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IMPAIRMENT IMPLICATIONS OF COVID-19 (HKAS/IAS 36 IMPAIRMENT OF ASSETS)

The negative effects of COVID-19 on business activities and economies may cause more entities to perform impairment assessment under HKAS/IAS 36 as indicators of impairment are expected to exist for many entities. The level of uncertainty created by COVID-19 and the rapid evolvement of events make impairment assessment more difficult to perform than usual.

BDO Global has recently published a newsletter providing practical reminders of and guidance on impairment assessment in the circumstances of COVID-19 pandemic. The BDO Global newsletter is appended to this *Update*.

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IMPAIRMENT IMPLICATIONS OF COVID-19 (IAS 36 *IMPAIRMENT OF ASSETS*)

INTERNATIONAL FINANCIAL REPORTING BULLETIN

2020/07

BDO

BACKGROUND

The 2019 Novel Coronavirus infection ('coronavirus') or 'COVID-19' outbreak poses a serious public health threat. It has interrupted the movement of people and goods throughout the world, and many levels of government have instituted restrictions on individuals and businesses. The resulting impact on financial reporting will be significant.

BDO has issued the following publications on coronavirus that address the reporting implications in broad terms:

- IFR Bulletin 2020/02 – Potential effects of the Coronavirus Outbreak on 31 December 2019 year-end financial reporting.
- IFR Bulletin 2020/03 – Potential effects of the Coronavirus Outbreak on 2020 reporting periods and onward.

ACCOUNTING IMPACT

The effects of COVID-19 may require entities to perform impairment tests as indicators of impairment will exist for many entities.

Impairment tests may also be difficult to perform due to the level of uncertainty created by the effects of COVID-19.

This Bulletin focuses on the financial reporting implications of COVID-19 that relate to the impairment requirements of IAS 36, which apply to many non-financial assets.

For further resources on applying the requirements of IAS 36 and other IFRSs, please refer to BDO resources such as IFRS In Practice publications and online training, which are available on BDO's IFRS Reporting Hub.

SCOPE OF IAS 36

IAS 36 applies to many assets recognised in an entity's financial statements, while IFRS 9 applies primarily to financial assets. As a reminder, the standards apply to:

IAS 36, *Impairment of Assets*	IFRS 9, *Financial Instruments*
• Goodwill; • Intangible assets; • Property, plant and equipment; • Right-of-use assets; • Associates and joint ventures accounted for under the equity method; • Investment properties not measured at fair value; and • Costs to obtain or fulfil a contract recognised in accordance with IFRS 15, after the impairment requirements of IFRS 15.101-103 have been applied.	• Financial assets classified at amortised cost and debt instruments classified at fair value through OCI, which will commonly include many types of loans and debt instruments; • Trade receivables arising from IFRS 15; • Lease receivables; and • Contract assets recognised in accordance with IFRS 15.

The impairment and/or valuation of certain other assets, including inventories, deferred tax assets, assets arising from employee benefits and insurance contracts are covered by other applicable IFRSs. However, many of the considerations noted in this document may apply similarly to assets within the scope of other standards, such as determining net realisable value of inventory under IAS 2 or determining whether deferred tax assets can be recognised in accordance with the criteria in IAS 12.

IAS 36 – WHEN THE IMPAIRMENT IMPLICATIONS OF COVID-19 SHOULD BE RECOGNISED

As noted in the previously issued publications, determining when the effects of COVID-19 should be reflected in the impairment calculations in accordance with IAS 36 will depend on:

- The period end of the financial statements (i.e. the balance sheet date); and
- The sector and geography in which the entity operates.

The effects of COVID-19 are generally a 'non-adjusting' subsequent event as at 31 December 2019. Significant government action and intervention began to take place on 30 January 2020 when the World Health Organisation declared coronavirus to be a global health emergency, which generally triggers the recognition of the broad economic effects of the outbreak in financial statements. However, 30 January 2020 should not be seen as a 'rule' for when entities should begin recognising the effects of the outbreak.

