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MOORE APAC WEBINAR: IMPAIRMENT OF ASSETS

TUESDAY, 13 OCTOBER 2020
12:00 - 13:30 (HKT)

SPEAKERS: David Holland from Moore Australia and Koon Min Wong from Moore Singapore

PANELISTS: Michelle Chu from Moore Hong Kong and George Dakis from Moore Australia

MODERATOR: Helen Tang from Moore Hong Kong

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Impairment of Non-Financial Assets

DAVID HOLLAND

October 2020

GUEST SPEAKER

DAVID HOLLAND

National Head of Technical Accounting at Moore Australia

- Board member AASB
  - David is responsible for providing the MA network and clients with in-house technical training and technical advice on specific accounting issues. As a specialist in his field, David has prepared and delivered a variety of IFRS seminars for Chartered Accountants ANZ.

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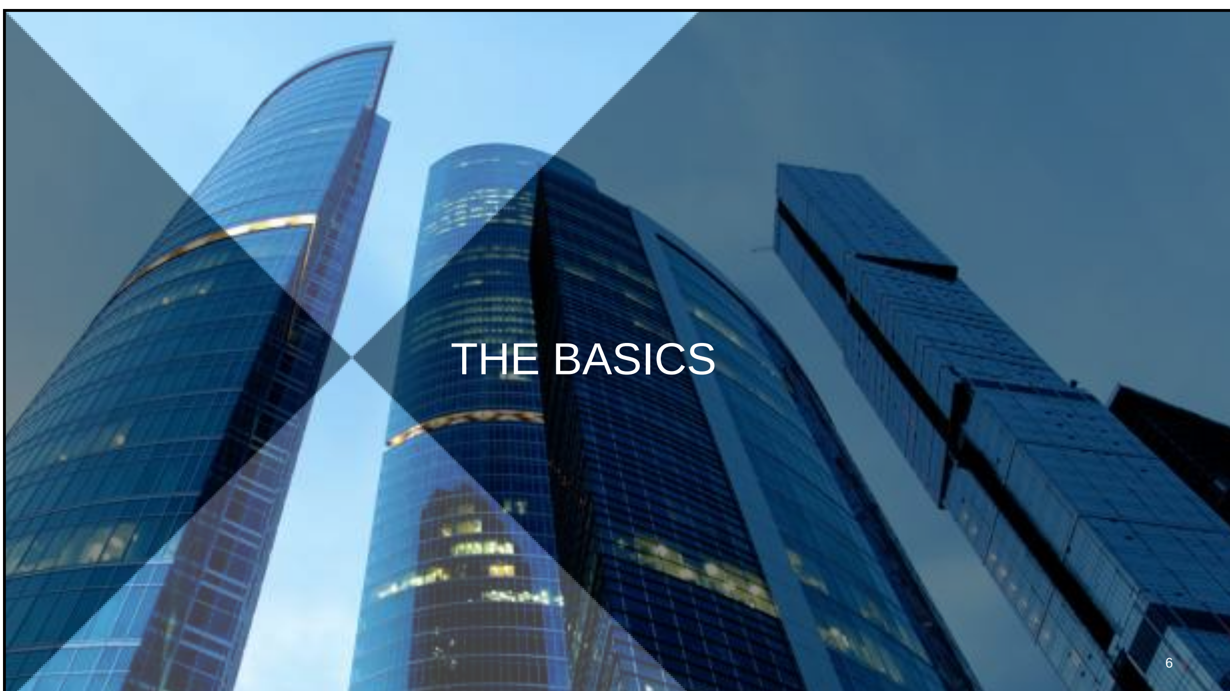

THE BASICS

INDICATORS OF IMPAIRMENT INCLUDE:

- There are observable indications that the asset's value has declined
- Significant changes with an adverse effect on the entity have taken place during the period
- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

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THE BASICS

INDICATORS OF IMPAIRMENT INCLUDE:

- The carrying amount of the net assets of the entity is more than its market capitalisation.
- Evidence is available of obsolescence or physical damage of an asset.
- Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

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THE BASICS

IRRESPECTIVE OF WHETHER THERE IS ANY INDICATION OF IMPAIRMENT, AN ENTITY SHALL ALSO:

- Test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount
- Test goodwill acquired in a business combination for impairment annually

THE BASICS

IAS 36.66:

- If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset.
- If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs

THE BASICS

IAS 36.68:

- An asset's cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement……

THE BASICS

CASCADING IMPAIRMENT TESTS:

- Individual assets
- CGUs
- Groups of CGUs
  - Corporate assets
  - Goodwill (lowest level within the entity at which the goodwill is monitored for internal management purposes – not larger than segment)

TANGIBLE ASSETS

- Generally tested an individual or CGU level.

