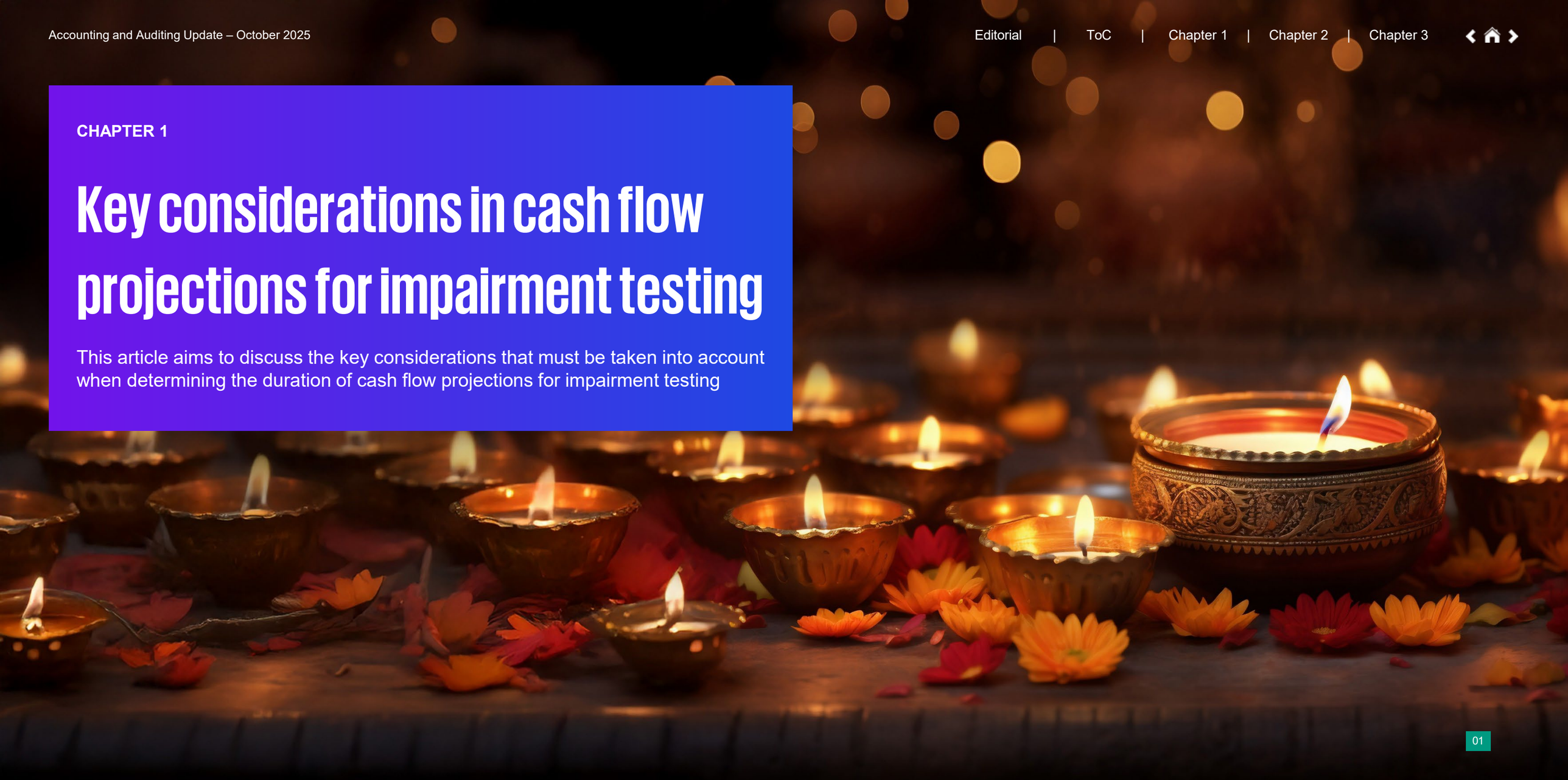
CHAPTER 1

Key considerations in cash flow projections for impairment testing

This article aims to discuss the key considerations that must be taken into account when determining the duration of cash flow projections for impairment testing



Introduction

In the evolving landscape of financial reporting, impairment testing of goodwill and other assets remains a critical area of judgement and regulatory scrutiny. Impairment testing plays a vital role in financial reporting, ensuring that assets are valued at their recoverable amounts and reflect their true economic worth. This not only supports sound financial reporting but also enhances the credibility of the financial statements. Impairment assessment is also a key requirement under accounting standards.

A critical aspect of this process is the determination of future cash flow projections - through value in use (ViU) or fair value less costs of disposal, that form the basis for assessing the recoverable amount of assets such as goodwill, intangible assets, and property, plant, and equipment. Given their forward-looking nature, these projections require careful assessment, as they reflect management's expectations of future economic benefits.

Essential aspects to consider when projecting cash flows

Paragraph 33 of Ind AS 36, *Impairment of Assets*, requires that cash flow forecasts be based on reasonable and supportable assumptions, reflecting management's best estimate of the economic conditions that will exist over the asset's remaining useful life.

Further, as per paragraph 35 of Ind AS 36, the forecast period for cash flow projections should generally not exceed five years because detailed, explicit and reliable financial budgets/forecasts for periods longer than five years are generally not available. A longer period may be used by the management only if the management's ability to forecast cash flow projections over that longer period can be demonstrated with reliable evidence, based on past experience to forecast accurately over such longer period. These principles are designed to ensure that impairment assessments are not overly optimistic and reflect a realistic view of asset performance.

Companies should consider using the latest financial budgets or forecasts that have been formally approved by management. Cash flow estimates should exclude anticipated benefits from future restructurings or operational enhancements that have not yet been committed. Furthermore, projections should avoid reliance on uncertain future events - such as regulatory approval - unless there is objective evidence to support their likelihood.

