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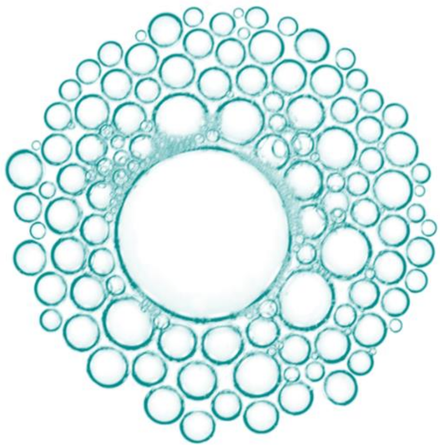

Impairment: A diagnosis

The impact of a pandemic on your AASB 136 assessment

Although none of us will know the full effects of COVID-19 for some time yet, it is important to consider the impact on impairment testing as soon as possible to ensure you can understand the potential effects on your financial statements and manage the expectations of your stakeholders.

To date, in Australia, the industries most disrupted are travel, education, hospitality, discretionary retail, and property investments but the ripple effect is unlikely to leave many unaffected.

The impacts of COVID-19 can be wide-ranging across an organisation, both financially and operationally, and as a result have a pervasive effect across the financial statements, either through fair valuing of assets such as investment property and agriculture assets, or impairment testing, for goodwill, property, plant and equipment, right-of-use assets, intangible assets, and other investments.

Amid this uncertainty, disclosures of the key assumptions and the sensitivity of these assumptions will be of particular importance to provide clear information to stakeholders that is useful for decision making.

The combined skill of Deloitte's business valuation experts and specialist accounting standards team can help you navigate this uncertainty and provide your organisation with an in-depth interpretation of the accounting standards as they are applicable to impairment and valuations.

Articulating the impact in a manner that's easy for stakeholders to understand will be important and require time.

Increased uncertainty in an area already based on estimation

Impairment of goodwill and other non-financial assets has been a focus area for the Australian Securities and Investment Commission, and of course various stakeholders, for many years. COVID-19 has heightened this attention. In fact, the U.S. Securities and Exchange Commission has specifically highlighted that the impact of COVID-19 needs to be considered by organisations.

Although the full effects of COVID-19 remain uncertain and are likely to be so in the near future, it is important that organisations consider the impact on fair value of assets and impairment testing to ensure you can understand the potential impact on your financial statements, and manage the expectations of your stakeholders through relevant and considered disclosures as and when needed.

The markets have already recognised the substantial impact on business value as a result of COVID-19, as demonstrated in Figure [1].

