Impairment of assets and asset valuations

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Introduction

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Key assets impacted

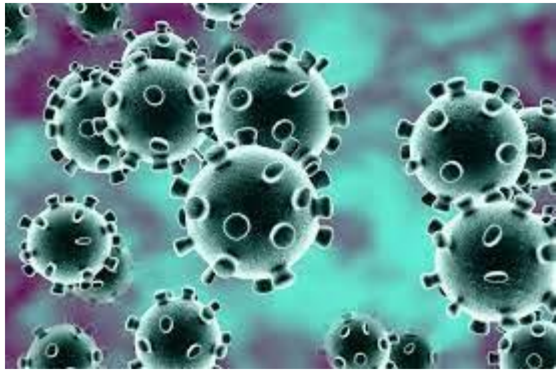
- Goodwill / other intangible assets
- Property, plant and equipment
- Investment property
- Investments such as share portfolios
- Financial assets (including trade receivables)
- Inventory

A key point to remember

- When assessing asset values and impairment, need to consider the situation **at the balance sheet date**
- For 31/12/19 year ends – pandemic is a non-adjusting post balance sheet event
- For 31/3/20 year ends – pandemic exists pre-year end
- Other 2020 year ends and going forwards:
  - consider state of pandemic and effect on the entity at the reporting date
  - include consideration of any national or local restrictions which may have an impact eg, hospitality businesses and the 10pm curfew / local lockdowns

Goodwill / intangible assets: accounting implications

- Goodwill: value may be impaired as a result of the pandemic
  - eg, if subsidiary operates in hospitality industry or in areas particularly affected (such as the Far East earlier this year)
- When there are indications of impairment, need to calculate recoverable amount
  - higher of value in use and fair value less costs to sell
- Based on discounted cash flows, using a sensible discount rate
- Largely the same process under FRS 102 and IFRS
- However, because FRS 102 mandates amortisation of goodwill, significant impairments may be more likely for IFRS reporters



Goodwill / intangible assets: accounting implications (2)

- If recoverable amount lower than carrying amount, impairment charge needs to be booked
- Key point: goodwill impairment cannot be reversed (other impairments can)
- Investment in subsidiary most likely also impaired
- Detailed disclosures likely to be required (especially for IFRS reporters)

Goodwill / intangible assets: audit implications

- Professional scepticism!
- Client needs to prepare decent cash flow forecasts
  – possibly more than one scenario
- Auditor needs to critically appraise forecasts and the underlying assumptions
  – consider sensitivities
- Do they make sense in light of auditor's knowledge of the client?
- Key area of focus for monitoring bodies
- Consider effect on opinion eg, is enough evidence available?
- Is it a critical estimate/ judgement which requires disclosure?

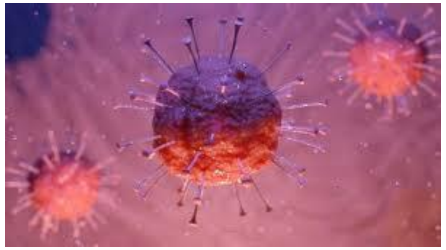
Example

- Company based in UK. Subsidiaries run events in various locations globally
- 31/12/19 – no pandemic declared
  - impairment reviews will not take into account effect of COVID-19 on goodwill: nothing affected at that date including in Far East – so non-adjusting PBSE
- 31/12/20 – events cancelled or rescheduled
  - impairment reviews need to take pandemic into account, including the situation in the jurisdictions in which they operate at 31/12/20
  - include effect on cash flows of events being rescheduled to later date or cancelled (or alternative arrangements such as virtual events)
  - cancellations likely to have greater effect on recoverable amount than postponements

Property, plant and equipment (PPE)

- When there are indicators of impairment, similar issues as for intangibles
- Assets held at valuation – caveats on values? (see next section!)
- Has there been a cessation or change in use of PPE as a result of COVID?
  - office space not being used
  - plant not being used
  - effect on values (but also useful life/ depreciation rates)
- For auditors, again assess based on knowledge of client and critically challenge assumptions
- Consider above factors and whether adjustments required

Investment property – accounting implications



- FRS 102 – measured at fair value with changes in value through profit or loss (FVTPL)
- IFRS – use either FVTPL or cost model
- Fair value – price paid by 3rd party in an active market at the reporting date
- Changes in value after that date – consider disclosure if material to the users of the accounts

Investment property – accounting implications (2)

- Issue: RICS valuations being subject to ‘material uncertainty’
- Due to lack of market data (nothing selling during lockdown)
- Being lifted now in some circumstances
- Does not mean valuation cannot be relied on but does mean it comes with a caveat

Investment property – accounting implications (3)

- For 31/12/20 and some earlier and subsequent year ends, property companies may be impacted by the following:
  - rent concessions being granted (deferrals will have less of an effect)
  - break clauses being activated (lessee needs less office space)
  - leases being renegotiated
- May have an effect on asset values as well as income
- COVID-related rent concessions – FRS 102 amendment coming soon (lessors and lessees)
- IFRS amendment already in issue (lessees only)