The European Securities and Markets Authority (ESMA) at regular intervals publishes enforcement decisions which are designed to inform market participants about which accounting treatments are considered to be complying with International Financial Reporting Standards (IFRS). Ind AS 36 is closely aligned with the principles of equivalent IFRS standard. The practical challenges and regulatory expectations in relation to evaluation of appropriateness of cash flow projections are illustrated by way of couple of cases published as part of ESMA's enforcement decisions.

Case 1: impairment test of goodwill – evaluation of forecast period

Company A (the Company) is a developer and seller of IT hardware components. The Company has significant goodwill, majority of it originating from a business acquired in 2017. The acquired business focussed on the development of solutions in the automotive industry and was largely in the development phase.

For the annual impairment test, the Company has been using a 9-year cash flow forecast to measure the value in use (ViU), starting from 2018. The cash flow projections includes revenues resulting from future sales of new technology products.

The Company justified the extended forecast period by citing the long development cycles in the automotive industry due to extensive quality testing, regulatory changes and the time required to develop technologies and patents before generating revenue. These forecasts projected most sales and operating profits toward the end of the forecast period. Each year, the forecast is rolled forward by one year, with the expected cash flows not materialising.

In 2020, the Company recognised partial impairment of goodwill due to COVID-19. In 2021, no impairment was recorded as the Company continued to use the 9-year forecast. By the end of 2022, further impairment was recognised due to increased discount rates and revised expectations that cash flows would be delayed due to macroeconomic factors.

In the given instance, the enforcement decision considered the following:

- The requirements of paragraphs 33(b) and 35 of International Accounting Standard (IAS) 36, *Impairment of Assets*, (mirrored in Ind AS 36) state that the cash flow projections should cover a maximum period of 5 years.
- Paragraph 35 further clarifies that reliable financial budgets and forecasts for periods longer than 5 years are generally not available, and management must be able to demonstrate, based on past experience, its ability to forecast cash flows over a longer period.
- The Company's inability to realise earlier projections and reliance on deferred cash flows undermines the credibility of its long-term forecasts.
- The material impairment recognised in 2020 supported the enforcer's view that the issuer could not justify a 9-year projection period.

Based on the above, the enforcer concluded that the Company was not able to demonstrate its ability to forecast cashflows over a period as long as 9 years. Consequently, the Company corrected the cash flow forecast, reducing the projection period to 5 years, which resulted in an additional impairment of goodwill.

[Source: Adapted decision ref EECS/0126-03 with modifications from ESMA, 30th Extract from the EECS's Database of Enforcement, Reference No. ESMA32-193237008-9182, dated 27 June 2025]

Case 2: cash flow projections for an asset in context of its useful life

Company B (Company) operates in the renewable energy sector, primarily producing electricity from wind and solar farms. It depreciates the wind plants over their useful life of 25 years, while the related concession rights are amortised over 29 years. These concessions are essential for the ongoing operation of the wind farms.

For impairment testing, the Company treats each wind farm as a separate cash-generating unit (CGU) and calculates the recoverable amount based on ViU. In 2022, no impairment was identified, however, the Company's approach to determining ViU involved projecting cash flows over a 49-year period which is significantly longer than both the plant's useful life and the concession period. This extended projection period was justified by the Company on the basis of continuous technological evolution in this industry, ongoing maintenance of the plant and the implementation of refitting measures (extension of the service life) could lead to an extension of the useful life of wind farms. Furthermore, the Company expects the concessions will be renewed.

In its impairment model, the Company explicitly forecasted operating cash flows for 29 years (the concession period) and then estimated a terminal value representing the net present value of cash flows generated during an additional 20-year period after the concession's expiry.

In the given instance, the enforcement decision considered the following:

- Paragraph 33(a) of IAS 36 (mirrored in Ind AS 36) requires projections to be based on reasonable and supportable assumptions which should reflect management's best estimate of economic conditions over the asset's remaining useful life. In the present case, the Company had no evidence about the extension of the useful life of the plant and/or of the concession for a total period of 49 years.
- Further, as per paragraph 49 of IAS 36 (mirrored in Ind AS 36), when a CGU consists of assets with different useful lives, and all are essential to its operation, the projection period should not exceed the longest useful life of an essential asset.

Consequently, the enforcer rejected the forecast period used by the Company (i.e., 49 years) and concluded that the cash flow projections should not exceed the useful life of assets essential to the ongoing operation of the CGU (i.e., the concession).

[Source: Adapted decision ref EECS/0126-03 with modifications from ESMA, 30th Extract from the EECS's Database of Enforcement, Reference No. ESMA32-193237008-9182, dated 27 June 2025]

Bottom line

To ensure compliance with Ind AS 36, companies should use reasonable and supportable assumptions based on management's best estimates of future economic conditions, entity-specific circumstances and ensure assumptions reflect realistic expectations, not overly optimistic scenarios.

Since the reliability of assumptions tends to diminish over longer horizons, cash flow projections exceeding five years should be avoided unless management can demonstrate that projections beyond five years are reliable and supportable - common in industries with long-term contracts or regulated environments. In situations where extended periods are used, management should maintain clear documentation of the forecasting approach, assumptions, and rationale.

The ESMA decisions discussed above underscore the importance of aligning cash flow projections with asset lives and ensuring that extended forecast periods are justified with reliable and objective evidence. They also reinforce the principle that speculative assumptions - such as future legislative changes or concession renewals - must be substantiated to be considered in impairment testing.

In summary, robust and evidence-based determination of cash flow projection periods is essential for reliable impairment testing and compliance with accounting standards.