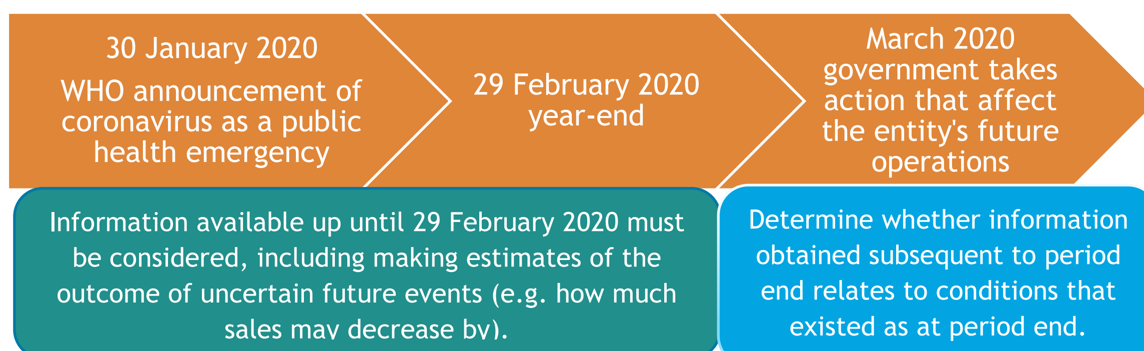
For example, a manufacturer with a 31 December 2019 year-end that imports significant amounts of inventory from the Wuhan region of China could have experienced disruption arising from the outbreak prior to 30 January 2020 (because there were significant effects in late 2019), and therefore this uncertainty would have been considered as at the 31 December 2019 year-end in the entity's application of various accounting policies, including impairment. This is because, on the basis of information known at 31 December 2019, one of the reasonably possible scenarios may have been significant effects from COVID-19.

Furthermore, the effects of the outbreak are evolving and changing on a day-to-day basis, such that it may be difficult in a practical sense for entities to 'cut-off' the information that is relevant as at a particular period end. While it is not appropriate to use hindsight, it will be appropriate to assess whether the various scenarios that are used for the purposes of IAS 36 at each reporting date incorporate reasonable and supportable assumptions at that date about the range of economic conditions that are forecast to exist in future.

IAS 10.22(g) uses the example of 'abnormally large changes after the reporting period in asset prices or foreign exchange rates' as an example of a situation that is normally a non-adjusting event (i.e. not reflected in period end financial statements). This is premised on the assumption that significant changes in value are typically an indication of events occurring at that point in time. This may be challenging to determine in relation to the effects of COVID-19, as the effects of the outbreak are developing very quickly.

For example, a retailer with a 29 February 2020 year-end would have had to consider the effects of COVID-19 in its impairment calculations under IAS 36 applicable to its assets, including property, plant and equipment, and right-of-use assets. However, if actions were taken by levels of government in March 2020 that affected the entity's operations (e.g. forced closures), management would have to consider whether those actions related to conditions that existed at the end of the reporting period, and hence, whether they would affect impairment calculations as at 29 February 2020.

To illustrate the timeline:



Using information available as at 29 February 2020, management may have included the possibility of the government action in its impairment calculations under IAS 36. The receipt of confirmation of one of the scenarios it had predicted to occur may require an adjustment to the 29 February 2020 impairment calculation if management concludes that the event occurring subsequent to period end is simply a confirmation of conditions present as at period end. However, care is required. The fact that a government took action after a reporting date does not mean that the reporting date forecasts should be adjusted to reflect that action as having been 100% likely, because that would incorporate hindsight which is not permitted. Instead, if a government took action shortly after a period end then it would be appropriate to consider whether the potential for that action to take place was included in forecasts with an appropriate probability weighting, based on all evidence available at the reporting date.

While future cash flows used in impairment calculations in accordance with IAS 36 are based on budgets and forecasts prepared by management, IAS 36.38 acknowledges that entities must also consider whether the information reflects reasonable and supportable assumptions and management's best estimate of the set of economic conditions that will exist over the remaining life of the assets. In circumstances where the effects of the outbreak are developing quickly, a budget approved by management some time before the reporting date may need to be adjusted significantly before the preparation of the financial statements is completed.

In addition, when (as is the case worldwide as at the publication date of this Bulletin) there is significant uncertainty about future events and potentially very significant adverse effects on entities, it is likely to be necessary for cash flows to be based on a number of probability weighted scenarios, including a significant adverse downside.

