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AUDIT UPDATE

IMPACT OF COVID-19 ON NON-FINANCIAL ASSETS

Impairment under Ind AS 36 "Impairment of assets"

Ind AS 36 *Impairment of Assets* applies to a variety of non-financial assets including property, plant and equipment, right-of-use assets, intangible assets and goodwill, investment properties measured at cost and investments in associates and joint ventures. Following needs to assess:

- Investment in Subsidiary, Associates and Joint Ventures
- Goodwill and Other Non-Financial Assets
- Impact on Useful life and Residual Value

Investments in Subsidiary, Associates and Joint ventures

The guidance in Ind AS, Investments in Subsidiary, Associates and Joint Ventures is used to determine whether it is necessary to perform an impairment test for investments in equity-accounted investees. If there is an indication of impairment, then the impairment test follows the principles of Ind AS 36.

Goodwill and other Non-Financial Assets

Ind AS 36 requires goodwill and indefinite-lived intangible assets to be tested for impairment at least annually and other non-financial assets when there is an indication of possible impairment (a triggering event). It provides examples of indicators of triggering events, including:

- when significant changes have taken place during the period (or will take place in the near future) in the market or in the economic environment in which the company operates and these changes will have an adverse effect on the company; and
- when the carrying amount of the company's net assets is higher than its market capitalization.

The impacts of Covid-19 have caused a significant deterioration in economic conditions for many companies and an increase in economic uncertainty for others, which may constitute triggering events.

- Certain sectors have been significantly impacted – e.g. travel tourism, entertainment, retail, construction, manufacturing, insurance and education.
- Companies in extractive industries may also have been significantly affected by decreases in commodity prices and companies in countries that are economically dependent on these commodities may also be exposed to a greater risk of adverse economic impacts.
- Certain types of investment properties (and right-of-use assets arising from leased real estate) – e.g. retail and industrial properties – may be considerably affected by Covid-19. Tenants that have been forced to suspend operations may not be able to pay rent in the near term or may ask to renegotiate a lower rent. They may also become less creditworthy. Similar considerations would also apply for companies that lease assets (e.g. aircraft and shipping vessels) to the transport sector.

Management should consider whether:

- COVID-19 and the measures taken to control it are likely to reduce future cash inflows or increase operating and other costs for the reasons described above;
- These events, including for example a fall in an entity's share price such that market capitalization is lower than carry value, are an indicator of impairment requiring that goodwill and indefinite lived intangible assets are tested outside of the annual cycle or that other assets are tested;
- The assumptions and cash flow forecasts used to test for impairment should be updated to reflect the potential impact of COVID-19;
- Budgets, forecasts and other assumptions from an earlier impairment testing date that were used to determine the recoverable amount of an asset should be revised to reflect the economic conditions at the balance sheet date, specifically to address increased risk and uncertainty;

- An expected cash flow approach (multiple probability-weighted scenarios) might be a better way to estimate recoverable amount than a single predicted outcome to capture the increased risk and uncertainty. The potential impact of measures taken to control the spread of the virus could be included as additional scenarios in an expected cash flow approach. There might be a range of potential outcomes considering different scenarios;
- The factors used to determine the discount rate, however the recoverable amount is determined, should be revised to reflect the impact of the virus and the measures taken to control it, for example the risk free rate, country risk and asset risk. The discount rate used in a single predicted outcome approach should be adjusted to incorporate the risk associated with COVID-19. Management should ensure that appropriate risk is reflected in either the cash flows or the discount rate.

Whichever approach management chooses to reflect the expectations about possible variations in the expected future cash flows, the outcome should reflect the expected present value of the future cash flows. When fair value is used to determine the recoverable amount, the assumptions made should reflect market participant assumptions.

Impact on useful life and residual value

If recent events have changed the company's usage or retention strategy for any of its property, plant and equipment, then management should review whether the useful life and residual value of these assets, and the depreciation method applied to them, remains appropriate. This review may also be required after testing a CGU or an asset for impairment. Any such changes are accounted for prospectively as a change in accounting estimate.

Disclosure

Annual reports

In the context of impairment testing of goodwill and indefinite-lived intangible assets, Ind AS 36 requires disclosure of the key assumptions used to determine the recoverable amount. It also requires sensitivity disclosures if a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount. Furthermore, Ind AS 1 Presentation of Financial Statements requires disclosure of the key assumptions that a company makes about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year.

Because the uncertainty associated with management's assumptions about the future is likely to be significant, it is important that management develops robust disclosures to help users understand the degree of estimation uncertainty that exists in estimating the recoverable amount and the sensitivity of the recoverable amount to reasonably possible changes to key assumptions. For example, it may be appropriate to disclose management's views about the degree of uncertainty associated with the macroeconomic outlook (such as the severity and duration of the impact that Covid-19 is expected to have on the company's business) and/or the potential significance of disruption to the supply chain, factory shutdowns, fall in demand etc.

Interim condensed reports

Ind AS 34 Interim Financial Reporting requires disclosure of the nature and amount of changes in estimates. Impairment losses are examples of events and transactions that require disclosure under Ind AS 34 if they are significant.

Ind AS 36 disclosures are not required in interim condensed financial statements. However, given the current economic uncertainties – and depending on the circumstances of the company – providing some or all of the disclosures required by Ind AS 36 may be helpful to users in understanding management's assessment of the economic outlook and how different scenarios could impact the recoverability of assets.

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