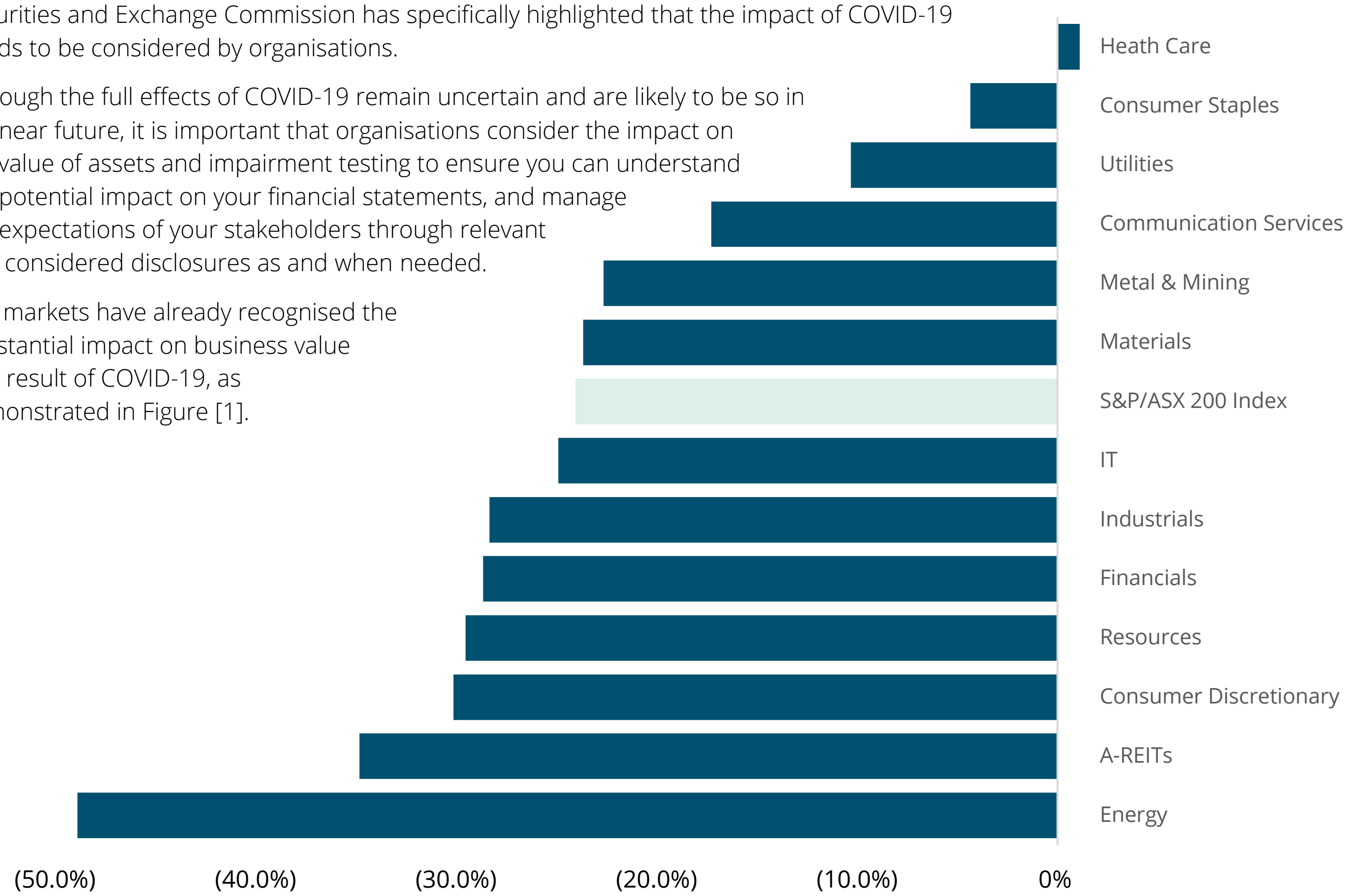

Figure [1]: Impact of COVID-19 on various sectors of the S&P/ASX 200 Index *Source: Capital IQ, Deloitte analysis*

A pervasive issue

The scope of the impairment standard is broad and the potential impact of COVID-19 is pervasive – it is not only limited to financing and capital market considerations but also goes deep into organisational and operational impacts. We anticipate substantial changes in individual inputs to both fair value and impairment calculations and, as a result, the potential to impact a number of balances in the financial statements.

Goodwill | Right-of-use assets | Intangible assets | Biological assets

Property, plant and equipment | Equity method associates and joint ventures

Investment properties | Investments in subsidiaries | Cash-generating units

The early symptoms

Large-scale quarantines, travel restrictions, and enforced shutdowns are impacting consumer and business spending in a dramatic way. In Australia, our normal way of life is changing rapidly with the forced closure of all places of social gathering and law-enforced social distancing. Even where businesses can remain open to comply with government guidelines, consumers are leaving their homes less and, as a result, many bricks and mortar and in-person businesses are experiencing sharp declines in customer demand. To date we have seen financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels and reductions in production because of decreased demand, layoffs and furloughs.

