Project **New items for initial consideration**

Topic **IAS 36 *Impairment of Assets* – Calculation of value in use**

Purpose of this paper

1. The purpose of this paper is to document the staff analysis and recommendations relating to a request received by the IFRS Interpretations Committee (the Interpretations Committee), to clarify whether an entity can use a Dividend Discount Model (DDM) when calculating value in use (VIU) for the purpose of performing an impairment test in accordance with IAS 36 *Impairment of Assets*.

2. Specifically, the request raises this issue in the context of an impairment test of a subsidiary in the consolidated financial statements of a parent, when the subsidiary is:

   (a) in the financial services sector[1]; **and**

   (b) a separate cash-generating unit (CGU).

3. In this specific situation, the request considers whether a DDM can be considered an appropriate discounted cash flow methodology for the purposes of calculating VIU when performing an impairment test of a subsidiary that is a separate CGU.

4. This paper:

[1] Specific examples include investment funds, insurance entities, Real Estate Investment Trusts (REITs) and banks.

(a) provides background information on this issue;

(b) analyses the issue within the context of IFRSs;

(c) makes a staff recommendation on the tentative agenda decision; and

(d) asks the Interpretations Committee whether they agree with the staff recommendation.

Background Information

5. This issue arises because of concerns in comparing the guidance in IAS 28 *Investments in Associates* with the guidance in IAS 36.

6. IAS 28.33 provides specific guidance on performing an impairment test of an investment in an associate in the consolidated financial statements of a parent. It states that:

> … the entire *carrying amount of the investment is tested for impairment in accordance with IAS 36* as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired… *In determining the value in use* of the investment, an entity estimates:
>
> (a) its *share of the present value of the estimated future cash flows* expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; *or*
>
> (b) *the present value of the estimated future cash flows expected to arise from dividends* to be received from the investment and from its ultimate disposal.
>
> *Under appropriate assumptions, both methods give the same result*. (Emphasis added)

7. In contrast, IAS 36 defines VIU as the present value of the future cash flows expected to be derived from an asset or CGU. It states that:

> 31 *Estimating the value in use* of an asset involves the following steps:
>
> (a) *estimating the future cash inflows and outflows* to be derived from continuing use of the asset and from its ultimate disposal; and
>
> (b) applying the appropriate discount rate to those future cash flows.

> 33 In measuring value in use an entity shall:
>
> (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. … (Emphasis added)

8. IAS 36 requires the use of present value techniques (a Discounted Cash Flow or DCF) to calculate VIU. However, unlike in IAS 28, the guidance in IAS 36 (for example, paragraphs 33–57 and Appendix A) does not specify whether a calculation based on the present value of the estimated future cash flows expected to arise from dividends can be applied to calculate VIU.

9. As a result, the request specifically asks for clarification, when applying IAS 36, on whether the:

   (a) estimated future cash flows expected to arise from dividends meet the requirements to be considered a DCF; and specifically

   (b) General Dividend Discount Model (GDDM[2]) or Dividend Discount Model – Excess Capital version (DDM-EC[3]), collectively the DDMs, are compliant with IAS 36 requirements?

Staff Analysis

10. The staff have identified a number of factors that should be assessed in determining whether the DDMs are compliant with the requirements in IAS 36 for calculating VIU.

11. These factors include considering whether the DDMs:

    (a) meet the IAS 36 criteria for calculating cash flow projections of VIU. For example:

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[2] Generally defined as a financial model that values shares (eg of a subsidiary) at the discounted value of future dividend payments.

[3] In the request, the DDM-ED is described as a method that determines the value of a company on the basis of future cash flows that may be distributed to the to the shareholders in compliance with the capital requirements provided by the law, discounted at a rate expressing the cost of risk capital.

(i) do reasonable and supportable assumptions exist in relation to the amount, timing and growth of future dividend payments, specifically when dividend payments are variable and discretionary in nature? (IAS 36.33 (a))

This may be the situation when all, or a certain proportion, of cash inflows and profits are distributed to the parent.

(ii) do dividends best reflect the projections of cash flows of the subsidiary included in the financial budgets/forecasts used by management, for example, because the subsidiary's cash flows are all related to investment activities? (IAS 36.33 (b))

(iii) does the discount rate used appropriately reflect the time value of money and the risk specific to the subsidiary because it may only include the cost of equity, and not the cost of debt? (IAS 36.55 and IAS 36.56)

(b) because they are primarily a business valuation model, are prepared in a manner that is consistent with the type of valuation required by IAS 36 in determining VIU.

(c) by estimating future cash flows based on amounts distributed to the shareholders can, in specific situations, provide a better calculation of VIU.

