IND AS 36 - Impairment of Assets & its Valuation aspects to be considered for impairment testing of Cash Generating Units & Goodwill

Background

IND AS 36 deals with the subject of *Impairment of Assets*, and includes various provisions relating to periodic testing of Cash-Generating Units (‘CGU') and their relatable Goodwill for impairment. The key provisions are summarized hereunder

A CGU has been defined in the definition’s clause of as *"the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets".*

An impairment test of a CGU essentially comprises of an exercise to compare the Recoverable Amount ('RA') of the CGU, with its Carrying Amount (‘CA') including its Goodwill. If the RA of the CGU exceeds the CA of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the CA of the unit exceeds the RA of the unit, the entity shall recognize the impairment loss in accordance with the provisions of paragraph 104 IND AS 36 which states about *Impairment loss of Cash Generating Unit*.

Definitions

RA of an asset is defined in the definition’s clause of IND AS 36 as the **HIGHER** of

(a) the asset's Fair Value less Costs of Disposal (`FVLCD') and

(b) the asset's Value In Use ('VIU')

IND AS 36 para 66 further clarifies that in IND AS 36, references to an 'Asset' apply equally to a CGU. Also, in this case, the RA of the CGU is the higher of the FVLCD and VIU of the CGU.

The definitions clause of IND AS 36 further defines Fair value less cost of disposal as “*is the amount obtainable from the sale of an asset or cash-generating unit in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal”.* This is consistent with the definition of Fair Value as per IND AS 113 Fair Value Measurement.

VIU is defined in the definition's clause of IND AS 36 as "*the present value of the future cash flows expected to be derived from an asset or cash-generating unit".*

IND AS 36 also provides detailed guidance regarding the basis for estimating the VIU of a CGU.

CA of an asset (or CGU) is defined as "*the amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon".*

Measurement of Recoverable Amount (RA)

IND AS 36 paragraph 19 states: "*It is not always necessary to determine both an asset's fair value less costs of disposal and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired, and it is not necessary to estimate the other amount."* Thus, IND AS 36 provides that it is not always necessary to determine both the FVLCD and the VIU. If either of these amounts exceeds the CA, there is no impairment, and it is not necessary to estimate the other amount.

Usually, in the case of a CGU which is NOT a separate entity listed on a stock exchange, it is not easy to reliably estimate the FVLCD, since quoted market prices are not available. Accordingly, it is more common to estimate the VIU in such cases. Hence in general, it is better to first estimate the VIU and compare it with the carrying amount and decided that we would estimate the FVLCD only if it becomes necessary as provided in IND AS 36 paragraph 19.

Carrying amount to be tested for impairment

According to terms of IND AS 36, the Carrying Amount relatable to the CGU, including the Goodwill relatable to the CGU, requires to be compared with the Recoverable Amount.

The carrying amount of a cash-generating unit: **(paragraph 76)**
(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 recognized liability, unless the recoverable

amount of the cash generating unit cannot be determined without consideration of this liability.

Thus, carrying amount is generally calculated considering all the assets and deducting all the liabilities pertaining to that CGU. Any asset or liability which pertains to the holding Company or to the other group company should be excluded from calculation of carrying amount.

Allocation of Goodwill and its Impairment testing

Allocating goodwill to cash-generating units (paragraph **80)**

"For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units."

Thus, paragraph 80 talks about allocation of goodwill that arise out of business combination on the basis expected synergies that will be generated from the respective CGU.

Paragraph 90 of IND AS 36 states *"A cash-generating unit to which goodwill has been allocated shall be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognize the impairment loss in accordance with paragraph 104."*

Thus, two things are evident from the above paragraph, that impairment testing of goodwill has to be done atleast annually and if RA is more than CA, then goodwill is not to be impaired and if vice-versa goodwill impairment has to be done.

Measurement of Value In Use (VIU)

The following elements shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;
(c) the time value of money, represented by the current market risk-free rate of interest;
(d) the price for bearing the uncertainty inherent in the asset; and
(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

As per paragraph 31 of IND AS 36, estimating the VIU of a CGU involves the following steps:

a) estimating the future cash inflows and outflows arising from continuing use of the CGU and from its ultimate disposal; and
b) applying the appropriate discount rate to those future cash flows.

In other words, VIU of a CGU is determined by applying what is commonly referred to as the Discounted Cash Flow or DCF methodology.

Specific Guidance regarding Cash Flow projections

IND AS 36 also provides guidance about the basis on which the Cash Flows are to be estimated. These include the following important points:

a) base cash flow projections 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. Greater weight shall be given to external evidence. (paragraph 33a)

b) Cash flows should be based on the most recent financial budgets / forecasts that have been approved by management. Projections based on these budgets / forecasts should cover a maximum period of five years, unless a longer period can be justified. ***(paragraph 33b)***

c) Cash flow projections beyond the said five-year period should be estimated by extrapolating the projections based on the budgets/forecast, using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. The growth rate should not exceed the long-term average growth rate for the products, industries or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified ***(paragraph 33c)***

d) *Estimates of future cash flows should include projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset. **(para 39b)**.* **In other words, it is necessary to determine the "Free Cash Flows" (`FCF') from the CGU.**

Future cash flows are estimated in the currency in which they will be generated, and then discounted, using a discount rate appropriate for that currency. An entity translates the present value using the spot exchange rate at the date of the VIU calculation. (paragraph 54). Thus, in case where CGU is in other country, cashflows and the discounting rate should be considered that of other country and the it should be converted through exchange rate as on the date of valuation.

