

# Impairment & COVID-19

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## Points of reference for preparers of financial reports

### Introduction

The recent COVID-19 outbreak has caused extensive disruptions to the global economy causing most countries to enter recessions while also significantly increasing the level of uncertainty inherent in forecasting exercises.

This document seeks to provide some points of reference and guidance on the implications of AASB 136 *Impairment of Assets* in the context of a COVID-19-impacted economic environment.

### What is the issue?

Generally, AASB 136 requires that each entity assess at its reporting date whether indicators of impairment exist as it relates to its assets – that is, whether information available to the entity, whether internal or external, indicates that the value of these non-financial assets has decreased.

This requirement applies to all assets apart from those that are specifically outside scope (including investment property at fair value under AASB 140 or measured using the valuation methodologies of other standards, such as AASB 9 *Financial Instruments and AASB 102 Inventories*).

Where indicators of impairment are identified, the entity must assess whether the asset is impaired by reference to the greater of either the Value in Use (“VIU”) of the asset or its Fair Value less Cost of Disposal (“FVLCD”).

### What are indicators of impairment?

The term “Indicators of impairment” is not defined in AASB 136, however examples are given. The standard explicitly refers to these as a **minimum** examples of items to be considered (136.12) – it is **not** a comprehensive list.

These listed indicators can be summarised as:

- Observable indicators of losses of value;
- Significant technological, market, economic or legal environmental changes impacting the entity;
- Increases in market interest rates or other rates of return which are likely to impact the discount rate used in calculating the VIU;
- The carrying amount of the net assets of the entity is more than its market capitalisation;
- Damage or obsolescence of assets;
- Assets being idle, planned discontinuation of operations, operational restructures, or planned disposals of assets;
- A change in the useful life of an asset from indefinite to finite; and
- Dividends from a subsidiary, joint venture, or associate.

This listing is not comprehensive. Other indicators may be present which are not included in the list or are indicative of items in the list, such as:

- Significant decreases in revenue;
- Expectations of a recession;
- Expectations of trading limitations;
- Difficulty sourcing inventory; and
- Forecasts (such as budgets) forecasting decreases in operational profitability.

In the current economic environment, we would expect that the majority of entities are exhibiting characteristics that indicate impairment.

### Take-away:

In the current economic environment, we expect that the majority of entities are exhibiting characteristics that are indicators of impairment.



## Indicators are identified – what next?

An impairment analysis is required to be prepared. An impairment analysis requires determination of either the ViU or FVLCD of an asset (where “asset” includes in its definition a CGU). Impairment occurs where the carrying value of the asset is less than the largest of its ViU or its FVLCD. Entities generating cash inflows through operations typically exhibit the greatest value through their ViU – as a result, this document will focus on the components of such a method.

### Forecasting

Forecasts should be prepared to the extent that they can be considered reliable. AASB 136 presumes that detailed, explicit and reliable financial budgets/forecasts for periods greater than five years from the reporting date are generally not available. It is therefore generally not appropriate to include forecasts that extend past this point. However, many entities may not be capable of preparing reliable forecasts for more than one or two years. A reminder that a detailed budget for one year with growth rates used to estimate Years 2 to 5 is a one-year forecast, not a five-year forecast.

Forecasts are required to be reasonable and supportable, representing management’s best estimate of the range of economic conditions that will exist over the forecast period - these forecasts are required to be approved by management.

The use of a terminal value is appropriate, where the growth rates used within the terminal value do not exceed the long-term average growth rate for the products, industries or jurisdictions of the entity. This requirement is able to be rebutted to the extent that it can be justified.

The inputs to a ViU calculation are:

1. A management-approved forecast of cash flows for a period of up-to 5 years;
2. A terminal value calculation; and
3. A Weighted Average Cost of Capital (“WACC”).

## How are multiple outcomes considered?

The term ‘consider multiple outcomes’ is broad, but can be summarised as achievable using two methods:

- increasing the WACC utilised for the relative risk of achieving the forecast results; or
- create multiple probability-weighted forecasts which consider different scenarios.

Double counting (i.e. preparing multiple scenarios and increasing WACC) should be avoided. ASIC has indicated a preference for a multiple-scenario approach in [COVID-19 implications for financial reporting and audit: Frequently asked questions \(FAQs\)](#) point 2.

Forecasts must therefore factor in a range of possible outcomes where uncertainty exists, and be reliable.

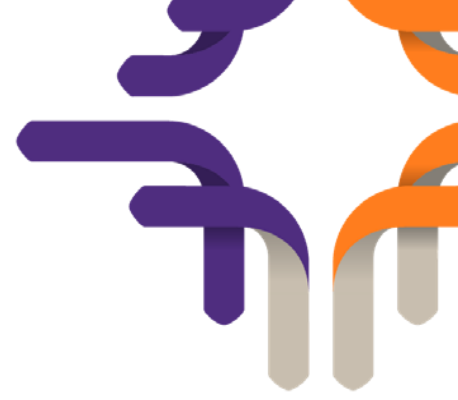
## Developing a reliable forecast

A forecast should consider a reasonable expectation of the outcome for a given scenario. For example, let us assume an entity has a year end of 30 June 2020 and has experienced the following cash inflows during the pandemic. A vaccine is forecast for approval in March 2021:

January 2020:	180
February 2020:	95
March 2020:	85
April 2020:	80
May 2020:	85
June 2020:	90

In such an instance, the entity must consider:

- The time for vaccination to reasonably impact the population;
- The impact of the pandemic-caused recession on expectations of cash flow;
- The potential impact for shut-downs occurring, further impacting cash flows; and
- Whether the uncertainty introduced results in forecasts in later periods – such as years four and five – being unreliable and thus not meeting the requirements of AASB 136.



