COVID-19 | Have non-financial assets become impaired

(e.g. PPE, intangible assets and goodwill?)

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What's the issue?

Trigger for impairment testing

Many countries are implementing stringent measures to contain the spread of the COVID-19 coronavirus. These measures have significantly affected economic activity and sentiment, disrupting the business operations of companies worldwide – particularly those that:

- have been hit by a fall in demand for their products or services, or by restrictions imposed by the state;
- are dependent on supply chains or have production facilities in countries significantly affected by COVID-19; and/or
- trade with countries significantly affected by COVID-19.

The rapid deterioration in the economic environment and the increase in uncertainty in the macroeconomic and business outlook have triggered high volatility in stock markets worldwide accompanied by significant fluctuations in certain foreign exchange rates and commodity prices. As a result, the likelihood that a triggering event has occurred in 2020 and therefore that an impairment test is required has increased significantly.

IAS 36 *Impairment of Assets* requires a company to assess at the end of each reporting period whether there is any indication of impairment (or an indication that a previously recognised impairment loss has reversed).

Irrespective of any indicator of impairment, IAS 36 requires goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use to be tested for impairment at least annually. The annual test is required *in addition* to any impairment tests performed as a result of a triggering event.

An impairment loss recognised for goodwill is not reversed in subsequent periods, even if it was recognised in an interim period of the same financial year.

Challenges in estimating cash flows

When a triggering event has occurred, management needs to determine the recoverable amount (the higher of VIU and FVLCD[1]) of an asset or cash-generating unit (CGU), which usually requires management to forecast future cash flows. Budgets and cash flow forecasts prepared by management generally serve as the starting point for the discounted cash flows used in calculating the recoverable amount. Significant assumptions, such as forecast sales volumes, prices, gross

1. VIU: value in use; FVLCD: fair value less costs of disposal.

Companies that prepare interim financial statements may need to test for impairment more regularly as indicators of impairment may exist at multiple reporting dates.

margins, changes in working capital, foreign exchange rates and discount rates will need to be reassessed and updated as appropriate due to the significant changes in economic and market conditions. Cash flows used in determining FVLCD should be updated to reflect the assumptions that market participants would use based on market conditions and information available at the reporting date. *[IAS 36.4, 9, 33, IFRS 13.2]*

Making the estimate could be challenging given the degree of uncertainty about:

- the nature, severity and duration of measures taken to contain or delay the spread of COVID-19;
- how long it could take for business operations and economic activity to return to normal;
- the expected trajectory of the recovery (i.e. how quickly economic growth will resume and the rate of recovery) and the duration of recessions; and
- any lasting impact on the economy or the sector.

Reflecting risks in the discount rate

The discount rate used to discount the forecast cash flows under both VIU and FVLCD may be significantly affected by COVID-19 due to the increase in uncertainty and risks. The discount rate should reflect the impact of changes in interest rates and the risk environment at the reporting date. *[IAS 36.56]*

If the expected cash flow approach is used, the discount rate should exclude risks that have been reflected in the cash flows to avoid double counting.

Getting into more detail

Trigger for impairment testing

IAS 36 applies to a variety of non-financial assets including property, plant and equipment, right-of-use assets, intangible assets and goodwill, investment properties measured at cost and investments in associates and joint ventures[2]. *[IAS 36.2, 4]*

IAS 36 provides examples of indicators of triggering events, including:

- when significant changes have taken place during the period (or will take place in the near future) in the market or in the economic environment in which the company operates and these changes will have an adverse effect on the company; and
- when the carrying amount of the company's net assets is higher than its market capitalisation. *[IAS 36.9–10, 12]*

The effects of COVID-19 have caused a significant deterioration in economic conditions for many companies, and an increase in economic uncertainty for others, which may constitute triggering events.

- Certain sectors have been significantly impacted – e.g. travel, tourism, entertainment, retail, insurance and education.
- Companies in extractive industries may also have been significantly affected by decreases in commodity prices and companies in countries that are economically dependent on these commodities may also be exposed to a greater risk of adverse economic impacts.
- Certain types of investment properties (and right-of-use assets arising from leased real estate) – e.g. retail and industrial properties – may be considerably affected by COVID-19. Tenants that have been forced to suspend operations may

2. The guidance in IAS 28 *Investments in Associates and Joint Ventures* is used to determine whether it is necessary to perform an impairment test for investments in equity-accounted investees. If there is an indication of impairment, then the impairment test follows the principles of IAS 36. *[IAS 28.40–42]*

not be able to pay rent in the near term or may ask to renegotiate a lower rent. They may also become less creditworthy. Similar considerations would also apply for companies that lease assets (e.g. aircraft and shipping vessels) to the transport sector.

Challenges in estimating cash flows

Estimating future cash flows could be particularly challenging for many companies due to the increase in economic uncertainty.

- Under VIU, the cash flow projections should be based 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 or CGU. Greater weight is given to external evidence. *[IAS 36.33(a)]*
- Under FVLCD, the estimates and assumptions used are from the perspective of market participants. *[IFRS 13.22]*

Due to the high degree of uncertainty and resulting challenges in forecasting cash flows, it could be helpful to base those forecasts on external sources such as economic projections by respected central banks and other international organisations, if available.

To cushion the economic and financial market impacts, governments in certain regions and international organisations have committed to fiscal stimulus, liquidity provisions and financial support. Companies will need to understand the terms and status of these provisions and consider what impact they might have on their cash flow projections.

