

# Impact of COVID-19 on impairment assessments

## Reporting Update

26 June 2020, 20RU-015



### **COVID-19 will result in indicators of impairment for many entities**

#### Highlights

- Significant judgment will be required to estimate the effects of COVID-19 on recoverable amount calculations
- COVID-19 could impact the timing of indicator based impairment testing
- Determining reasonable earnings multiples may be complex
- Disclosures on judgments and estimates are expected to be increased

The spread of COVID-19 has seen an unprecedented response by governments, regulators and numerous industry sectors in Australia and around the world. The Australian response to this pandemic has seen the closure of our international and state borders, significant restrictions on corporate Australia's ability to operate, volatility and instability in financial markets and significant economic slowdown and uncertainties.

Impairment of non-financial assets is a key area of focus for entities, stakeholders and regulators alike. The effects of COVID-19 will result in indicators of impairment for many entities, driving an increase in impairment testing.

In this reporting update we summarise some of the key impacts of COVID-19 on impairment assessments through a series of frequently asked questions and provide our insights from recent experience.

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## Recoverable amount cash flows

*Higher of value in use (VIU) and fair value less costs of disposal (FVLCD)*

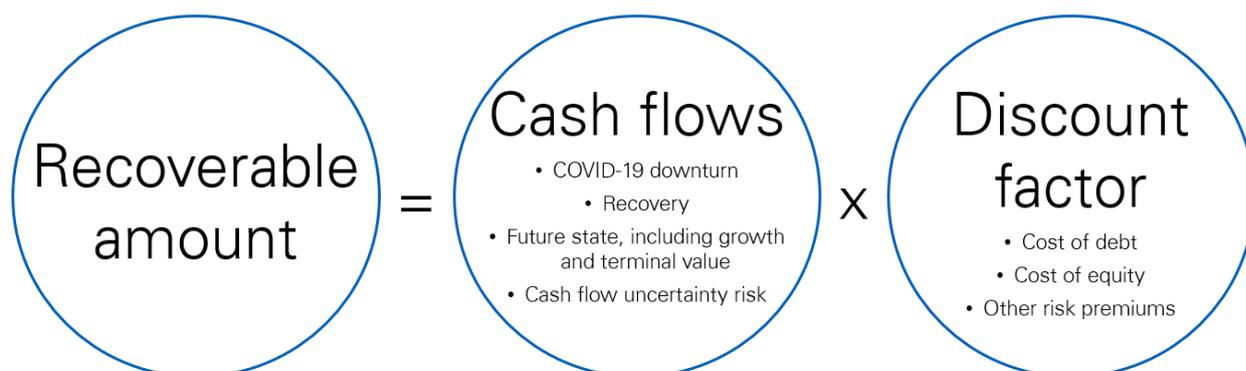
AASB 136 *Impairment of Assets* defines recoverable amount as the higher of VIU and FVLCD. Value in use (VIU) is the present value of the future cash flows expected to be derived from the continuing use and ultimate disposal of that asset or cash generating unit (CGU). Fair value less costs of disposal (FVLCD) is the price which would be received to sell that asset or CGU in an orderly transaction between market participants.

### Could COVID-19 impact which is higher – FVLCD or VIU?

Whilst there is potential upside in the nature of the cash flows which can be included in FVLCD, such as cash inflows relating to expansionary capital expenditure, the fundamental principle is that the FVLCD cash flows reflect the expectations of a market participant.

If market sentiment indicates that a market participant may be more pessimistic than management in their valuation of the business given the increased level of uncertainty it is possible that a FVLCD may be lower than VIU. Entities could see a shift between which is higher, FVLCD or VIU.

Entities may need to calculate both VIU and FVLCD when performing impairment assessments if the usual method used does not support the carrying amount of the asset or CGU. If there are significant differences between VIU and FVLCD these should be understood and supported.



## How will COVID-19 impact cash flow forecasts?

The determination of recoverable amount is underpinned by a number of assumptions. VIU and FVLCD discounted cash flow models incorporate management’s budgets or forecasts and market inputs such as inflation, GDP growth rates, foreign exchange rates and market prices where relevant.

