IASB Research project - Goodwill and Impairment

Improving value in use calculation

Issues Paper

Objective

1 The purpose of this paper is to seek preliminary views from EFRAG TEG members on the IASB preliminary decisions on exploring whether to improve the calculation of value in use (VIU) for goodwill impairment test by permitting:

(a) the inclusion of future restructuring and future enhancement to an asset; and

(b) the use of post-tax inputs and post-tax discount rate.

2 As it has been explained in agenda paper 10-02 *Goodwill and impairment test - Quantitative test and amortisation of goodwill* provided for this session, the IASB tentatively decided that the mandatory annual quantitative goodwill impairment test should be removed. Instead, entities would need to perform a quantitative test only when there is an indication that impairment may have occurred.

Future restructuring and future enhancements in the calculation of VIU

3 During the PIR of IFRS 3 *Business Combinations,* stakeholders including preparers indicated that they did not support the existing restriction on including cash flows arising from a future restructuring or future enhancement when calculating VIU because it creates cost and complexity and it is not consistent with management budgets/forecasts.

4 Accordingly, the IASB reached a preliminary view in its June 2019 meeting that it should develop proposals to allow future restructuring and future enhancement in the estimation of future cash flows in the calculation of VIU.

5 In favour of removing the restriction on including cash flows arising from a future restructuring, it has been noted that it could eliminate an inconsistency in IAS 36 *Impairment of Assets* in the sense that it would capture within VIU the cash flows that will arise from any existing potential to restructure or enhance an existing asset (or CGU) rather than ignoring this potential, and align with the way restructuring cash flows are considered when determining fair value. It would capture the value of the existing potential of an asset, helping to make the unit of account adopted for estimating VIU the same as that adopted for measuring fair value less costs of disposal.

6 Against removing the restriction, it could be argued that it could increase the use of unjustifiably optimistic inputs and would add further management judgement to the estimation of VIU.

7 AASB research on IAS 36 presented to the April 2019 ASAF meeting highlighted concerns about inappropriate assumptions used in cash flow forecasts as a regular enforcement focus area as well as audit quality issues. Although users of financial statements would benefit from inclusion of the cash flows from future restructuring and future enhancement, that benefit will be limited if users of financial statement have concerns over the reasonableness of the associated cash flows forecast.

8 In order to address these concerns, if it were decided to include cash flows arising from a future restructuring, it would be necessary consider the following issues:

(a) setting a threshold;

(b) consider a ‘more likely than not’ threshold;

(c) develop guidance on when to include restructuring cash flows in VIU calculation; and/or

(d) possible disclosure requirements about future restructurings to which an entity is not yet committed and future enhancements of an asset which are yet to occur.

9 However, the IASB considered that it should not:

(a) set any threshold for the inclusion of cash flow projections associated with future restructurings or future enhancements; and

(b) require additional qualitative disclosures about future restructurings to which an entity is not yet committed and future enhancements of an asset which are yet to occur.

10 The IASB considered that setting a “more likely than not” threshold for the inclusion of such cash flows would add complexity to the impairment test, and it would not align with the recognition criteria in the *Conceptual Framework for Financial Reporting*. In addition, some IASB members indicated that the objective was to align the cash flows with the business plan which would not be affected by a threshold. However, other IASB members commented that having no threshold could increase the risk of using optimistic and unjustifiable forecasts and indicated that a clarification of what is meant by “reasonable and supportable assumptions” in IAS 36 would be needed.

11 Overall the IASB considered that current disclosures requirements about future restructurings in IAS 36 are reasonable and sufficient to provide useful information to users.

Previous EFRAG discussions

12 EFRAG TEG-CFSS members generally supported removing the requirement to exclude from the VIU calculation cash flows resulting from a future restructuring or a future enhancement when they discussed the proposal at their meetings in April 2018 and November 2018.

13 EFRAG User Panel members at its meeting in July 2019 generally supported allowing future restructuring and future enhancement in the estimation of future cash flows in the calculation of VIU.

Previous EFRAG’s research

14 EFRAG’s Discussion Paper *Goodwill Impairment Test: Can It Be Improved?* issued in June 2017 (‘June 2017 EFRAG DP’) suggested that the requirements for VIU measurement should be changed to allow the effect of planned future restructurings (inflows and outflows) to be incorporated in the cash flow projection, even when the threshold to recognise a provision for restructuring costs has not yet been met. The suggestion could increase the relevance of the VIU calculation and effectiveness of the impairment test because it would take into consideration the dynamic

management of the business and it would also simplify the impairment test as it allows entities to use their budgets and forecasts, which are likely to include the impact of future restructurings.