This is because a subsidiary may have to comply with certain statutory capital requirements that restrict the amount of cash flows generated by the subsidiary to which the parent entity may be entitled. As a result, use of a DDM, rather than an alternative DCF approach, may generate a lower estimate of VIU.

12. The staff also note that some believe that DDMs can only be used in accordance with IAS 28 because IAS 36 does not specifically mention DDMs within the guidance on calculating VIU.

13. However, IAS 36 does not prohibit an entity from considering the future cash flows distributed by a subsidiary to be a cash flow projection in determining the value in use of a CGU, and, by definition DDMs are a type of DCF.

14. In addition, as noted by IAS 28.33, under appropriate assumptions, the DDM may provide the same results as other calculations of estimated future cash flows of the subsidiary are expected to.

15. Consequently, some believe that using the DDMs may provide a practical expedient for some entities to avoid having to perform a DCF when they have already prepared DDMs.

Staff view

16. The staff believe that there may be specific situations when the DDMs could be an appropriate method of calculating VIU in accordance with IAS 36. These specific situations may exist in the limited fact pattern identified in the request (eg when the subsidiary is in the financial services sector and is a separate and single CGU).

17. The staff believe that these specific situations are limited to those when the DDMs are applied in a manner that is consistent with the principles in paragraphs 30 – 57 of IAS 36 for the calculation of VIU. However, an entity should use judgement in determining the appropriate type of DCF to be applied based upon the entity's specific facts and circumstances.

Staff recommendation

Agenda criteria assessment for the committee

18. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) The issue is widespread and has practical relevance.

    Yes.

    The staff understand that the issue is widespread across a number of jurisdictions, specifically within the financial services industry.

    This reflects the results of additional outreach that the staff asked the requestor to perform with the National Standard Setters.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No.

The staff understand that practice does not currently prohibit application of the DDMs, although acknowledging that the situations when it should be applied may be limited to specific facts and circumstances.

The staff understand that the diversity in practice that currently exists is primarily related to the consistency with which DDMs are applied, rather than being based on concerns over interpreting whether they can be applied at all.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

N/A.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

No.

The staff believe that if the Interpretations Committee believe current IFRSs should be clarified, the most efficient way of resolving the issue would be through an amendment to current IFRSs, and not through the interpretation process.

In part, this is because the staff think that there may be a lack of consistency between the words used in IAS 28 and the words used in IAS 36 relating to the use of DDMs in calculating VIU.

However, more specifically the staff believe the issue is not about how the guidance in IAS 36 should be interpreted, but about how this guidance should be applied in determining an appropriate calculation of VIU.

(e) *It is probable that the Interpretations Committee will be able to reach a consensus on the issue on a timely basis.*

Yes. The staff think it is probable that the Interpretations Committee would be able to reach a consensus on this issue on a timely basis.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the committee requires to complete its due process.*

Not applicable.

The IASB does not have any current or planned projects on its agenda that are expected to address this issue.

19. Based on the assessment of the agenda criteria, the staff recommend that the Interpretations Committee should not add the issue to its agenda because current IFRSs are clear.

Assessment against Annual Improvements criteria

20. However, if the Interpretations Committee does not believe that current IFRSs are clear, the staff believe that the Interpretations Committee should recommend that the Board consider an amendment to IFRSs as part of *Annual Improvements*.

21. The staff believe that the Interpretations Committee could recommend that IAS 36 should be amended as part of AIP to clarify that the DDMs can be used in specific circumstances to calculate VIU.

22. This is because the change:

    (a) is **non-urgent**, because the staff believe that the amendment would clarify, and not change, an existing principle, and nor would it introduce a new principle into IFRSs; and

    (b) may be viewed as **necessary** by the Interpretations Committee if they conclude that IAS 36 does not provide clear guidance relating to this issue.

23. Consequently, the staff believe that a proposed improvement would meet the existing criteria for inclusion in the 2010-2012 *Annual Improvements*.

24. However, in addition to believing that current IFRSs in relation to this issue are clear, the staff also have concerns with recommending an improvement to IFRSs, because:

    (a) an amendment to specifically identify that the DDMs can be used may lead to additional questions relating to whether other alternative valuation approaches can be applied to determine VIU; and

    (b) of concerns that any additional guidance on when it may be appropriate to apply DDMs may lead to the creation of rules, rather than requiring constituents to continue applying the current principles and judgements in IAS 36.

Staff recommendations

25. Based on the Interpretations Committee agenda criteria assessment, the staff recommend that the Interpretations Committee should not add this issue to its agenda because the current principles and guidance in IAS 36 are clear. As a result, the staff do not believe that significant diversity exists in practice regarding the application of the principles in IAS 36.