A number of significant judgments will need to be made to estimate the impact of COVID-19 on forecast cash flows. Some of the key assumptions to think about are outlined below.



<p><b>COVID-19 downturn</b></p>	<p>It is unknown how long the period of downturn will be. This will be influenced by a variety of factors, including government restrictions, the potential for a “second wave” and other factors. A best estimate of the period of downturn will need to be made based on information that is reasonably available at period end. The revenue a business earns and costs it incurs may be impacted by this downturn. Some things to think about include:</p> <p><i>Revenue</i></p> <ul style="list-style-type: none"> <li>• Impact of government restrictions</li> <li>• Changes in consumer habits and impact on demand</li> <li>• Supply chain disruptions impacting product availability</li> <li>• Business response and adaptation to market changes i.e. discontinued and/or new products or service lines</li> <li>• Government stimulus</li> </ul> <p><i>Costs</i></p> <ul style="list-style-type: none"> <li>• Production capacity e.g. impact of social distancing, travel restrictions and illness of employees</li> <li>• Business restructuring</li> <li>• Impact on supply chains</li> </ul> <p><i><b>Our observations:</b> The impact of the downturn on operations will depend on the industry an entity operates in. For a diversified business with multiple revenue streams, the period of downturn could vary for each revenue stream.</i></p>
<p><b>Recovery</b></p>	<p>Following the downturn, there will be a period of recovery as business operations pick up and head towards a new normal. Entities will need to estimate:</p> <ul style="list-style-type: none"> <li>• The period of recovery</li> </ul>

- The pace of recovery.

The severity of the impact of COVID-19 related events will vary by entity, industry sector and jurisdiction. As a result, entities may anticipate various recovery patterns.

			
<b>Hard reset:</b> Struggle to recover	<b>Transform to re-emerge:</b> Likely to recover over a protracted period	<b>Modified business as usual:</b> Suffer effects but recover quickly	<b>Surge:</b> Scale aggressively post-COVID-19

The expectation surrounding the period and rate of recovery may be informed by the period of time the entity has been in downturn and the impact of the gradual opening up of economies in the lead up to period end.

**Could the period of forecast cash flows be extended beyond 5 years?**

For a VIU approach, cash flow forecasts should cover a maximum of 5 years, unless a longer period can be justified. The final year of cash flows used to determine a terminal value should be representative of expected future steady state cash flows. Therefore, if an entity estimates that cash flows would not have returned to steady state within 5 years, then cash flow forecasts beyond 5 years may be justified. There may be additional forecasting risk when estimating cash flows beyond 5 years and associated risk adjustments considered.

$$\text{Value in use} = \text{Forecast period (Typically a maximum of 5 years)} + \text{Terminal value (Steady state cash flows extrapolated into the future)}$$

**Our observations:** *The expected period of recovery for individual entities and sectors is wide ranging and estimates are constantly changing. At present we are seeing a range of recovery expectations across a population of sectors starting as early as 2021 through to 2024. Therefore we anticipate most entities would not need to extend cash flow forecasts beyond 5 years, however there may be exceptions to this, such as more heavily impacted sectors requiring a hard reset.*

**Future state**

There is a lot of discussion over what the “new normal” will look like and whether it is reasonable to expect that operations will return to levels consistent with pre COVID-19.

Entities will need to consider whether there is expected to be a sustained change in the demand for the goods or services which they provide, and the resources required to support the business into the future and how this impacts revenue and costs. Entities should be balanced in their estimation, and assumptions should be supported by information which is reasonably available at period end. Being overly pessimistic when it might be “too early to tell” could result in impairments being incorrectly recognised or overstated, and being overly optimistic could see impairments not recognised or understated.

Some key areas to think about may include:

- *Ways of working* – Does remote working become the new normal and in office/business become the exception?

