



COVID-19: Considerations for impairment testing

May 2020

Introduction

The outbreak of COVID-19 and the impact on the wider economy is placing unprecedented pressures on communities and businesses. Attention needs to be paid to the value of balance sheet assets and the requirement to consider if these are impaired. 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?

- Cash flow forecasts generated by businesses and assets 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? Decreases 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 in 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 (or omitting) 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	<ul style="list-style-type: none"> • Have there been significant changes to the economic environment in which the entity operates? • Is the market capitalisation of a company less than its net assets?
2. Revisit cash flow forecasts	<ul style="list-style-type: none"> • 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 commodity prices? • Are assumptions of the entity's ability to continue as a going concern valid? • Have you assessed impact of the changes in working capital which leads to liquidity needs? • 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? • Given the high degree of uncertainty, would an expected cash flow (which uses multiple, probability-weighted cashflow projections) rather than single cash flow projection be used?
3. Reflecting risk in discount rate	<ul style="list-style-type: none"> • Do discount rates used in recent valuations need to be updated to reflect the risk environment at the reporting date? • How likely would a decrease in risk-free rate from the reduction of the yield on government bonds directly translates to a decline in a company's discount rate, if at all? • Should you include any additional risk premiums to reflect the overall greater uncertainty in forecasting inputs, credit risk and liquidity risk? • How will you determine any CGU and asset specific adjustments?
4. Determine the disclosure requirements	<ul style="list-style-type: none"> • 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 at least 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 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 risk and financial reporting process.

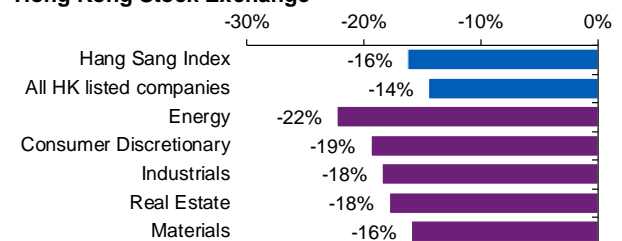
For example, COVID-19 may give rise to force majeure events or triggers to material adverse contract clauses which can be the catalyst for asset specific impairments. In our view, the cash flows (at least in the near term) of many, if not all, asset classes will be affected by COVID-19. They may also trigger the requirement for impairment tests for PP&E, inventory, 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 trigger impairment events 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.

In terms of the market trend of Hong Kong and Mainland China (which includes Hang Seng Index, Shanghai Stock Exchange 50 A Share Index, Shenzhen Stock Exchange Component Index), all showed a decreasing trend where Hang Seng index significantly dropped by 16% from year end of 2019 to end of March 2020, while the market indices in China declined at a smaller degree by 12% (Shanghai) and 4% (Shenzhen) during the same period.

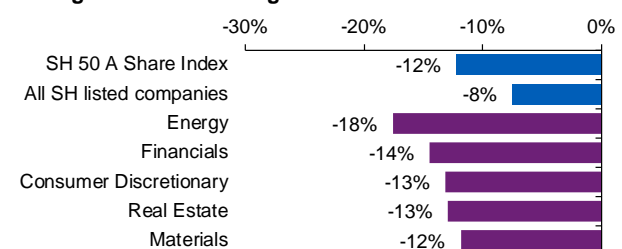
Similarly the market capitalization for most of the sectors have fallen in the first quarter of 2020. Some of these decreases have been dramatic, meaning that condition 2 is also (potentially) met. The graphs below illustrate a selection of sectors with significant market value decline in the Hong Kong, Shanghai and Shenzhen markets.

Selection of sectors with significant market value decline

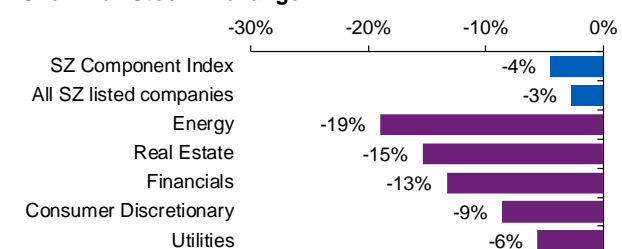
Hong Kong Stock Exchange



Shanghai Stock Exchange



Shenzhen Stock Exchange



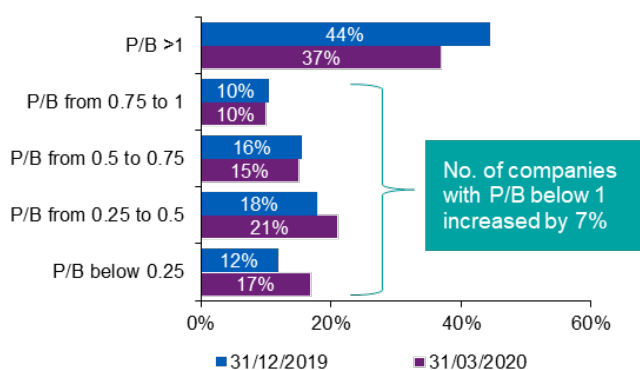
Source: S&P Capital IQ



Has there been a trigger event or indicator of impairment? (continued)

With the drop in market capitalization, more listed companies in Hong Kong have a market capitalization lower than its reported net book value (i.e. P/B ratio lower than 1). For the companies listed in the Hong Kong Stock Exchange, the number of companies with P/B ratio below 1 has increased by 7% percentage points from 31 December 2019 to 31 March 2020, whilst the median of P/B ratio has dropped from 0.85x to 0.69x during the period.

Distribution of P/E ratio of HK listed companies



Source: S&P Capital IQ



Key takeaways

Covid-19 is likely a triggering event for impairment testing. A company should accelerate the normal annual impairment tests, assess other assets for impairment that it would not typically require an assessment for.

There are no shortcuts in revisiting cashflow forecast or estimating the discount rate. A robust analysis is required to determine the risk adjustment factors based on the facts and circumstances of the company. With the uncertainty on the duration and impact of Covid-19, significant informed judgements are required in preparing the projections.

The assumptions adopted in the cashflow projections should be backed by external market evidence and a robust documentation which setting out the determination bases.

For listed companies, a reconciliation of the fair value estimates to market capitalization should be performed when there is premium. The larger the premium, the more analysis should be conducted to see if the underlying assumptions should be adjusted.



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

Contact us



Janet Cheung

Partner, Head of Valuation Services, China
Phone: +852 2140 2818
Email: janet.cheung@kpmg.com



Dennis Zhang

Partner, Valuation Services, Beijing
Phone: +86 10 8508 5860
Email: dennis.zhang@kpmg.com



Nikki Shen

Partner, Valuation Services, Shanghai
Phone: +86 21 2212 3511
Email: nikki.shen@kpmg.com



Winston Wang

Partner, Valuation Services, Guangzhou
Phone: +86 20 3813 8238
Email: winston.wang@kpmg.com

[kpmg.com/cn](https://www.kpmg.com/cn)

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