Investment property – auditing implications

- Is the fair value at the reporting date the right one based on market conditions at that date?
- Effect on audit report if RICS caveat is included in valuations:
  - property not material – probably nothing
  - if material – is there enough evidence? Consider other sources not just the valuation
  - if not enough evidence – limitation in scope
  - if enough evidence – possible emphasis of matter
- Professional scepticism (again!) if valuation not RICS eg, director valuation
- Consider critical estimates/ judgements disclosures

Example

- Entity has a significant investment property portfolio, both commercial and residential property (all in London)
- Year end is 31 March
- For 31/3/20 – main issue was the RICS caveat; emphasis of matter in audit report
- For 31/3/21 – rent concessions granted to commercial tenants; need to ensure
  - effect on valuation taken into account by valuers where relevant
  - accounting for the rent concessions is correct (spread over period concession intended to compensate)
  - deferrals – simply a timing issue not recognition
  - accounting for any lease renegotiations etc is correct

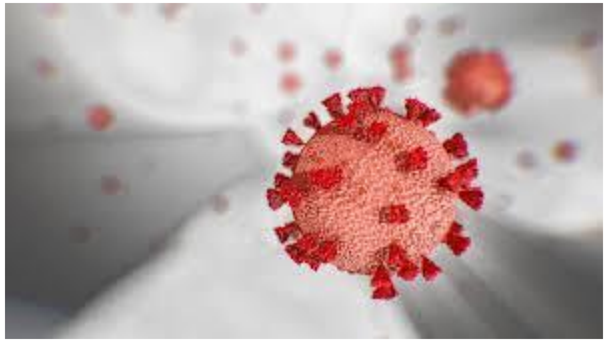
Investments – accounting implications

- Investments in subsidiaries, associates & JVs are usually measured at cost, but situation may provide indicators of impairment
- Similar requirements to goodwill for preparation of discounted cash flows etc
- Investment portfolio values may be affected
  - eg, portfolios held by charities or pension schemes
- Valuation will be at reporting date (eg, listed security traded price) so could be impacted by stock market fluctuations. This happened in March and may happen again if there is 2nd national lockdown?
- If valuation changes significantly between reporting date and date of approval, then disclose as non-adjusting PBSE

Investments – auditing implications

- For investments in subsidiaries etc, similar to goodwill (professional scepticism!)
  - are cash flow forecasts/ assumptions appropriate?
- Other investments:
  - has the correct value been used ? Agree to supporting evidence eg, stock market prices
  - is the disclosure appropriate? Post year end change in values may well be important to the users of the accounts
  - potentially also important for going concern (eg, charity reliant on income from or value of investment portfolio)

Other financial assets – accounting implications



- For most businesses, the key impact will be on recoverability of trade receivables
- FRS 102 – incurred loss model
- IFRS – expected loss model
- Still need to look at situation at balance sheet date; was the loss incurred/ expected at that point?
- How was the receivable affected by the pandemic at the balance sheet date?

Other financial assets – audit implications

- Consider post balance sheet evidence – is it evidence of conditions that existed at balance sheet date?
- For auditors, may not be that easy to tell (not least given pace of change of situation)
- Normally if a trade receivable goes bad post year end, it’s an adjusting PBSE, but may not be that simple if gone bad due to something that happened post year end
- Will be crucial to review after date cash collections up to the point of signing the audit report

Inventories – accounting implications

- Under both FRS 102 and IFRS, measured at the lower of cost and net realisable value (NRV) ie, what it can be sold for
- Key point – has NRV reduced as a result of the pandemic?
- Similar considerations for WIP / accrued income – is carrying value appropriate?
- For some entities, may well reduce ability to sell goods/ services depending on situation (eg, local lockdowns)

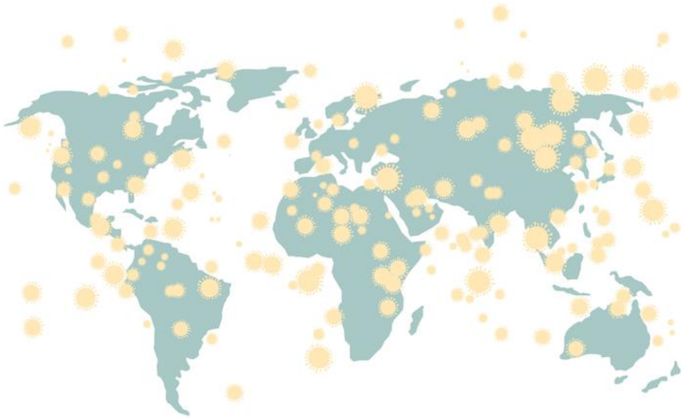
Inventories – audit implications

- Post year end sales review will always be key, combined with knowledge of client / industry
- Again, what was the situation at the reporting date?
- Examples:
  - pub companies had to throw away millions of pints of beer due to lockdown – could happen again?
  - online retailers – did pretty well
  - will depend very much on what they sell and where/ to who they sell it