	<ul style="list-style-type: none"> <li>• <i>Labour force</i> – Will displaced jobs come back? Will automation accelerate? This will be particularly relevant where business restructurings have been undertaken</li> <li>• <i>Digital commerce</i> – Is this the tipping point for the dominance of the digital economy over the physical economy? Consumer habits could permanently change forcing business transformation</li> <li>• <i>Supply chain and manufacturing</i> - Will existing supply chains return to normal or be reconfigured? Entities may diversify their supply chain to reduce reliance on one country, seeing an impact on cost to operate</li> <li>• <i>Globalization</i> - Will countries increasingly look inwards for prosperity? Entities may increasingly produce goods locally and use local labour to bolster resilience against disruptive events, however potentially at the cost of limiting the flow of talent cross-borders.</li> </ul> <p>There are many possible outcomes, however recoverable amount cash flows can only reflect what is reasonably expected at period end based on reasonable and supportable assumptions. Refer also to <a href="#">How is cash flow uncertainty risk factored into the recoverable amount?</a> Entities also need to consider any VIU or FVLCD modelling limitations when forecasting future cash flows.</p> <p><i>Growth</i></p> <p>Growth assumptions could impact both the shorter term forecast period and the calculation of terminal value. Practice in the past may have been to incorporate historic growth into future growth assumptions in combination with other factors such as GDP and inflation forecasts. Historic growth may no longer be a relevant input when estimating future growth. Changes to GDP and inflation forecast have also been observed.</p> <p>In Australia long term inflation forecasts have been trending downwards, with previous reasonable ranges of 2-3%, now closer to 2-2.5%. Entities should ensure they consider market information of growth for their industry when determining these assumptions.</p> <div style="border: 1px solid purple; border-radius: 10px; padding: 5px; margin: 10px 0;"> <p><b><i>Our observations:</i></b> A decrease in long term growth rates in some industries influenced by declines in current GDP/inflation forecasts.</p> </div> <p><i>Terminal value</i></p> <p>The value attributed to the terminal value of an asset or CGU makes up a significant proportion of VIU. The inputs to terminal value are going to be key assumptions, and include:</p> <ul style="list-style-type: none"> <li>• Forecast steady state cash flows</li> <li>• Growth rate; and</li> <li>• Discount rate – refer to <a href="#">Discount rate</a> section.</li> </ul> <div style="border: 1px solid purple; border-radius: 10px; padding: 5px; margin: 10px 0;"> <p><b><i>Our observations:</i></b> The proportion of a CGU’s value attributed to the terminal value may increase as a result of a decline in value from the explicit cash flows due to the impacts of COVID-19.</p> </div>
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### What independent sources of information could inform cash flow modelling assumptions?

Judgments and estimates about the future should be based on reasonable and supportable assumptions based on reliable information that is reasonably available at period end. The impairment

accounting standard places greater emphasis on external rather than internal information that supports these expectations.

Some reliable independent sources of information a company can turn to, to inform them or support future expectations include the following:

- Government announcements of phases for lifting restrictions
- Economists' forecasts – Including Morgan Stanley, Moody's Analytics, Big 4 banks, BIS Oxford Economics, The Economist Intelligence Unit, IMF World Economic Outlook, Bloomberg
- Publicly available government modelling
- Reserve Bank of Australia
- Australian Bureau of Statistics
- Analysts commentaries
- Specific Industry group forecasts
- Media releases of peer companies

### How is cash flow uncertainty risk factored into the recoverable amount?

Cash flow uncertainty in recoverable amount models can be adjusted for in either the cash flows or the discount rate. There are two recoverable amount DCF models that are used in practice:

- One set of "Most likely" cash flows, discounted at a discount rate that is adjusted for cash flow uncertainty risk
- Probability weighting of multiple cash flow scenarios, discounted at discount rates that exclude cash flow uncertainty risk (also known as the Expected cash flow approach).

The following case study illustrates each of these approaches.

#### Case study

An entity assesses a restaurant as a CGU for impairment testing purposes. On 23 March 2020, Australia moved to stage 1 restrictions requiring the closure of all restaurants. At 30 June 2020, the restaurant has re-opened however is not operating at full capacity due to social distancing restrictions. The following are considered key areas of uncertainty in forecasting future cash flows:

- Period of downturn and revenue during downturn
- Period of recovery and revenue during recovery
- Future steady state

#### Option 1: Most likely cash flow approach

The valuation is based on a single "most likely" cash flow and cash flow uncertainty risk is adjusted for in the discount rate. Value in use is \$1,031,000 based on the following assumptions:

	<b>Most likely cash flow assumptions</b>
<b>Downturn</b>	<ul style="list-style-type: none"> <li>• \$1,080,000 revenue p.a. (10% reduction in pre-COVID 19 revenue)</li> <li>• Downturn ends mid-2021</li> </ul>
<b>Recovery to steady state</b>	<ul style="list-style-type: none"> <li>• Recovery by mid-2022</li> <li>• Recovery is steady</li> </ul>
<b>Future steady state</b>	<ul style="list-style-type: none"> <li>• \$900,000 dine-in revenue p.a. (return to pre-COVID 19 revenue)</li> <li>• \$330,000 take-away revenue (10% increase on pre-COVID 19 revenue)</li> </ul>
<b>Discount rate</b>	14%: Including an adjustment for cash flow uncertainty risk
<b>Terminal growth</b>	2.5%
<b>Other assumptions</b>	Gross profit margin of 20%, operating costs equal to 10% of revenue

### Option 2: Expected cash flow approach

The valuation is based on multiple probability weighted cash flows. Cash flow uncertainty risk is reflected in the cash flows, therefore the discount rate excludes cash flow uncertainty risk. Value in use is \$1,053,000<sup>11</sup> based on the following assumptions:

	Low case	Base case	High case
<b>Downturn</b>	<ul style="list-style-type: none"> <li>\$600,000 revenue p.a.</li> <li>Downturn ends by the end of 2021</li> </ul>	<ul style="list-style-type: none"> <li>\$1,080,000 revenue p.a.</li> <li>Downturn ends mid-2021</li> </ul>	<ul style="list-style-type: none"> <li>Downturn ends mid-2020</li> </ul>
<b>Recovery to steady state</b>	<ul style="list-style-type: none"> <li>Recovery by 2024</li> <li>Recovery is gradual and accelerates approaching 2024</li> </ul>	<ul style="list-style-type: none"> <li>Recovery by mid-2022</li> <li>Recovery profile is steady</li> </ul>	<ul style="list-style-type: none"> <li>Recovery by mid-2021</li> <li>Recovery is quick to start and slows</li> </ul>
<b>Future steady state</b>	<ul style="list-style-type: none"> <li>\$630,000 dine-in revenue p.a.</li> <li>\$270,000 take-away revenue</li> </ul>	<ul style="list-style-type: none"> <li>\$900,000 dine-in revenue p.a.</li> <li>\$330,000 take-away revenue</li> </ul>	<ul style="list-style-type: none"> <li>\$900,000 dine-in revenue p.a.</li> <li>\$360,000 take-away revenue</li> </ul>
<b>Discount rate</b>	12%: No adjustment for cash flow uncertainty risk		
<b>Terminal growth</b>	2.5%		
<b>Other assumptions</b>	Gross profit margin of 20%, operating costs equal to 10% of revenue		
<b>NPV</b>	\$794,000	\$1,159,000	\$1,194,000
<b>Probability weighting</b>	30%	60%	10%

### When might it be appropriate to use a most likely vs a probability weighted cash flow approach?

An entity should identify where the key areas of uncertainty are in the cash flow models, and what the reasonably possible changes in those cash flows could be. Where an entity has a clear view on different reasonably possible scenarios and finds it challenging to determine a single “most likely” set of cash flows due to significant uncertainty, it may be appropriate to use the expected cash flow approach which probability weights the cash flow scenarios.

If however an entity considers there to be a lower level of uncertainty in these cash flows, or considers the upside and downside scenarios to be equally likely to deviate by the same percentage from the base case (i.e. +/-10%), then a single most likely cash flow approach with adjustments to the discount rate for cash flow uncertainty risk may be a reasonable approach.

### Are entities more likely to use a probability weighted cash flow approach in the current environment?

It depends. The level of forecasting risk is commonly a factor entities consider when determining how to reflect cash flow uncertainty in a valuation as this informs whether an entity can reasonably determine “most likely” cash flows. Whilst in March 2020 the declaration of COVID-19 as a global pandemic and the commencement of a raft of government imposed restrictions introduced additional uncertainty, the level of this uncertainty has decreased over time as government restrictions are lifted and operations start to resume.