15 However, the suggestion could also have the following consequences:

(a) it may be difficult to identify the unit of account, if the restructuring is expected to modify the existing group reporting structure;

(b) it may require long-term projections (in some cases exceeding the 5-year usual term); and

(c) it would change the current notion in IAS 36 that the entity should assess the recoverable amount of the asset/CGU in its current state.

Post-tax inputs in the calculation of VIU

16 IAS 36 requires entities to use pre-tax rate because it was considered that post-tax inputs without specifying the tax attribute could cause double counting of some future tax consequences of temporary differences.

17 Various stakeholders during the PIR of IFRS 3, including users, commented that a pre-tax discount rate is hard to understand and does not provide useful information because that rate is not observable and is generally not used for valuation purposes. The current value of an asset is regarded as a post-tax measure which is more directly observable. In practice, the impairment test is performed on post-tax basis.

18 The pre-tax discount rate is a number derived from discounted cash flow calculations that are, in practice, performed using post-tax inputs. Disclosure of this computed pre-tax rate does not provide useful information to users because it is not the input used in estimating the recoverable amount of an asset (or a cash generating unit (CGU)).

19 To address these concerns, the IASB has tentatively decided to:

(a) remove the explicit requirement to use pre-tax inputs and pre-tax discount rate to calculate VIU;

(b) require entities to use internally consistent assumptions for cash flows and discount rates; and

(c) disclose the discount rates used in the estimation of VIU.

20 These proposals would reduce the cost of the goodwill impairment test, would provide more useful information, and would make the test more understandable. In addition, using post-tax discount rate and post inputs would be more consistent with other IFRS Standards.

21 When developing IAS 36 and requiring a pre-tax rate, the IASB observed that using post-tax input without specifying the tax attribute could double-count future tax consequences. However, the IASB Staff considers that the double counting issue can also exist with a pre-tax calculation, although the Basis for Conclusions of IAS 36 explains how to avoid the double count effecting [1]. This is because whether a pre-tax discount rate is used with pre-tax inputs or a post-tax discount rate is used with post-tax inputs, the resulting current value is a post-tax vale of the asset (or CGU) being measured.

[1] The Basis for Conclusions in IAS 36 (paragraphs BCZ81 and BCZ82) explains the two components of future tax cash flows that can affect recoverable amount, and notes that to avoid 'double-counting' the future tax consequences of temporary differences are not considered in determining recoverable amount.

22 This issue would not exist if the recoverable amount is based on fair value less cost of disposal.

23 The forthcoming discussion paper is expected to explore whether there is a need for further guidance on how to ensure that there is a no double counting of tax cash flows in estimates of VIU, where the tax cash flows included in the measurement of deferred tax assets or deferred tax liabilities are also included in the recoverable amount of an asset.

Previous EFRAG discussions

24 EFRAG TEG-CFSS members generally supported removing the explicit requirement to use pre-tax inputs to calculate value in use and to disclose the pre-tax discount rates used when they discussed the proposal at its meetings in April 2018 and in November 2018.

25 The EFRAG User Panel members at its meeting in July 2019 generally supported to use a post-tax discount rate and the use of pre-tax inputs in the calculation of VIU.

Previous EFRAG's research

26 In the June 2017 EFRAG DP, EFRAG indicated that the requirements should be changed to allow entities an election between a pre-tax or post-tax calculation. Entities would need to disclose the basis chosen.

27 The inclusion of a choice would simplify the calculation of VIU and reduce the cost when entities only have observable post-tax discount rates for an asset/CGU. Entities usually use WACC as a starting point for determining the discount rate, and the WACC is typically a post-tax rate. The relevance of the calculation would not be affected, because both basis should result in the same recoverable amount when the pre-tax rate is adjusted to reflect the timing of creation and reversal of temporary differences.

28 However, allowing a post-tax basis could raise some issues. For example, it is unclear if this would have implications for the composition of the CGU and calculation of the amount of tax that should be allocated to the different CGUs. Moreover, since the estimates of future cash flows should include cash inflows or outflows from income tax receipts or payments, a number of practical questions would arise (as noted in paragraphs BCZ81 to BCZ84 of the Basis for Conclusions of IAS 36), such as how deferred taxes should be reflected in the future cash flows or if the carrying amount of the CGU should be adjusted.

Questions for EFRAG TEG

29 What are your views on the IASB's proposal to allow the inclusion of cash flows from future restructuring or future enhancement in the calculation of VIU?

30 What are your views on the IASB's tentative decision to remove the explicit requirement to use pre-tax discount rates and pre-tax inputs to estimate VIU calculation?

31 Do EFRAG TEG members consider that any other improvement to the calculation of VIU should be addressed? If so, please explain which and why.