Discount Rates: Pre-tax or post-tax

a) An important factor in any DCF analysis is the decision regarding whether to discount the pre-tax cash flows or the post-tax cash flows, and further, whether the discount rate to be applied should be a pre-tax rate or a post-tax rate.

b) Paragraph 50 and 51 of IND AS 36 require that the Cash Flows which are sought to be discounted should be Pre-tax Cash Flows. Further IND AS 36 states that the Discount Rate should be a Pre-tax rate.

Estimating discount rates

This discount rate, which is applied to the free cash flows, should reflect the opportunity cost to all the capital providers (namely shareholders and creditors), weighted by their relative contribution to the total capital. The opportunity cost to the capital provider equals the rate of return the capital provider expects to earn on other investments of equivalent risk. Cost of Capital for any entity typically comprises of two components:

a) Cost of Debt ('CoD'), ie the typical cost at which the entity can borrow money; and

b) Cost of Equity ('CoE'), which is the rate of return that an equity investor in the entity would typically expect on his investment.

c) Cost of equity and cost of debt combine to form cost of capital. CoD and CoE are taken in proportion to their total share in the capital structure of the Company.

c) Cost of Debt

Cost of debt is the cost to the company at which it can borrow money from the market.

d) Cost of Equity

Cost of Equity is typically defined as the return that investors in the equity of a business would expect to make on their investment.

CoE is commonly estimated by using the Capital Asset Pricing Model ('CAPM'). The CAPM formula can be summarized as follows:

$$Re = Rf + \beta(Rm-Rf)$$

Where: -

Re = Return on equity

Rf = Risk free rate

β = Beta

Rm = Market return

The COE is computed in the following manner:

e) Risk-Free Rate

The Risk-free rate is typically represented by the Yield-to-Maturity (YTM) available on long-term Government Securities.

f) Equity Risk Premium ('ERP')

Various sources of published data are available from time to time about the reasonable premium expected by an investor for investment in equities.

g) Beta for the Sector

Beta is the sensitivity index of any particular industry with respect to the market risk. To estimate the premium expected from a particular sector one would have to make an adjustment to factor in the Beta for the sector. Beta of a scrip is a reflection of the correlation between the price-movement of the individual scrip vis-a-vis price movement in an equity index. Beta is usually estimated by analyzing the Beta of comparable companies.

h) Company-Specific Risk Premium (or Alpha):

Apart from beta-adjusted risk premium, an investor would expect an additional premium for investing in a single company. This additional premium is often referred to as the 'Alpha'.

i) Corresponding Pre-tax WACC

Paragraph 20 of Appendix A of IND AS 36 requires that where the basis used to estimate the discount rate is post-tax, that basis should be adjusted to reflect a pre-tax rate.

IND AS 36 does not provide specific guidance on the methodology to make such adjustment from post-tax to pre-tax. However, guidance in this regard is available from the corresponding IFRS Standard viz IAS36: Impairment of Assets. In the said IAS 36, paragraph A20 of Appendix A (which is an integral part of IAS 36) contains a provision identical to paragraph A20 of Appendix A of IND AS 8, i.e. that when the basis used to estimate the discount rate is post tax, that basis should be adjusted to reflect a pre-tax rate. IAS 36 further contains another appendix entitled *"Basis For Conclusions"*. The said Basis for Conclusions, though not a part of the standard, outlines the basis on which the various provisions of IAS 36 were compiled, and hence the said Basis for Conclusions carries substantial persuasive value.

Paragraph BCZ85 of the said Basis for Conclusions states that it would be erroneous to convert a post-tax rate into a pre-tax rate by merely grossing up the post-tax rate by the marginal rate of tax. For example, if the marginal rate of tax is taken at 25%. The post-tax WACC has been estimated for example at 20.0%, and para BCZ85 cautions that it would be wrong to assume the pre-tax rate to be 20.00/ (100-25%) or 26.67% pa. The corresponding pre-tax rate could be higher or lower than the grossed-up rate, depending upon the timing of the cash flows, the effective tax rates etc.

The said para BCZ85 goes on to provide an illustrative example, and states that the correct approach is to determine the corresponding pre-tax rate by an iterative computation, such that the present value figure determined by discounting the pre-tax cash flows by a pre-tax discount rate exactly equals the present value figure determined by discounting the post-tax cash flows by a post-tax discount rate.

Terminal Value:

Terminal value is generally calculated by applying the Gordon Growth Model('GGM') which is the most commonly applied methodology. The GGM solves for the present value of an infinite series of future inflows, assuming a constant growth rate, and assuming a given discount rate.

Terminal Value (TV) by GGM model is computed as
TV = [(Normalized Annual Free Cash Flow in Yr. 1 of perpetual period)
(Discount Rate minus Perpetual Growth Rate)

Perpetual Growth Rate:

IND AS 36 **paragraph 33c** states that the constant or perpetual growth rate is not expected to exceed the long-term growth rate of the country where the entity operates. Thus, the long-term growth rate of the country of which the cashflows is determined is considered for perpetual growth rate.

All the above factors cumulatively are used to determine the Value In Use (VIU).

Timing of impairment tests

Paragraph 96 of IND AS 36 states that "*The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times. However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period".*

Thus, impairment testing of CGU has to be done annually at the same time every year.

Impairment loss for a cash-generating unit

According to para 104 of IND AS 36 "*An impairment loss shall be recognized for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of*

the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:
(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
(b) then, to the other assets of the unit (group of units) pro-rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognized in accordance with paragraph 60".

Conclusion

An impairment test of a CGU essentially comprises of an exercise to compare the Recoverable Amount ('RA') i.e. Value in Use ('VIU') of the CGU, with its Carrying Amount (‘CA') including its Goodwill. If the RA of the CGU exceeds the CA of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the CA of the unit exceeds the RA of the unit, the entity shall recognize the impairment loss in accordance with the provisions of paragraph 104 of IND AS 36.