<sup>1</sup> \$1,053,000 = (\$794,000 x 30%) + (\$1,159,000 x 60%) + (\$1,194,000 x 10%)

We expect that some entities significantly impacted by COVID-19 may find it challenging to determine “most likely” cash flows and may change their approach, probability weighting multiple cash flow scenarios to determine “expected cash flows”. However others may continue to determine a single “most likely” cash flow and reflect cash flow risk uncertainty in the discount rate.

***Our observations:*** *As time has passed since March 2020, the extent of uncertainty surrounding the impact of COVID-19 has lessened with the downturn and path forward becoming clearer. Some entities are becoming more comfortable to form a view on the “most likely” cash flows.*

### **Are recoverable amount cash flows updated for events which occur post period end?**

Events that occur post balance date that impact the recoverable amount assumptions should be considered to determine if they represent adjusting or non-adjusting events.

An event is considered to be adjusting if it provides evidence of conditions which existed at period end. To determine whether an event is an adjusting event, entities should consider whether revised assumptions arising from this post balance date event could be reasonably expected to be made as at period end.

For example, an entity performs an impairment test for a football stadium at 30 June 2020. If in mid-July 2020 a government restriction requiring the closure of football stadiums to fans is lifted, to determine whether the cash flows should reflect this the entity considers whether any information was available at 30 June 2020 to indicate the likely removal of that restriction in or around mid-July.

The following factors could indicate the cash flows should reflect the lifting of restrictions in mid-July:

- If the government announced in June that they expect to lift the restrictions in mid-July if certain targets were met; and
- Management’s best estimate based on publically available information at 30 June was that these targets would be met.

There may be significant judgment involved in assessing whether information existed at period end supporting the specific event being reasonably expected at year end.

Where the amounts in the financial statements are not adjusted, entities are required to disclose material non-adjusting subsequent events in the financial report, including the nature of such events and where possible an estimate of their financial effect, or state that such an estimate cannot be made.

## Discount rate

The discount rate used for impairment assessments is based on a market participant's view of the asset or CGU at reporting date. In our experience, the entity's weighted average cost of capital (WACC) adjusted for the risks specific to the asset or CGU is generally used as the discount rate.

### How could WACC be impacted by COVID-19?

The WACC is built up from multiple inputs. In the current environment, there will likely be different directional changes across those inputs. The below table provides some examples of how the effects of COVID-19 in isolation could affect the WACC.

Whilst it is important that entities reflect changes in those inputs in the calculation of WACC, holistically any significant change in the WACC needs to be understood, particularly where an impairment assessment is sensitive to this estimate. Entities should consider whether the change in the WACC aligns with the business' exposure to risk.

**Our observations:** *There has been a decrease in the risk-free rate in comparison to 2019 which in isolation indicates a potential decrease in WACC. In the current environment, the rate of return required by an investor is unlikely to reduce, hence, a decrease in risk-free rate is not expected to drive a decrease in WACC.*

Potential COVID-19 effects	WACC input to review/adjust	Potential change in WACC
Increased credit and liquidity risk of entity	Cost of debt	Increase in WACC
Higher volatility of entity's equity compared to market	Beta	Increase in WACC
Increased cash flow uncertainty and forecasting risk	Increase in specific risk premium (alpha)	Increase in WACC
Lower appetite for risk by market participants*	Market risk premium	Increase in WACC
Decline in government bond rates	Risk-free rate	Decrease in WACC
Increased level of borrowing and therefore leverage	Target capital structure, geared beta and cost of debt	Increase/no change in WACC

\*Investors are commonly risk averse. This means that in times of increased uncertainty, investors may expect the value of an asset to be discounted to compensate for the increase in risk associated with realising the expected future returns from that asset.

**Our observations:** *There are many risks which can impact a valuation. It is important to understand whether and how risks have been reflected in the cash flows to ensure that an appropriate discount rate is used and there is no double counting of risk. Adjusting both the cash flows and discount rate for the same risk would result in an understated valuation and potential inappropriate or overstated impairment.*

## Market capitalisation

Market capitalisation represents the market value of publicly traded shares which is often used as a proxy or a sense check for the valuation of an entity.