Reflecting risks in the discount rate

COVID-19 might have a significant impact on the risk-free rate and on entity-specific risk premiums (e.g. financing risk, country risk and forecasting risk) used in determining the appropriate discount rate to discount future cash flows. *[IAS 36.A1, A16, A18]*

The risk-free rate is generally based on the yield on government bonds that have the same or similar duration as the cash flows of the asset or CGU. In certain jurisdictions, the yield on long-term government bonds decreased in 2020. However, a decrease in the risk-free rate following a decrease in the yield on government bonds may not translate into declines in a company's discount rate due to possible increases in credit and/or other risk premiums. *[Insights 3.10.300.120]*

For more information, see our article on **fair value measurement**.

Considering the approach to projecting cash flows

Given the uncertain macroeconomic outlook, with scenarios ranging from a relatively quick rebound in economic activity and strong long-term growth, through to a muted recovery or recession followed by slow long-term growth, estimation uncertainty will be significantly higher than normal and there will probably be a wider range of reasonably possible cash flow projections.

Two approaches can be used to project cash flows:

- the traditional approach, which uses a single cash flow projection, or most likely cash flow; and
- the expected cash flow approach, which uses multiple, probability-weighted cash flow projections. *[IAS 36.A4–A14]*

Given the high degree of uncertainty, it may be helpful to consider using an expected cash flow approach as opposed to the traditional approach. Under the traditional approach, cash flows are not adjusted for risk but, rather, risk is reflected in determining the discount rate. Under the expected cash flow approach, uncertainty about future cash flows is reflected in different probability-weighted cash flow projections, rather than in the discount rate. The expected cash flow

The assumptions used in calculating the recoverable amount should be reasonable and supportable, despite the high level of economic uncertainty. To achieve this, management will need to apply significant judgement.

approach inherently requires a more explicit consideration of the wider than normal range of possible future outcomes. *[IFRS 13.B26, IAS 36.A7, Insights 3.10.220]*

Whichever approach a company adopts, the rate used to discount cash flows should not reflect adjustments for factors that have been incorporated into the estimated cash flows and vice versa. Otherwise, the effect of some factors will be double counted. *[IAS 36.55–56]*

Impact on useful life and residual value

If recent events have changed a company's usage or retention strategy for any of its property, plant and equipment, management should review whether the useful life and residual value of these assets, and the depreciation method applied to them, remains appropriate. This review may also be required after testing a CGU or an asset for impairment. Any such changes are accounted for prospectively as a change in accounting estimate. *[IAS 16.61, Insights 3.10.350.30]*

Disclosure

Disclosures related to impairment testing are likely to be a focus area for regulators. In a recent statement ESMA[3], the European regulator, emphasised the need for transparent and meaningful disclosures related to impairment testing. For more information, see our **web article** on ESMA's enforcement priorities for 2020.

Annual reports

In the context of impairment testing of goodwill and indefinite-lived intangible assets, IAS 36 requires disclosure of the key assumptions used to determine the recoverable amount. Due to the increase in the level of uncertainty, a higher number of key assumptions may need to be disclosed – e.g. if and when a return to pre-crisis cash flow levels is assumed. Management should also consider disclosing how uncertainty was factored into the impairment test.

IAS 36 also requires sensitivity disclosures if a reasonably possible change in a key assumption would cause a CGU's carrying amount to exceed its recoverable amount. Furthermore, IAS 1 *Presentation of Financial Statements* requires disclosure of the key assumptions that a company makes about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year. *[IAS 1.125, 129, 36.134(d)–(f)]*

Because the uncertainty associated with management's assumptions about the future is likely to be significant, it is important that management develops robust disclosures to help users understand the sensitivity of recoverable amount estimates to significant changes in key assumptions affected by COVID-19. For example, it may be appropriate to disclose management's views about the degree of uncertainty associated with the macroeconomic outlook (such as the severity and duration of the impact that COVID-19 is expected to have on the company's business). The scale of reasonably possible changes in the key assumptions may be larger than usual. *[IAS 1.129(b)]*

Interim condensed reports

IAS 34 *Interim Financial Reporting* requires disclosure of the nature and amount of changes in estimates. **Impairment losses** are examples of events and transactions that require disclosure under IAS 34 if they are significant. As noted in IAS 34, when an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual reporting period, as may be the case with material impairment losses recognised in an interim period, the company's interim financial report should provide an explanation of and an update to the relevant information included in the financial statements of the last annual reporting period. IAS 36 provides relevant disclosures to be considered in this regard. *[IAS 34.15B(b), 15C, 16A(d)]*

3. European Securities and Markets Authority

Actions for management to take now

Consider whether there are any indicators of impairment for the company's CGUs or assets that are tested on a stand-alone basis. In particular, assess:

- the impact of measures taken to contain COVID-19 on the company's business; and
- whether net assets exceed market capitalisation.

Consider whether budgets and cash flow projections reflect the following to the extent applicable to the company, based on information available at the reporting date:

- projections of central banks and other international organisations about the duration and severity of the impact of COVID-19;
- supply of and demand for the CGU's products or services;
- the decline in economic activity;
- the impact of restrictions on transport, travel and quarantines;
- the impact of exchange rates and commodity prices; and
- the fiscal stimulus, liquidity provision and financial support from the state or international organisations, including the potential effects of the withdrawal thereof.

Consider whether discount rates used in recent valuations have been updated to reflect the risk environment at the reporting date.

Consider enhancing sensitivity disclosures and disclosures about the key assumptions and major sources of estimation uncertainty in the interim and annual reports.

Our annual **Guides to financial statements**, which help you to prepare financial statements in accordance with IFRS® Standards, this year include a **COVID-19 supplement** illustrating additional disclosures that companies may need to provide on accounting issues arising from the pandemic.

References to 'Insights' mean our publication **Insights into IFRS**

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