When considering a method of determining an appropriate outcome, we generally note the following:

- Most entities in Australia are adopting AASB 16 *Leases* for the first time. AASB 136 requires that the ROU assets be included in CGU assets (and lease liabilities excluded), and that cash outflows relating to lease liabilities be excluded from forecasts.
- AASB 16 significantly changes the relative gearing of many entities. The reliability of market WACCs (as required by AASB 136) is therefore reduced. Including a risk-adjustment on this WACC therefore runs the risk of compounding estimate error and should be avoided;
- Further reading on methods to include leases in the context of AASB 16, including inclusion/exclusion of assets and liabilities, can be found in [“Application of AASB 16 Leases in impairment models”](#).

### Terminal value

The terminal value in a VIU is driven by the long-term expectations of results for the entity with adjustment for an assumption of cash flows existing into perpetuity. These long-term expectations are typically based on the final year of the forecast prepared by management as being ‘representative’ of the cash flows expected to be realised into the future – both the cash inflows generated by the entity from operations and the investing cash outflows required to maintain these operations into perpetuity.

The final year cash flows in a model are therefore not necessarily appropriate to be incorporated directly into the terminal value calculations and may require a level of modification or amendment – for example, a long-term lease may require adjustment to the terminal value as described in [“Application of AASB 16 Leases in impairment models”](#).

- AASB 136 requires that expectations about possible variations in the amount or timing of future cash flows be adjusted for in either the cash flows or the discount rate. Generally, regulators have indicated a preference for including such risks in cash flow forecasts with an expectation of at least three different scenarios being developed to derive a VIU. A larger number of forecasts will give a more accurate estimate, however forecasts should not consider cases considered only remotely possible. There may be some residual risks that should be included in the WACC.

## What is WACC?

“WACC” is the “Weighted Average Cost of Capital” of an entity – the weight-adjusted relative cost of funds for an entity with certain defined characteristics.

There is a commonly held misconception that the WACC used in a forecast is the WACC of the entity preparing the ViU calculation. While this is intuitive, it is not the case – the WACC to be utilised is the WACC of the market in which the asset or CGU operates – specific to geography, industry, and relative riskiness of the entity (i.e. smaller entities are typically more risky than larger entities).

The determination of an appropriate WACC is thus something best referred to experts – we recommend liaising with a provider of valuation services.

## Case: Developing a terminal value

Consider an entity who has prepared a three year forecast for a CGU. It is a mature operation in a mature market; this market is forecast to grow for 1.5% into the future after recovery from a COVID-19 induced recession. The prepared forecast extends to 2023 (Year 3); 2024 & 2025 (Years 4 & 5) were considered too unpredictable to be included. Full recovery to historic levels (i.e. 2019) is expected to occur in 2024.

We will assume that the CGU’s WACC is 11.5%.

## Case: Developing a terminal value (continued)

	2019	2020	2023	Adj	TV	
Revenue	1,000	750	1,000	77	A	1,077
Costs	(700)	(650)	(770)	16	B	(754)
<b>EBITDA</b>	<b>300</b>	<b>100</b>	<b>230</b>	<b>93</b>		<b>323</b>
<b>CAPEX</b>	<b>(50)</b>	<b>(5)</b>	<b>(10)</b>	<b>(90)</b>	<b>C</b>	<b>(100)</b>
<b>Working Capital</b>	<b>(10)</b>	<b>10</b>	<b>(20)</b>	<b>-</b>	<b>D</b>	<b>(20)</b>
<b>Cash Flows</b>	<b>240</b>	<b>105</b>	<b>200</b>	<b>3</b>		<b>203</b>
<b>TV Factor, being WACC adjusted for perpetual growth rate (i.e. 11.5% - 1.5%)</b>						<b>10.0%</b>
<b>Terminal Value, being TV Cash Flows ÷ TV Factor</b>						<b>2,030</b>

### Adjustments

- A** Revenue for terminal value calculated by reference to 'standard' year, adjusted for inflationary impacts of period from 2019 to 2024, assuming a flat inflation rate of 1.5%
- $$1,000 \times 1.015^5 = 1,077$$
- B** Assuming consistent cost structure to historic – e.g. due to aggressive discounting and higher proportion of fixed to variable costs in post-recession recovery;  $1,093 \times 70\% = 765$ .
- C** Long-run CAPEX forecast, including need for replacement periodic replacement of longer-term assets such as leasehold improvements or critical manufacturing equipment.
- D** Long-run estimation of absorption of cash in increasing working capital to match long-term absorption relative to growth rate of 1.5%.

Note that the example adjustments are examples only. Other factors may be appropriate to the entity, and adjustments from the selected base should be relevant to the facts and circumstances in place at the date of the forecast.

## Further reading

This document is not a comprehensive guide and represents only a summary of certain targeted issues. We recommend that readers also visit [Grant Thornton's Financial Reporting Advisory Home Page](#)

Additional discussion of COVID-19 related impacts can be found in our guide: [Accounting Implications of Coronavirus \(COVID-19\)](#).

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