



COVID-19 Impairment Considerations

Introduction

The outbreak of COVID-19 and the impact on the wider economy is placing unprecedented pressure on communities and businesses. Near-term business priorities and focus will be on liquidity and potential going concern issues. However, attention also needs to be paid to the value of balance sheet assets and the requirement to consider whether these are impaired. This is an important consideration for all industry sectors, but particular attention should be paid to those entities that have large property, plant and equipment (PP&E) balances or material goodwill and/or intangible assets. Assessments made about the fair value of such assets a few months ago may no longer be valid. At the very least, they will need to be reconsidered in light of the COVID-19 pandemic and the potential impact this will have on all businesses.

Accounting standards are prescriptive as to how to conduct an impairment review, but in the current environment, there are a number of significant challenges in applying these rules.

What are the challenges?

- Business and asset forecasts will need to be reassessed and updated to reflect the impact of COVID-19. This will be challenging due to increased economic uncertainty.
- How do you update discount rates to reflect the current risk environment? Falls in risk-free rates may not translate into declines in a company's discount rate due to possible increases in credit and/or other risk premiums appropriate to the company's circumstances.
- Which sources can you go to for benchmarking purposes and how reliable are market based observations?
- Should cash flows, discount rates, or both be adjusted? How do you mitigate the danger of double-counting risk adjustments?
- What are your disclosure obligations? Should these be extended to include further sensitivities or other inputs to aid transparency?
- What are the next steps?

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Action	Considerations
Consider whether there is a triggering event or indicator of impairment	<ul style="list-style-type: none"> — Have there been significant changes to the economic environment in which the entity operates? — Is the market capitalization of a company less than its net assets?
Revisit cash flow forecasts	<ul style="list-style-type: none"> — Do budgets and cash flow projections reflect the impact of COVID-19, both in duration and severity? — How will the supply and demand of asset specific and cash-generating unit (CGU) products and services be affected by restrictions on transport, travel and quarantine? — Have forecasts been updated to reflect changes in expectations over exchange rates and commodity prices? — Are assumptions of the entity's ability to continue as a going concern valid? — Have you assessed liquidity needs, debt covenants, and refinancing headroom? — Have you updated key assumptions for the latest view from sector experts, central banks and other international organisations? — Are your cash flow models agile, robust, and reliable enough to reflect changes to key inputs as well as further sensitivities? — Are your financial records (including in-year balance sheet data) up-to-date?

Action	Considerations
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Recalculate discount rates	— Do discount rates used in recent valuations need to be updated to reflect the risk environment at the reporting date?
	— How will you reflect the changes to risk free rates and gearing?
	— Should you include any additional risk premiums to reflect the overall greater uncertainty in forecasting inputs?
	— How will you determine any CGU and asset specific assessments?

Determine the disclosure requirements	— Consider enhancing sensitivity disclosures and disclosures about the key assumptions and major sources of estimation uncertainty in interim and annual reports.
	— Which scenario information and sensitivities details should be disclosed in respect of the impact from COVID-19 on the business' operations and the potential impairment of assets?
	— Are there CGU specific risks that need to be disclosed (e.g. components of the discount rate, operational and other sector specific issues, and potential functional/ economic obsolescence)?

Has there been a trigger event or indicator of impairment?

There are two questions management should consider to determine whether a triggering event has occurred.

- Have significant changes to the economic environment in which my company operates occurred and will these changes have an adverse effect on the company or its assets?
- Has the market capitalization of my company (or my listed peers) fallen below the carrying value of the net assets on the balance sheet?

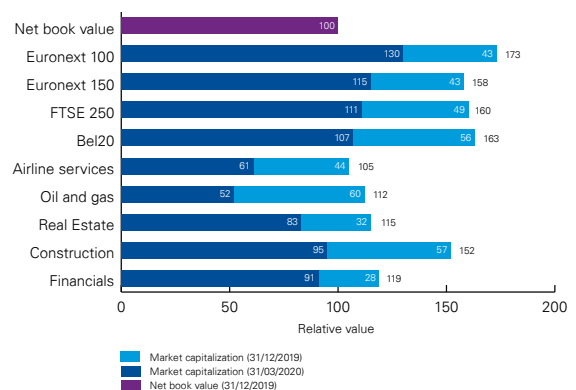
It seems hard to imagine that condition 1 is not met for most companies. COVID-19 has caused a significant deterioration in economic conditions for most companies, and an increase in economic uncertainty for others, which may constitute impairment triggering events. However, such a major economic shock may also trigger events and circumstances not typically assessed as part of the business as usual (BAU) risk and financial reporting process.

For example, COVID-19 may give rise to force majeure events or triggers to material adverse contract clauses which can be the catalyst for asset specific impairments. In our opinion, the cash flows (at least in the near term) of many, if not all, asset classes will be affected by COVID-19. They may also trigger the requirement for impairment tests for PP&E, inventory, financial assets, real estate and investments (including investments in associates and joint ventures). As such, not only will businesses need to accelerate their annual impairment reviews for goodwill and long life intangible assets, but COVID-19 may also trigger impairment events for other balance sheet assets. Not all of these impairment tests are performed under IAS 36 and many asset classes have their own accounting standards which prescribe how the impairment test should be performed. However, the principle that the carrying value cannot exceed the recoverable amount (or fair value) is typically applied.

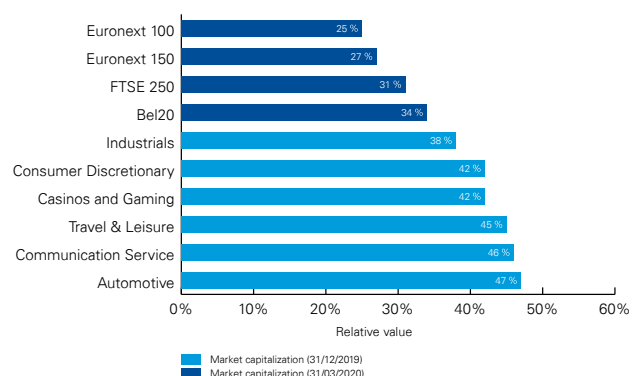
Similarly the market capitalization of almost every FTSE 250 and BEL 20 listed company has fallen in the first quarter of 2020. Some of these falls have been dramatic, meaning that condition 2 is also (potentially) met.

The graphs below illustrate how significant market value falls, for a selection of FTSE 250 companies, have eroded the headroom and, for some sectors, the market capitalization has declined below net book value (NBV).

Sectors whose NBV declined below its market capitalization (rebased to 100)



Selection of sectors with significant market value decline between 31 December 2019 and 31 March 2020



Once this high level assessment has been performed, the areas to focus your work will become more apparent.

In summary, you may need to accelerate your normal annual impairment tests, assess other assets for impairment that you would not typically require an assessment for and consider the disclosure implications for reporting in the interim and future accounting periods.



How is KPMG helping?

Estimating fair value (or value in use) requires significant informed judgement in the best of times. The current environment requires enhanced consideration of individual facts and circumstances with a rapidly changing macroeconomic overlay. KPMG's Valuation specialists are happy to talk with you and share their views and experience to help you navigate through these complex times.

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