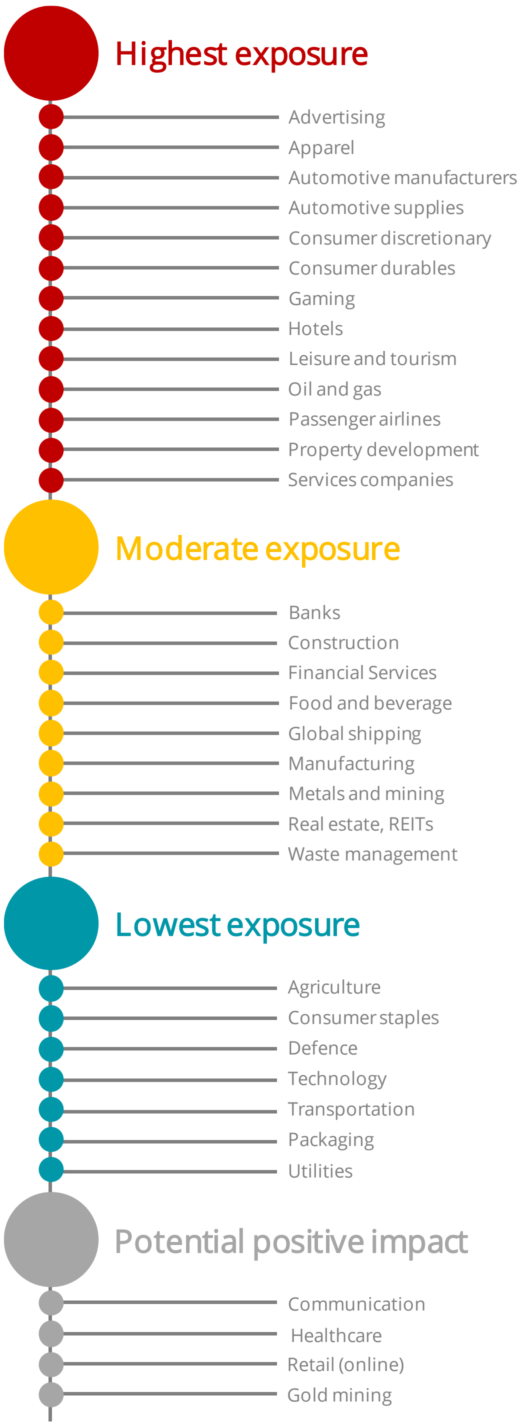

Figure [3]: COVID-19 Relative impact on sectors.
Source: Deloitte analysis

Figure [2]: Anticipated impacts of COVID-19
Source: ABS, Deloitte analysis

Is your organisation affected?

The restriction on social life, mentioned above, is rippling beyond the obvious sectors and leading to substantial indirect impacts. When restaurants close their doors, they no longer need tablecloths delivered by linen services or vegetables from local producers. When non-essential travel is banned, people no longer need taxis to the airport or bottles of water from the airport newsagent. When restaurants, taxi services, newsagents and other organisations experience a sharp and material downturn, the impact on their suppliers is significant. So far in Australia the industries most disrupted are travel, education, student accommodation, hospitality, and discretionary retail, including investments in these industries made through real estate investment trusts, but the ripple effect will not leave any industry unaffected. The challenge is that we are potentially still only in the early stages of the crisis and the timing of the eventual recovery is unknown.

While this presents significant challenges, such market disruption can also create opportunities for business, and it's often at points of significant disruption that great organisations stand out and repivot themselves for a better future.

Permanent shift, short term loss, or timing difference?

Regardless of which side of the supply and demand curve you sit, in terms of forecasting cash flows, the extent of the impact will depend on where your organisation falls into this range of outcomes:

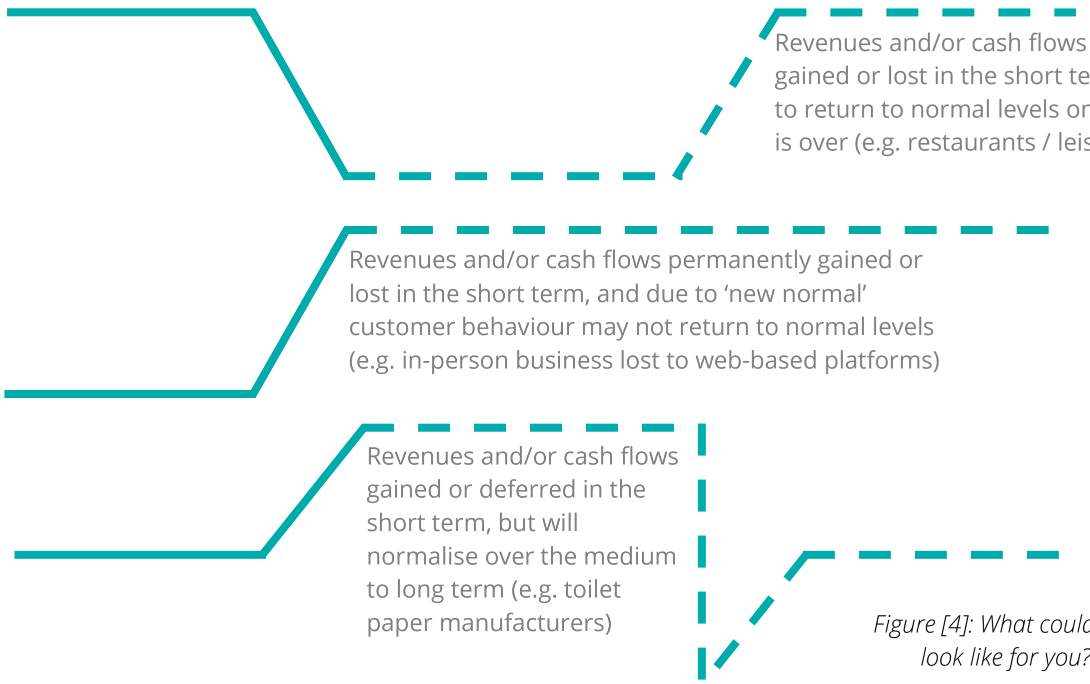

Figure [4]: What could the impact of COVID-19 look like for you? Source: Deloitte analysis

Using one of these scenarios to determine the impact on your cash flows will help to establish both the degree of movement and the relevant time frame required to bridge the gap between previous forecasts and now. It's also important to evaluate these scenarios using a top-down approach – understanding the possible health and social outcomes, translated down to the economies that your organisation operates and then the implications on changes in supply chain, workforce, demand and supply on your projections.

Set out below are the early stage changes in view on current profitability and future growth in profitability as a result of COVID-19 across various sectors:

Industry	Change in market cap from Figure [1]	Change in EPS outlook for current year	Expected growth over 3 years	
			Pre COVID-19	Post COVID-19
Heath Care	1.5%	1.0%	12.2%	14.5%
Consumer Staples	(4.3%)	6.6%	9.7%	8.3%
Utilities	(10.3%)	(11.6%)	(5.8%)	4.4%
Communication Services	(17.3%)	(17.6%)	(4.1%)	(2.9%)
Metal & Mining	(22.6%)	(6.3%)	1.0%	(2.6%)
Materials	(23.7%)	(1.9%)	0.4%	(1.2%)
S&P/ASX 200 Index	(24.0%)	(11.6%)	2.0%	1.2%
IT	(24.9%)	(8.8%)	8.0%	17.9%
Industrials	(28.3%)	(43.1%)	8.0%	2.6%
Financials	(28.7%)	(12.6%)	0.6%	0.2%
Resources	(29.5%)	(10.0%)	0.3%	(3.3%)
Consumer Discretionary	(30.1%)	(15.9%)	1.4%	3.5%
A-REITs	(34.8%)	(4.7%)	3.1%	4.4%
Energy	(48.9%)	(36.6%)	2.5%	(2.5%)

Figure [4]: Changes in earnings expectations *Source: CapitalQ, Deloitte analysis*

Estimating the unpredictable

The use of forecast information is pervasive in any organisation's business. There will be unique complexities associated with preparing forward-looking information as a result of COVID-19 and the economic downturn:

- There is uncertainty about the penetration rate of COVID-19 amongst different countries and the path and time needed to 'flatten the curve', get to 'herd immunity', when the virus will be 'contained' or when a vaccine will be found
- This goes in hand with efforts by governments to influence outcomes with measures, such as prohibiting business and personal activities, the associated level of compliance by citizens and the nature and effectiveness of government assistance and incentives, which have been unprecedented
- Each entity must then translate the effect of those macro conditions into estimates of its own future cash flows. The impacts over the short, medium and long-term will be different.

The diagnosis for your impairment assessment

Applying AASB 136 *Impairment of Assets* (AASB 136), outside of actual changes in cash flows, we expect changes to the assessment of indicators, construct of cash-generating units (CGUs), discount rate inputs, and increased attention on disclosure. The graphic below outlines a non-exhaustive insight into the impacts on the various aspects of the impairment testing.