Examples of information obtained subsequent to period end that would generally not be reflected in estimates made in financial statements if the information becomes known before the financial statements are released:

- Announcement of government assistance and/or tax relief that had not previously been committed;
- Movements in market interest rates that would affect the discount rate used in impairment calculations.

Instead, detailed and transparent disclosures will be required of non-adjusting post balance sheet events that may have a significant effect on the reporting entity. The timing of an entity's period end and the development of the consequences of the outbreak may have significant effects on an entity's financial reporting from one period to another. This highlights how important disclosure is of the key estimates and assumptions used in preparing financial statements will be during periods most affected by COVID-19.

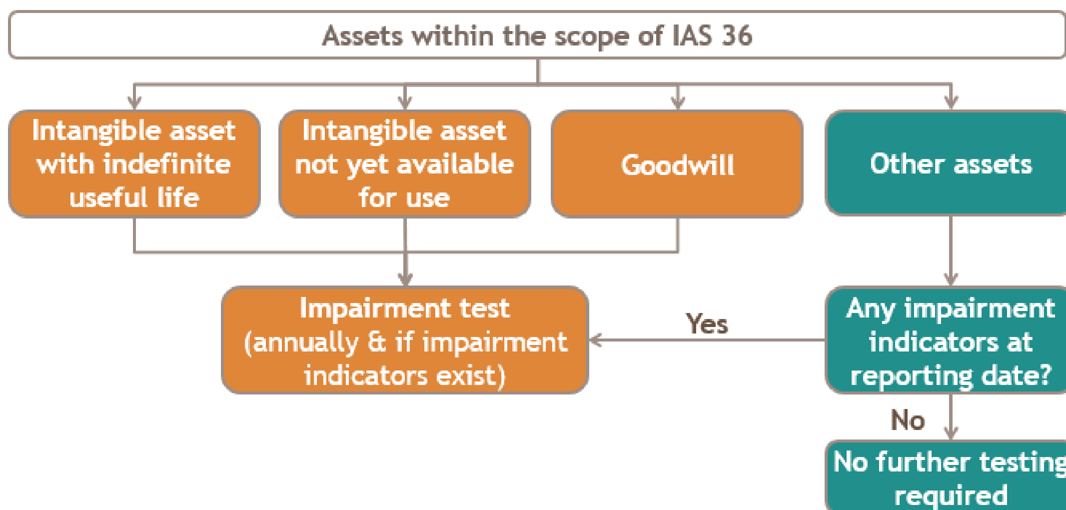
IAS 36 – WHEN TO TEST FOR IMPAIRMENT

IAS 36 requires assets within its scope to be tested for impairment when indicators of impairment exist at the end of a reporting period (IAS 36.9). Many of the indicators of impairment noted in IAS 36.12(a)-(h) may exist due to the effects of COVID-19, including declines in quoted asset values, operational disruptions to supply chains, and decreases in revenue and profitability. Many entities will have to perform impairment calculations in accordance with IAS 36, and these calculations may need to be significantly more detailed than have been prepared at previous period ends.

IAS 36 requires goodwill, intangible assets with indefinite useful lives and intangible assets not yet available for use (e.g. capitalised research costs on incomplete intangible assets) to be tested at least annually for impairment and at the end of each reporting date whether there is any indication of impairment (IAS 36.9-10). Consequently, entities that prepare interim financial statements may need to prepare impairment calculations on these assets more regularly as indicators of impairment may exist at

multiple reporting dates despite the minimum requirement (i.e. an annual test) having been carried out already. For example, an entity with a 31 December 2020 year-end may have tested its goodwill and indefinite life intangible assets for impairment as at 31 December 2020. Despite this, the entity may need to test the same assets for impairment again prior to 31 December 2021 (the next mandatory testing date), because indicators of impairment may exist at an interim reporting date. As a result of COVID-19, almost all entities that prepare interim financial statements would be expected to be required to carry out an impairment test at the next reporting date in 2020 (whether this is 31 March for quarterly reporters or 30 June for entities that only publish half year interim financial statements).

The requirements of IAS 36 in terms of when to test for impairment can be summarised as follows:



Entities may also be required to prepare impairment calculations after the effects of COVID-19 have started to decline. Impairment charges for most assets other than goodwill are reversed in subsequent periods if indications exist that previous impairment may have reduced or be eliminated. This may occur if asset values recover, uncertainty relating to the effects of COVID-19 are resolved and entities are able to resume operations to their pre COVID-19 levels.