Markets have experienced significant volatility as a result of COVID-19 and there is increased discussion around how to make comparisons to market capitalisation.

### Is impairment testing always required when net assets exceeds market capitalisation?

When market capitalisation falls below net assets this is an indicator of impairment, however, this does not automatically lead to impairment testing. It is appropriate to consider and document the magnitude and drivers of the deficiency and whether other indicators of impairment exist to determine whether impairment testing is required.

**Our observations:** *In the current environment, it is likely that a market capital deficiency would be accompanied by other impairment indicators such as decline in demand, suspended or restricted operations, restructurings and supply chain disruptions, and therefore impairment testing will be required.*

### When is it appropriate to perform a reconciliation to market capitalisation?

If the carrying amount of net assets exceeds market capitalisation and no other impairment indicators exist, entities should seek to understand the key drivers of the deficit in order to determine whether detailed impairment testing is required. For example:

- Is the entity thinly traded around balance date such that the market price does not accurately reflect the value of the business at balance date?
- Has an exceptional event, market event or broker commentary driven a reduction in the share price at period end? Is there support that it is not indicative of the value of the business?
- Would a control premium be attributed to a controlling interest in the business that is not reflected in the share price? If so, how much?

Where impairment testing is performed, we would recommend an entity performs a reconciliation between recoverable amount assessments and market capitalisation to understand the basis of any material valuation gaps.

### What are some possible reconciling items between market capitalisation and VIU or FVLCD recoverable amounts?

It is common that recoverable amount and market capital are not aligned. The reason for the gap can differ depending on whether the recoverable amount is based on VIU or FVLCD. Some drivers of differences may include:

VIU	FVLCD
<ul style="list-style-type: none"><li>• VIU focusses on the value from long term use of assets within the entity, whereas market capitalisation is based on share price of minority trades at balance date which may be impacted by short term factors</li></ul>	<ul style="list-style-type: none"><li>• A FVLCD discounted cash flow focusses on the value from long term use of assets which could be realised in an orderly transaction between market participants, whereas market capitalisation is based on share price of minority trades at balance</li></ul>

<ul style="list-style-type: none"> <li>• Market capital is based on the market price of outstanding shares, whereas VIU is management’s perspective of value: <ul style="list-style-type: none"> <li>• Growth rates – VIU assumes a steady growth rate in the extrapolated period beyond the explicit forecast period; this may not align with a market participant’s view</li> <li>• Expansionary capital expenditure – VIU includes maintenance capital expenditure only and excludes enhancements/ expansions; a market participant can reflect the effects of maintenance, enhancements and expansions</li> <li>• Restructuring costs and benefits – VIU excludes the effects of restructuring unless committed; a market participant may include the effects</li> <li>• Approach to debt – The share price and hence market capitalisation reflects the return to equity holders. A VIU is a measure of the business (or enterprise) and reflects the return to debt and equity holders. To reconcile VIU assessments to market capitalisation the debt held by the entity needs to be added back, increasing the market capitalisation to an enterprise value that is comparable with the VIU.</li> <li>• Control premium – An entity’s share price (which is used to calculate market capitalisation) represents the value of one share whereas VIU of a CGU assumes a controlling interest in the whole CGU. In other words, a share price reflects a minority interest. That said, a control premium is not simply added to market capital to explain the gap between VIU and market capital. Differences between VIU and market capitalization are first explained by differences in assumptions, including those referred to above, plus a possible control premium if there is appropriate justification for it.</li> </ul> </li> </ul>	<p>date which may be impacted by short term factors</p> <ul style="list-style-type: none"> <li>• Approach to debt – The share price and hence market capitalisation reflects the return to equity holders. A FVLCD is a measure of the business (or enterprise) and may reflect the return to debt and equity holders or the return to equity holders only, depending on whether a buyer would be required to assume that debt. Depending on the debt assumptions made in the FVLCD, debt held by the entity may need to be added back to market capitalisation so it increases to an enterprise value that is comparable with FVLCD.</li> <li>• Control premium – An entity’s share price (which is used to calculate market capitalisation) represents the value of one share whereas FVLCD of a CGU assumes a controlling interest in the whole CGU. In other words, a share price reflects a minority interest. That said, a control premium is not automatically added to market capital, there must be appropriate justification for it, such as synergies.</li> </ul>
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## Other considerations

### Could COVID-19 impact the timing of indicator based impairment testing?

Yes, it could. Indicator based impairment testing is performed at the end of the reporting period.

