COVID-19: Impairment considerations

Introduction

The outbreak of COVID-19 and the impact on the wider economy is placing unprecedented pressures 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 if these are impaired. This is a question regardless of industry sector 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 in 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 or 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?

Action	Considerations
1. Consider if there is a triggering event or indicator of impairment	— Have there been significant changes to the economic environment in which the entity operates? — Are there indications that the asset's value has declined significantly more than would be expected under normal conditions or use?
2. Revisit cash flow forecasts	— Do budgets and cash flow projections reflect the impact of COVID-19, both its duration and severity? — How will the supply of and demand for asset specific and cash-generating unit (CGU) products and services be affected by restrictions on transport, travel and quarantines? — 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?

What are the next steps? (cont.)

Action	Considerations
3. 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?
4. 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. — What 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 needs to consider to determine whether a triggering event has occurred:

1. 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?
2. Has the market capitalisation of my company (or my listed peers) fallen significantly or have there been other indications that the asset's value has declined more than would be expected under normal conditions or use?

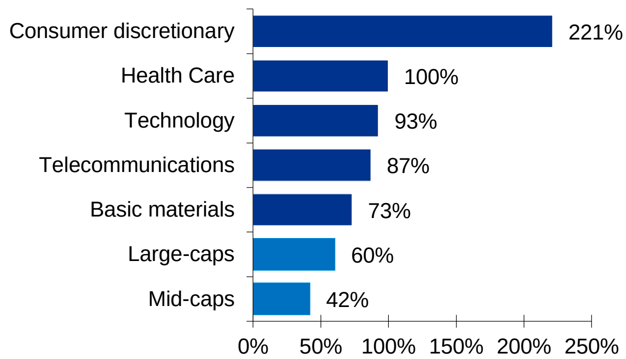
It seems hard to imagine that condition 1 is not met for most companies. COVID-19 has caused a significant deterioration in economic conditions for most companies, and an increase in economic uncertainty for others, which may constitute impairment triggering events. However, such a major economic shock 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 be an impairment trigger for other balance sheet assets too. 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.

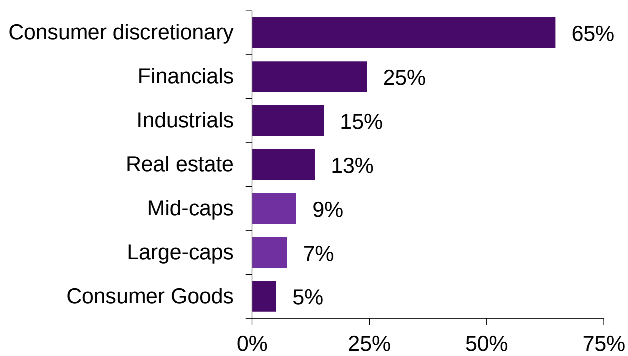
Goodwill and intangible assets are typically the first assets to suffer from an impairment loss.

The graphs below illustrate that many Swiss public companies have a significant amount of goodwill and intangible assets, and that a significant market value decline brings risk of headroom erosion.

Goodwill & other intangible assets as a percentage of net assets by sector as of 31 May 2020



Selection of sectors with a market value decline from 31 December 2019 to 31 May 2020



Source: S&P Capital IQ, KPMG analysis

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 interim and future accounting period's reporting.

How is KPMG helping?

Estimating fair value 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 would be happy to talk with you and share their views and experience to help you navigate through these complex times.

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