26. However, if the Interpretations Committee disagree with the view of the staff, the staff think that the Interpretations Committee could recommend that the Board should make an amendment to IAS 36, or IAS 28 as part of AIP.

27. The staff provide the draft wording for the proposed tentative agenda decision in Appendix A.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee not add this issue to its agenda? If not, how does the Interpretations Committee recommend the staff to proceed? 2. Does the Interpretations Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A – Proposed wording for tentative agenda decision

A1. The staff proposes the following wording for the **tentative** agenda decision:

IAS 36 *Impairment of Assets* – Calculation of value in use

The Interpretations Committee received a request for clarification on whether, in specific facts and circumstances, dividend discount models (DDMs) are compliant with the IAS 36 requirements to determine a value in use when performing an impairment test of a subsidiary in the consolidated financial statements of a parent.

The Interpretations Committee noted that paragraphs 30 – 57 and Appendix A of IAS 36 provide guidance on the principles to be applied in calculating value in use. Entities should use their judgement to determine whether, in specific facts and circumstances, application of DDMs to calculate value in use is consistent with the principles in IAS 36.

The Interpretations Committee concluded that the current principles in IAS 36 relating to the calculation of value in use when performing an impairment test of a subsidiary are clear and that the request relates to the implementation of those principles. Consequently, the Interpretations Committee does not expect significant diversity in practice relating to this issue. Therefore, the Interpretations Committee [decided] not to add the issue to its agenda.

Appendix B – Request for the Interpretations Committee agenda

B1 The staff received the following Interpretations Committee agenda request[4]. All information has been copied without modification.

ISSUE

1. The issue relates to the determination of the value in use of a Cash Generating Unit (CGU) that coincides with a legal entity (i.e. a bank or an insurance company).
   Paragraph 33 of IAS 36 states that:
   "In measuring value in use an entity shall:
   (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…"
   The issue regards the interpretation of "*cash flow projections",* in particular: are the estimated future cash flows expected to arise from dividends a "*cash flow projections"?*
   In other words, is the Dividend Discount Model – Excess Capital version[5] (DDM) compliant with IAS 36 requirements?

CURRENT PRACTICE

2. The issue could be addressed following two different views.

   View A

3. Only the Discount Cash Flow (the DCF) model is compliant with IAS 36 requirements.
   According to view A, the DDM is not compliant with IAS 36.33 because:
   - IAS 36 does not mention the DDM and therefore the only acceptable model is the the DCF (Value in use is defined as: *the present value of the future cash flows expected to be derived from an asset or cash-generating unit*);
   - the DDM can be used only in determining the value in use of investments in associates, because IAS 28.33 clearly states that: "…*an entity estimates*:

[4] OIC – ORGANISMO ITALIANO DI CONTABILITA

5 The Dividend Discount Model – Excess Capital version (DDM) determines the value of a company on the basis of future cash flows which may be distributed to the shareholders in compliance with the capital requirements provided by the law, discounted at a rate expressing the cost of risk capital.

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or
(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.
Under appropriate assumptions, both methods give the same result."

View B

4. According to view B, the DDM is compliant with IAS 36.33 because:
   - in a broad sense, expected cash flows which may be distributed to the shareholders in compliance with the capital requirements provided by the law are "*cash flow projections*". In determining the value in use of a CGU an entity assumes that the carrying amount of such a CGU will be recovered by the cash flows that the CGU will generate during its useful life. IAS 36 does not forbid considering the future cash flows which may be distributed. Therefore the DDM, and others valuation models based on expected cash flows, under appropriate assumptions, can be compliant with IAS 36 requirements;
   - the DDM is more sophisticated than the the DCF model because it requires consideration of additional factors such as capital requirements of CGUs
   - as stated in IAS 28.33, under appropriate assumptions, both methods (the DCF and DDM) give the same result.

REASONS FOR THE IFRIC TO ADDRESS THE ISSUE:

5. The outreach shows us that the issue seems to be widespread because the DDM is applied in many jurisdictions, mainly financial institutions apply this approach.
6. The issue seems to have practical relevance given the impacts of impairment tests on the entities' financial results especially in this period of financial crisis.
7. The outreach shows us that there are divergent interpretations of "cash flow projections": a narrow interpretation (only the the DCF model is compliant with IAS 36 requirements) and a broad interpretation (DDM and others valuation models based on expected cash flows, can be compliant). The elimination of these divergent interpretations would improve the financial reporting.
8. The issue seems to be sufficiently narrow in scope, therefore we think that IFRIC will be able to reach a consensus on the issue on a timely basis.
9. The issue does not relate to a current or planned IASB project.