Looking to the future

- Uncertainty will be a key part of the 31/12/2020 reporting season
- Impact of COVID, related restrictions, and therefore effect on entities will be constantly changing
- Effects could be felt at international, national or local level
- Dare I mention Brexit?
- A lot of judgement will be required – by clients and auditors – to determine what the impact will be on the accounts
- Focused disclosure will be really important for users
- ICAEW coronavirus hub updated frequently with financial reporting and audit guidance

ICAEW Coronavirus Hub



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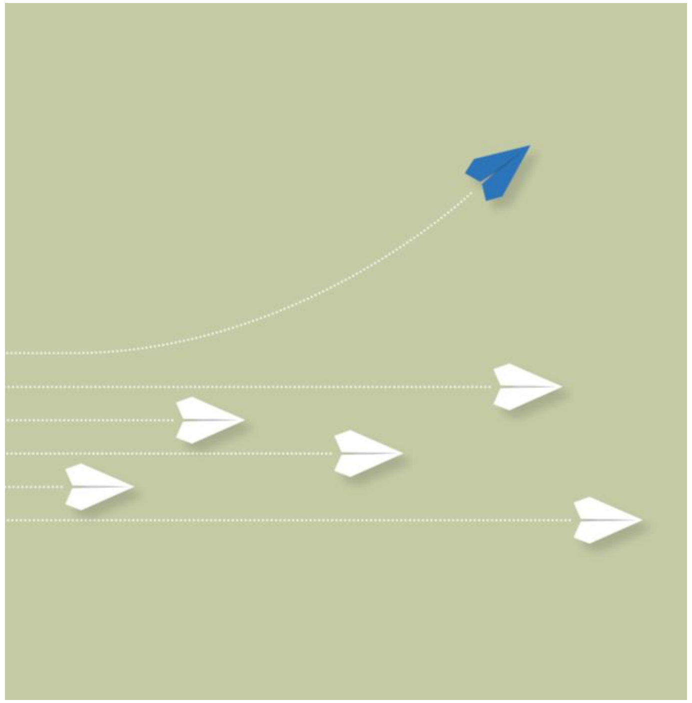

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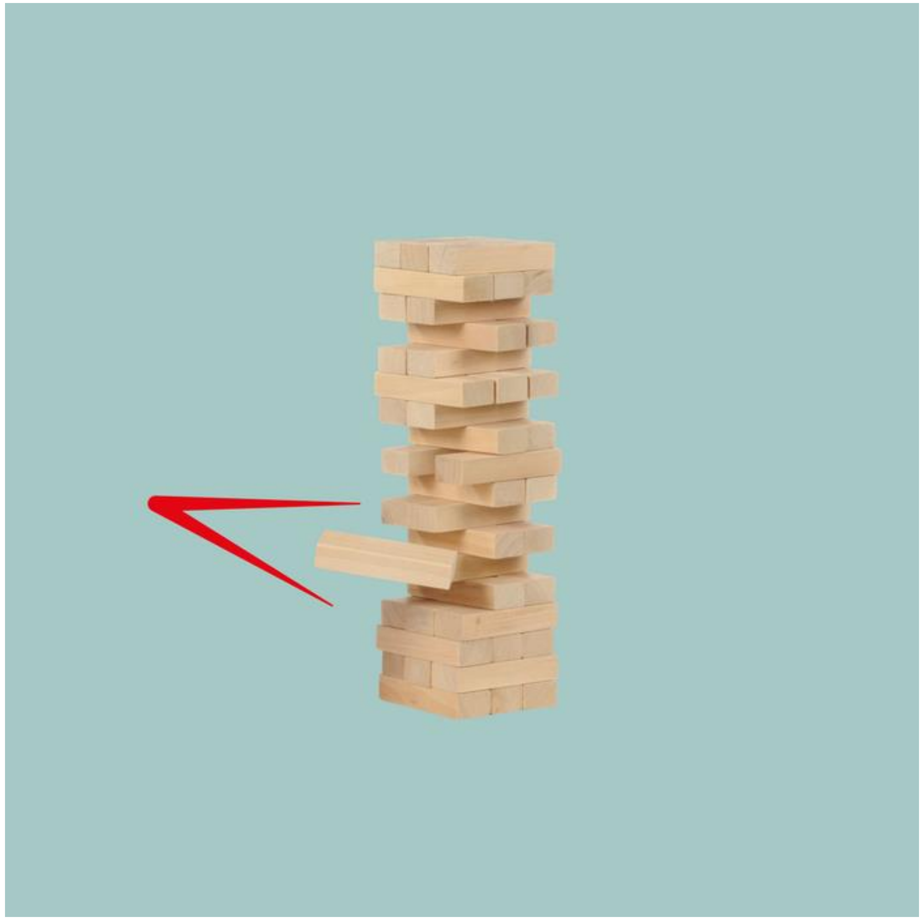
- Tune in on **30 October** for live Q&As with the presenters



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