It is however common for entities to perform this analysis prior to year end. Where this is the case, it may be appropriate given the significant volatility in market conditions to:

- Re-consider the timing of impairment assessments to align closer to period end; or
- Plan to update the impairment analysis closer to the balance sheet date to consider any new information.

For discussion on how events subsequent to period end are considered refer to [Are recoverable amount cash flows updated for events which occur post period end?](#)

### Can an entity use management's forecast cash flows as the basis for a FVLCD, when these forecasts have been withdrawn from the market?

It depends. Many listed entities have withdrawn previously released earnings forecasts as a result of uncertainty related to COVID-19. Previously it may have been easier to justify a market participant's view of future earnings being aligned with management's forecasts when that information was available to the market, however the withdrawal of forecasts makes this a larger gap to bridge.

The lack of earnings forecasts in the market may also indicate to a market participant that there is additional cash flow risk uncertainty. Entities should consider how to reflect that cash flow risk uncertainty in the valuation i.e. in the cash flows or discount rate.

Notwithstanding the withdrawal of earnings forecasts from the market, internally entities will be continuing to model and determine a strategy for their assets or CGUs. When calculating FVLCD, entities can continue to use management's internal forecasts however will need to consider whether their internal view of future performance is aligned with market sentiment, and make adjustments where appropriate. Part of this analysis could include comparison against market capital of the entity and/or comparable entity earnings multiples, refer also to the [Market capitalisation](#) section for further discussion.

### Is it still possible to use comparable entity earnings multiples to value a business?

Determining reasonable earnings multiples may be complex due to the impacts of COVID-19. If performance metrics have been adjusted to take into account lower expected performance, an appropriate multiple should be applied rather than a multiple derived from comparable public companies whose results have not yet been updated to included lower expected performance. In addition, it may no longer be appropriate to give significant weight to multiples implied by recent transactions (especially those from before the expansion of COVID-19).

The impacts of the new leases standard is also now starting to flow through to earnings, adding an additional layer of complexity when identifying comparable entity earnings multiples. AASB 16 *Leases* was effective for years beginning on or after 1 January 2019. Depending on the date entities adopted the new leases standard, their most recent annual results could either be based on the new or old leases standard, therefore may or may not provide a comparable earnings multiple.

### **When an external expert provides a fair value range for the valuation of an asset or CGU, is the mid-point in the range a reasonable estimation of fair value?**

It depends. Many external valuations present a fair value range in their valuation report. The mid-point of that range is often the stated point-estimate of value by the valuer. Entities need to consider what point within that range is most representative of fair value under current market conditions.

Given the increased level of uncertainty as a result of COVID-19, for some entities, it may be appropriate to pick a point lower within the fair value range if this aligns with a market participant's view of fair value.

***Our observations:** Given the uncertainties that exist, we consider that for certain assets, fair value may currently be skewed to the downside in a range. Therefore, entities should not automatically default to the mid-point in the range but consider the appropriate point estimate of value. The lower end may better reflect fair value where there is increased risk aversion of market participants.*

### **Are adjustments required to an external valuation that includes a valuation uncertainty disclaimer due to the impact of COVID-19?**

Both FVLCD and VIU valuations are required to incorporate cash flow uncertainty risk. If a disclaimer is included in a valuation report, entities need to understand that disclaimer and whether and how risk associated with COVID-19 has been reflected in the valuation. For example, has uncertainty associated with COVID-19 been reflected in the valuation and the disclaimer is to draw attention to the effects of COVID-19 being uncertain, or have uncertainties associated with COVID-19 not been reflected in the valuation. Where uncertainty risk associated with COVID-19 has not been reflected in the valuation, adjustments will be required to comply with the accounting standards. Refer also to [How will COVID-19 impact cash flow forecasts?](#)

### **Can the recoverable amount determined in the prior period be used to assess indefinite life intangible assets and goodwill for impairment in this environment?**

Whilst AASB 136 allows the most recent calculation of recoverable amount determined in a preceding period e.g. 30 June 2019 or 31 December 2019 to be used for indefinite life intangible assets and goodwill, this is subject to certain criteria being met.