Impact on	Explanation	Example
Indicators	Indicators are more likely to be triggered and may result in a requirement to test CGUs that do not contain goodwill. Keep a watch over indicators.	• Change in outlook due to changes in inputs/output prices, supply and/or demand challenges • Substantial extension of working capital cycles • Share market deterioration causing market capitalisation deficiency or increase in deficiency • Financing complexities and/or concerns over refinancing
Level of testing and CGUs	Assets may no longer yield the cash flows that were expected. Consider recoverable value of individual assets before including in CGU, especially where assets are idle.	• Risk of impairment to individual assets within carrying value of larger CGU • Idle property, plant and equipment where operations are directly affected • Plans to discontinue or restructure a segment or geography • Plans to dispose of an asset before the end of its useful life
Cash flows and discrete period	The effects on the economy are wide-ranging and unprecedented. It's unlikely that an organisation will not be impacted, whether directly from changes in supply or demand, or indirectly from changes in government policy or consumer behaviour. Different organisations will recover over different periods of time. There may be a need to consider whether the discrete period (the period of the projections) previously used is still applicable.	• Effect of quarantine plus travel and social distancing restrictions on workforce and machinery productivity • Impacts on supply chain and logistics • Changes in customer demand • Short and long term change in commodity price expectations • Exposure to foreign currency volatility • Impact of government stimulus packages • Adjustments due to changed or renegotiated working capital structure
Inflation	The economic downturn has caused a reassessment of the outlook for inflation over the short, medium and long term.	• What are the implications for product and services price growth and input price growth?
Terminal growth rate (growth rate into perpetuity)	Some organisations may never return to history and will operate in a 'new norm'. This will require organisations to reconsider growth rates into perpetuity.	• Impact of government and corporate debt on funding and government-linked revenues • Structural changes in consumer behaviour (increased work from home, increased online shopping) • Less dependency on just-in-time supply chain, greater use of local suppliers and more diversification of supply • The implication of changes in inflation

Impact on	Explanation	Example
Discount rate	While the return on government bonds has decreased, with the current volatility and uncertainty investors have become much more astute in pricing risk across different industries and organisations. This may necessitate specific risk premiums.	• Government bond rates have decreased, as a result of various fiscal and monetary policies that are being pushed through the economy by governments and central banks • Equity markets have become more discerning on the price of risk as it varies across markets, industries and organisations • The measure of beta is typically taken over long time periods. As such, the impact of COVID-19 will not be prevalent in any historical calculation and will need to be taken account of • Corporate bond spreads have increased indicating the cost of debt funding has increased • Organisations are considering resetting their capital structure via equity raisings or debt for equity conversions
Cross-checks	More than ever before history is not a reliable predictor of future events.	• The multiples implied by historical transactions may not provide guidance on the current fair values of assets • Private markets are being more astute and more considered about the current situation and thus there appears to be a dislocation between private and public markets
Disclosure	The disclosure requirements of AASB 136 are extensive and need to be considered in parallel with AASB 101 *Presentation of financial statements* in order to fully explain the major sources of estimation uncertainty underpinning the impairment assessment. Now more than ever, users will be looking to the Financial Statements to understand the impact of this crisis on each individual entity.	• Increased attention on risks and key inputs – not 'business as usual' • Consider disclosure of alternate scenarios flexed for different unknowns (e.g. extent and duration of government intervention) • Decreased headroom may trigger sensitivity disclosures not required in the past • Consider the requirement to disclose changes in key assumptions when compared to the prior period • Even in cases where there is no financial impact in the current reporting period, it's expected that entities will make disclosure of the reasons why that is the case

Figure [5]: Impacts of the pandemic on aspects of the AASB 136 Impairment assessment *Source: Deloitte analysis*

Take time to consider the issues

If one thing is certain, it is that most businesses will need to think harder about their impairment testing process than usual, and all organisations will need to do their best to make reasonable estimates, prepare comprehensive documentation supporting the basis for such estimates and provide robust disclosure of the significant judgements exercised, the key assumptions used and, potentially, their sensitivity to change. Articulating this in a manner that is easy for stakeholders, including your auditors, to understand will also be important. All of this will take time and we recommend organisations start themselves on this journey early and well in advance of year end.

How Deloitte can help

The business valuation specialists within our Financial Advisory – Mergers and Acquisitions (M&A) division can quickly gather an in-depth understanding of the market, the asset or liability being valued, the financial and non-financial information, as well as factors such as legal or regulatory environment, and capital market considerations. They work closely with our specialist Accounting Technical team who can provide an in-depth interpretation of the application of accounting standards as they are applicable to impairment and valuations.

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