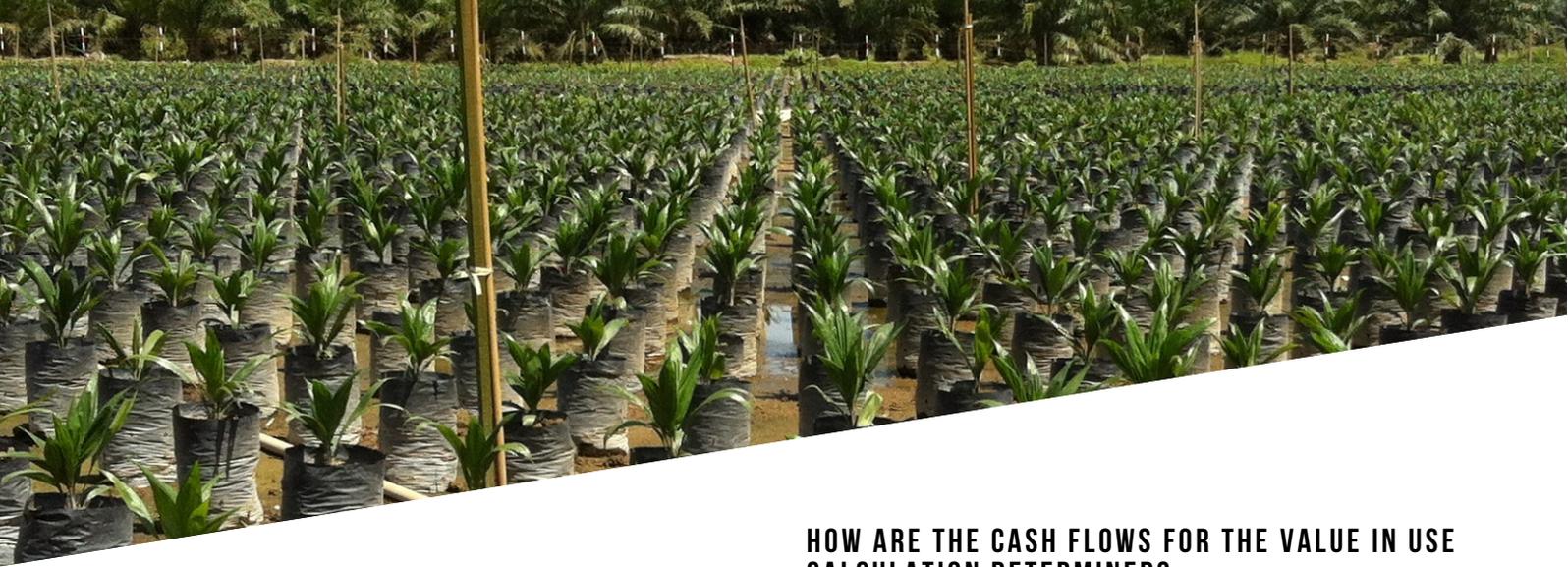# UNDERSTANDING THE ASSUMPTIONS USED IN DETERMINING THE EXPECTED FUTURE CASH FLOWS FOR IMPAIRMENT TESTING OIL PALM PLANTATIONS

BY: MASB SECRETARIAT

INTRODUCTION

1. Palm Oil is a significant industry in several jurisdictions. Given the recent economic environment, impairment of plantations is a key focus of investors and other interested parties, particularly the desire to understand the assumptions behind the numbers. This article seeks to provide directors with an understanding of some of the key assumptions used in performing value in use calculations when testing plantations for impairment.

WHAT IS THE AIM OF IMPAIRMENT TESTING?

2. The aim of impairment testing is to ensure an asset is not carried in the company's financial statements at more than the amount the company could recover through its use or sale, whichever is higher – this is referred to as the asset's recoverable amount. If the carrying amount of an asset is higher than its recoverable amount, the asset is impaired and must be written down to its recoverable amount. An impairment loss would be recognised in the company's income statement.

3. The recoverable amount of an asset is the higher of its value in use in the business and its fair value less costs of disposal. The concept of the fair value of an asset is generally well understood as it is the amount that would be received if the asset were sold in an orderly transaction between market participants at the measurement date, essentially a market value. On the other hand, value in use is the present value of the future cash flows expected to be derived from an asset.

HOW ARE THE CASH FLOWS FOR THE VALUE IN USE CALCULATION DETERMINED?

4. Sometimes, the value in use of an individual asset cannot be determined, because the asset does not generate cash flows independently from other assets. In this case, the value in use, and hence recoverable amount, is determined for the smallest group of assets to which the asset belongs that generates independent cash flows, known as a cash-generating unit (CGU). For example, for an oil palm plantation, trees do not generate cash flows independently from the land, and so their cash-generating unit will consist of both land and trees.

5. When management intends to continue to use the land for the plantation, and not to sell it after the first life-cycle of the trees, the land generally has a longer useful life than the trees (for example, the trees might have a useful life of 25 years, whereas the land might have a useful life of 60 years). In this case, there seem to be divergent views in practice about whether the expected future cash flows in the value in use calculation for the CGU include or exclude the expected replanting of the trees. This article highlights the appropriate accounting requirements.

6. When a company does not intend to dispose of the land after the first cycle of trees, the future cash flows used in the value in use calculation for the cash-generating unit reflect the useful life of the land and assumed replanting. The future cash flows are based on:

   a. the projections of cash inflows from the continuing use of the land,

b. the projections of cash outflows that are necessarily incurred to generate those cash inflows, which include:

   i. cash outflows to prepare the land for use, and

   ii. the day-to-day servicing of the land as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the land.

c. the estimated cash flows from the disposal of the land at the end of its useful life in an arm's length transaction.

Replacement of the trees is treated as part of the day-to-day servicing of the CGU estimating the future cash flows, since the trees have a shorter useful life than the land.

7. Cash flow projections must also:

   a. be based on reasonable and supportable assumptions representing management's best estimate of the range of economic conditions that will exist over the remaining useful life of the land. Management is required to assess the reasonableness of these assumptions by examining causes of differences between past cash flow projections and actual cash flows.

   b. use the most recent financial budgets/forecasts approved by management, but exclude any estimated future cash inflows or outflows from future restructurings or enhancing the asset's performance. Cash flow projections based on financial budgets/forecasts over a period longer than five years are only used if management can demonstrate its ability from past experience to make forecasts accurately over that longer period.

8. The cash flow projections until the end of the useful life of the land would be estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years, which is generally steady or declining. However, if appropriate, the growth rate is zero or negative.