disposal that should be deducted to derive the FVLCOD include:

- legal costs
- stamp duty and similar transaction taxes
- costs of removing the asset, and
- direct incremental costs to bring an asset into condition for its sale.

Practical insight – Quantum of costs of disposal

In estimating costs of disposal, entities often consider overall disposal costs as a percentage of the transaction price based on discussions with transaction advisors.

Practical insight – Selection of Valuation Approach

Valuers often default to the market approach in calculating FVLCOD. This is because the market approach, typically based on comparable enterprise value multiples, is most similar to the approach often used in negotiations during actual transactions when a company is bought and sold.

As long as the assumptions are consistent with the 'market participant' perspective of fair value, both the market approach and income approach should yield similar results.

Value in use

VIU in effect assumes the asset will be recovered principally through its continuing use and ultimate disposal. VIU is 'entity-specific' in that it reflects the entity's intentions as to how an asset will be used. VIU therefore differs from fair value because fair value reflects the assumptions market participants would use when pricing the asset. VIU reflects the following factors, which may not be reflected in fair value to the extent they would not be generally available to market participants:

- additional value derived from grouping assets
- synergies between the asset being measured and other assets
- legal rights or legal restrictions that are specific only to the current owner of the asset, and
- tax benefits or tax burdens that are specific to the current owner of the asset.

Estimating VIU using the income approach involves the following:

Estimating the future cash inflows and outflows to be derived from continuing to use the asset and from its ultimate disposal, and	Refer to **'Insights into IAS 36 – Value in use: estimating future cash inflows and outflows'**
Applying the appropriate discount rate to those future cash flows.	Refer to **'Insights into IAS 36 – Value in use: applying the appropriate discount rate'**

Practical insight – Selection of valuation approach
Due to the 'entity-specific' nature of the VIU calculation, valuers almost always calculate it using the income approach. However, for CGUs with few entity-specific cash flows, or which are operated in a manner consistent with the way in which a market participant would operate the CGU, a market approach may be appropriate.

How we can help

We hope you find the information in this article helpful in giving you some insight into IAS 36. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

Grant Thornton

grantthornton.global