IAS 36 – LEVEL AT WHICH THE IMPAIRMENT TEST IS PERFORMED AND GROUPING OF ASSETS

Assets are tested for impairment at the individual asset level (e.g. a single item of property, plant and equipment) unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Practically speaking, many assets will need to be grouped into cash generating units (CGUs) for the purpose of impairment testing.

The effects of COVID-19 have emerged shortly after the first annual period in which entities reported results in accordance with IFRS 16, *Leases*. IFRS 16 resulted in significantly more assets being included in the scope of IAS 36, as many leases that were previously accounted for as off balance sheet operating leases are now recognised as right-of-use assets (ROU assets).

Entities must ensure that the recent effects of IFRS 16, including testing for impairment of ROU assets and grouping ROU assets appropriately, are considered. IFRS 16 may also give rise to the recognition of more corporate assets (assets that contribute to the cash flows of many CGUs, e.g. a leased corporate head office), which must also be allocated appropriately to CGUs.

IAS 36 – DETERMINING THE RECOVERABLE AMOUNT

To measure impairment, the recoverable amount of an asset or CGU is compared to the asset's (or the CGU's) carrying value amount. The recoverable amount is the higher of:

- Fair value less costs of disposal (FVLCOD); and
- Value in use (VIU).

Recoverable amount is a 'higher of' test and it applies regardless of how management intends to use an asset. For example, if the carrying value of a CGU is higher than its VIU and management has no realistic intention of disposing of the CGU, if its FVLCOD is higher than its carrying value, the CGU is not impaired. This approach therefore prevents management from making provisions for future operating losses.

VIU calculations will always require a discount rate to be used and, if FVLCOD is estimated using a discounted cash flow ('DCF') model, then discount rate considerations will be applicable to both. The following points should be noted in relation to discount rates and DCF models used in IAS 36:

- Discount rates are not entity specific; they reflect the current market assessment of the time value of money and the risks specific to the assets (IAS 36.55). The rate is meant to be representative of what market investors would require when choosing an equally risky investment, resulting in the use of a rate which is estimated based on the rate implicit in current market transactions for similar assets, or from the weighted average cost of capital of a listed entity that has a single asset (or portfolio of assets) similar in terms of service potential and risk to the asset (or CGU) under review (IAS 36.56); and
- Discount rates do not reflect risks for which the future cash flows have already been adjusted or else the risks are 'double counted' (IAS 36.A18). This may be especially important to note given the increased uncertainty in cash flow projections affected by COVID-19. However, an appropriate discount rate in a VIU calculation with multiple scenarios may still increase compared to previous impairment calculations, as market investors may require higher returns in order to accept risks that are not wholly entity-specific (e.g. risks related to a particular industry sector).

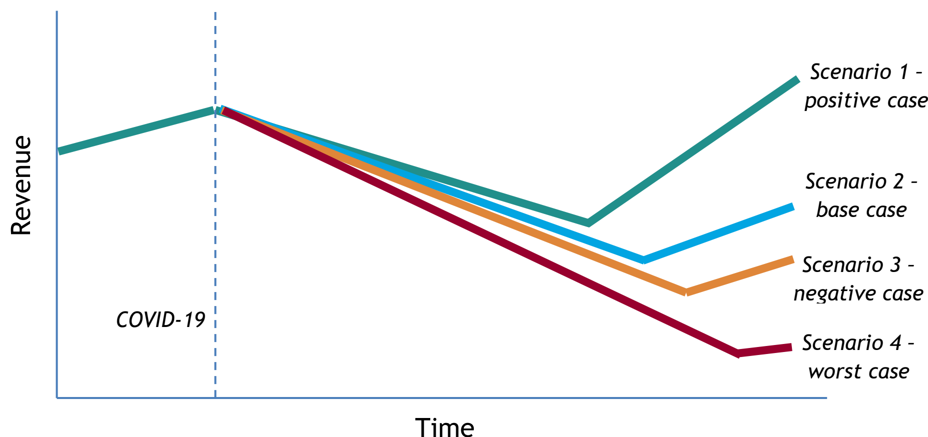
Additionally, entities may have previously used a single, best estimate cash flow projection in their DCF models. Such an approach may have been appropriate when the variability in future cash flows was low or the risks inherent in the cash flows could be appropriately captured in the discount rate used. Given the high level of uncertainty that COVID-19 creates, entities may be required to consider multiple scenarios in a DCF model, each of which are probability weighted.