Given the significant economic impact of COVID-19 on entities, we expect that many entities will be unable to rely on the preceding period calculation of recoverable amount at 30 June 2020.

## Disclosures

### Are more disclosures expected in the financial report as a result of COVID-19?

Yes. It is expected that the level of disclosure on judgments and estimates be increased as a result of the additional uncertainty associated with the impact of COVID-19.

Detailed disclosures around judgments and estimates relating to impairment assessments are required where there is either an impairment recognised, or an impairment test has been mandatorily performed due to the existence of goodwill or an indefinite life asset. AASB 101 *Presentation of Financial Statements* similarly requires disclosure of assumptions made about the future, and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets. Disclosures about assumptions used and the sensitivity of the carrying amount of assets to those assumptions are expected, refer to the question below for further detail.

**Our observations:** *We have seen an increase in judgment and estimates disclosures as a result of the estimation uncertainties associated with the impacts of COVID-19. Entities approach their disclosures relating to COVID-19 in different ways. Where the impact affects multiple areas within the financial statements, some entities have chosen to present a single note on the effects of COVID-19 which covers multiple financial statement items. In other cases the estimation and judgment associated with the effect of COVID-19 are included in the relevant notes.*

### What are the nature of disclosures expected on recoverable amounts and impairment assumptions?

The purpose of these disclosures are to give a user an understanding of the impairment approach and key assumptions made to enable them to make their own assessments about the carrying values of an entity's assets and the risk of impairment given the uncertainty which exists. The nature of disclosures expected related to COVID-19 includes:

<b>Key assumptions</b>	Management's approach to determining the value of key assumptions made underpinning recoverable amount will be key to a user's understanding. Disclosures providing details of these key assumptions could include: <ul style="list-style-type: none"><li>• The period of the expected downturn (e.g. 2, 3, 6 or more months)</li><li>• The extent of the expected downturn and impact on financial results (e.g. temporary closure, sales and profits reduced by 50% of historical operating levels)</li><li>• The period and pace of recovery (e.g. 6, 12 or 24 months before performance returns to steady state levels with the most significant increase in performance expected in the last X months of this period)</li><li>• Expectations for future state (e.g. above or below pre-COVID levels and details of terminal value assumptions including growth rates)</li><li>• Discount rate used including explanations for directional changes since previous periods</li><li>• Other assumptions in the cash flow forecasts to which the recoverable amount is sensitive.</li></ul>
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<p><b>Approach to cash flow uncertainty risk</b></p>	<p><i>If the most likely approach is used:</i></p> <ul style="list-style-type: none"> <li>• Disclosure that one most likely scenario has been modelled</li> <li>• Details of the key assumptions in that most likely scenario</li> <li>• Additional disclosures about the significant estimation uncertainty and judgments made to determine the discount rate risk premiums should also be considered.</li> </ul> <p><i>Probability weighted cash flows:</i></p> <ul style="list-style-type: none"> <li>• Disclose that multiple scenarios have been modelled and probability weighted</li> <li>• Details of the scenarios modelled e.g. how many scenarios and what do they represent i.e. base case, downside and upside scenarios</li> <li>• Key assumptions modelled in these scenarios – similar to those in the key assumptions above</li> <li>• The probability weighting assigned to each scenario.</li> </ul>
<p><b>Sensitivity</b></p>	<p>Sensitivity of the recoverable amount and any associated impairment to key assumptions. One way to quantify sensitivity is to present the effect of reasonably possible changes in key assumptions where that change would cause the carrying amount of the asset or CGU to exceed its recoverable amount.</p>
<p><b>External sources of information</b></p>	<p>Entities should articulate how they have determined the reasonableness of their assumptions. For example, assumptions have been determined after considering the latest economist forecasts, government modelling, industry, analyst or peer group publicly available information and assumptions are consistent with industry expectations/trends.</p>

## 20RU-015 Impact of COVID-19 on impairment assessments

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