For example, consider an entity that operates a number of restaurants, some of which are traditional 'sit down' dining, while others are primarily focused on delivery. Depending on the length of mandated cessation of operations by governments and the enduring caution of consumers to visit restaurants in the future, it will need to forecast multiple scenarios in its DCF models. An illustration of this follows:

Scenario	Probability Weighting	Key Assumptions	Discount Rate Used*
1 - positive case	5%	Operations at sit down restaurants are halted for 4 weeks, take-out and delivery options are popular with consumers and result in a net reduction in revenue of 20% for the year.	X%
2 - base case	5%	Operations at sit down restaurants are halted for 8 weeks, take-out and delivery options only compensate for a portion of lost revenue and result in a net reduction in revenue of 40% for the year.	X%
3 - negative case	60%	Operations at sit down restaurants are halted for 12 weeks, take-out and delivery options only compensate for a portion of lost revenue, resulting in a net reduction in revenue of 50% for the year.	X%
4 - worst case	30%	Operations at sit down restaurants are halted for 20 weeks, take-out and delivery options are not popular with consumers and operational and supply chain disruptions require most take-out options to cease operations, resulting in a net reduction in revenue of 65% for the year.	X%

*A single discount rate is applied to each probability weighted scenario as the rate reflects the risk specific to the assets from a market perspective for which the cash flows have not been adjusted. Applying a different discount rate to each scenario would result in 'double counting' of the risks, as they would be reflected in the cash flows and the discount rate.

In many cases, DCF models will be significantly affected by the assumptions underlying the length of time it will take for revenue and operational activities to recover from the effects of COVID-19. This can be illustrated by the length of time the 'V-shape' of the operational disruption takes to begin recovering. The amount of uncertainty in this assumption will depend significantly on the jurisdiction or jurisdictions in which an entity operates and the expected timeframe for the effects of COVID-19 to begin decreasing. To illustrate:



Determining the number of scenarios to include, their relative weightings, the key assumptions and the discount rate used in each scenario will require significant judgment.

IAS 36 – RECOVERABLE AMOUNT: FAIR VALUE LESS COSTS OF DISPOSAL (FVLCOD)

'Fair value' is defined in IFRS 13, *Fair Value Measurement* as 'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'

Depending on an entity's period end, the price it would receive at that specific point in time may be significantly lower than prices or estimates of prices it may have received at previous dates due to the implications of COVID-19 on global asset prices, availability of capital and risk appetites of market participants.

These decreases in value at a point in time may appear to be a 'distress sale' requiring adjustment in the fair value estimation. However, other than in extreme cases, such decreases in value would not be attributable to factors that would be adjusted for (e.g. a lack of current information, declines in trading). Significant decreases in prices at one point in time are a consequence of fair value measurement, which is a current amount as at the period end. Similarly, the fact that there may have been a significant reduction in trading volumes for a particular asset listed on a public market does not mean that it is appropriate to disregard the 'level 1' quoted price.

As noted in the previous section, many FVLCOD estimates may be carried out using a DCF model. In these cases, the model used is likely to incorporate significant unobservable inputs (e.g. financial forecasts developed using the entity's own data – IFRS 13.B36(e)), which require specific disclosures (IFRS 13.91-99).

IAS 36 – RECOVERABLE AMOUNT: VALUE IN USE (VIU)

Whereas FVLCOD is not an entity-specific measure, VIU is entity-specific to the extent that the cash flows included in the model reflect the expected cash flows to be derived from the asset/CGU. This reflects management's intentions (e.g. how it expects to deploy the asset or CGU to generate cash flows). The effects of COVID-19 may significantly impact DCF models used, as noted in the earlier sections, however, several points should be considered in VIU calculations:

- The expected effect and endurance of operational disruptions (i.e. the slope and severity of the 'V-curve' as noted earlier), which will be affected by the jurisdiction and sector in which the entity operates. Note that the 'V curve' above has been used for illustrative purposes; depending on information available at a reporting date, and the economic and other forecasts at that time, the curve may be different, such as 'U' or 'W' in shape;
- The availability of necessary resources to 'ramp up' operations once the entity expects to be able to increase (or resume) operations (e.g. employees, raw materials, etc.);
- The survival rate of competitors;
- The demand for its goods and services during and following the harshest effects of the outbreak (e.g. a medical supply firm vs. a tour operator); and
- VIU calculations are based on assets in their current condition. That is to say, future restructurings to which the entity is not yet committed or improvements to assets may not be considered (IAS 36.44). Therefore, if an entity is considering a significant overhaul to its operations to redeploy assets given the outbreak, these cash inflows and outflows may not be considered unless an entity is committed to such a restructuring (e.g. the plan has started to be implemented and the main features have been announced to those affected).

IAS 36 – INTERACTION WITH IAS 34 AND IFRIC 10

For entities that prepare interim financial statements in accordance with IAS 34, several specific points should be noted.

IAS 34, *Interim Financial Reporting* requires the same accounting policies to be applied in interim financial statements as annual financial statements, and the frequency of an entity's reporting should not affect the measurement of results in either an annual or an interim financial statement. For example, impairment recorded relating to property, plant and equipment in an interim financial statement may be reversed in subsequent interim or annual financial statements, as IAS 36 permits such a reversal. However, there is an exception because IFRIC 10, *Interim Financial Reporting and Impairment* requires that no such reversal may occur for goodwill, as IAS 36 does not permit an impairment recorded against the value of goodwill to be reversed.

If indicators of impairment exist for CGUs that contain goodwill, then goodwill will need to be tested for impairment at an interim period reporting date, even if that does not align with the annual testing cycle for goodwill. This is because IAS 36.9 requires an impairment test to be carried out at the end of any reporting period if there is any indication that an asset may be impaired. For a CGU that contains goodwill, any impairment is allocated first to goodwill and then pro rata to other assets based on their carrying amounts.

Additionally, if goodwill should have been impaired in an interim financial statement (e.g. a half-year or quarterly financial statement) due to the above-noted interaction between IAS 34, IAS 36 and IFRIC 10, then this will affect the next annual financial statements. Said another way, if goodwill was not impaired in an interim financial statement, but it should have been, that impairment should be reflected in the next annual financial statements, even if goodwill would not have been impaired if the impairment test had been performed at the annual reporting period end (e.g. if conditions had improved by the year-end period). This is because IFRIC 10 clarifies that the requirements of IAS 36 (i.e. 'impair goodwill and never reverse') override the general requirement of IAS 34 that the frequency of an entity's reporting should not affect the measurement of its annual results (IAS 34.28).

IAS 36 – DISCLOSURES

IAS 36 contains significant disclosure requirements in instances where entities record impairment charges, including the significant assumptions used in calculating the impairment, the events and circumstances that led to the impairment, and the composition of CGUs. (IAS 36.126-133). Several points should be considered in satisfying the disclosure requirements of IAS 36 and IAS 1:

- The objective of the disclosure requirements in IAS 36 are to communicate how an impairment charge arose and how an entity determined the amount. In achieving this objective in relation to impairment charges arising from COVID-19, entities should consider whether the disclosures communicate the following information:
    - Which assets were affected by the impairment charge and why?
    - How many scenarios has management considered in determining the recoverable amount if a DCF model has been used?
    - What assumptions have been made in each of the scenarios? How do they differ from one another and how are they similar?
    - What are the weightings of probabilities assigned to each scenario and how were they determined?
    - How was the discount rate (or rates) used determined?
- The disclosure requirements of IAS 36 also apply when an impairment charge is reversed, which may occur in subsequent periods; and

- If the recoverable amount of an asset or CGU exceeds its carrying amount (i.e. no impairment charge is recorded), but it is a 'close call' or significant assumptions support this conclusion, the entity would be expected to be required to disclose the significant judgments and estimates based on the requirements of IAS 1.122-133. This is because these requirements apply generally, and despite the fact that no impairment charge has been recorded, that conclusion may rely on significant judgments or estimates, which trigger the requirements of IAS 1. In addition, in such cases if a reasonably possible change in a key assumption used by management in determining the recoverable amount of a CGU (or group of CGUs) would result in the CGU (or group of CGUs) carrying amounts exceeding their recoverable amounts, additional disclosures are required by IAS 36.134.

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