KEY FOCUS AREAS:

- Obsolescence
- Physical damage
- Technological changes
- Other data (i.e. lack of performance)

TANGIBLE ASSETS

MEASURE RECOVERABLE AMOUNT AS THE HIGHER OF:

- Fair value less costs of disposal; and
- Its value in use.

TANGIBLE ASSETS

FACTORS ADVERSELY AFFECTING THE VALUES OF COMMERCIAL AND RESIDENTIAL PROPERTIES SHOULD BE CONSIDERED, DESPITE ANY ABSENCE OF MARKET TRANSACTIONS, THESE MAY INCLUDE:

- Expected changes in office work practices affecting future space requirements of tenants;
- Possible changes in consumer preferences between ‘bricks and mortar’ retail and on-line shopping;
- Economic or industry impacts on future tenancy;
- Changes in the financial condition of existing tenants; and

TANGIBLE ASSETS

FACTORS ADVERSELY AFFECTING THE VALUES OF COMMERCIAL AND RESIDENTIAL PROPERTIES SHOULD BE CONSIDERED, DESPITE ANY ABSENCE OF MARKET TRANSACTIONS, THESE MAY INCLUDE:

- Restructuring of agreements with tenants.
- The recent new lease accounting requirements, the treatment of rental concessions by lessors and lessees, and the impairment of lessee right-of-use assets.

OTHER ASSETS

VALUES OF OTHER ASSETS

- The value of Inventories, including where demand reduces and inventory levels increase.
- Whether it is probable that deferred tax assets will be realised.
- The impact of the COVID-19 pandemic on the value of investments in unlisted entities.

INTANGIBLE ASSETS

- Much more complicated
- Often hard to establish Fair Value
- Results in a reliance on value in use (VIU):
  - Significant judgment
  - Hard to audit/verify

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INTANGIBLE ASSETS

- COVID 19 a perfect example why it is so hard to estimate future values

INTANGIBLE ASSETS

IMPAIRMENT OF NON-FINANCIAL ASSETS ISSUE TO CONSIDER:

- The appropriateness of key assumptions supporting the recoverable amount of non-financial assets.
- Given uncertainties, it may be necessary to use probability-weighted scenarios in making estimates of both fair value and value in use. In those cases, modelling risk may still need to be factored into the discount rate used in a discounted cash flow model.
- Disclosure of estimation uncertainties, key assumptions, and sensitivity analysis or information on probability-weighted scenarios.

INTANGIBLE ASSETS

REMEMBER:

- Cash flows and assumptions are reasonable having regard to matters such as historical cash flows, economic and market conditions, and funding costs. Particularly where prior period cash flow projections have not been met, careful consideration should be given to whether current assumptions are reasonable and supportable
- Discounted cash flows are not used to determine fair value less costs of disposal where forecasts and assumptions are not reasonable and supportable
- Cash flows used are matched to carrying values of all assets that generate those cash flows, including inventories, receivables and tax balances

INTANGIBLE ASSETS

REMEMBER:

- Discount rates and other key assumptions are reasonable and supportable;
- Cash generating units (CGUs) are not identified at too high a level, including where cash inflows for individual assets are not largely independent.

INTANGIBLE ASSETS

- A company's weighted average cost of capital may be relevant in determining recoverable amount using discounted cash flows.
- Where borrowing rates change or the split of debt and equity changes, care needs to be taken as to whether the recoverable amount has changed.
- A change in the split of debt and equity from recognising more liabilities under the new lease accounting standard.

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ROU ASSETS

WHERE ROU ASSETS GENERATE LARGELY INDEPENDENT CASHFLOWS:

- Test on a stand alone basis when required

WHERE ROU ASSETS DON'T GENERATE LARGELY INDEPENDENT CASHFLOWS:

- Test as part of a CGU when indicators exist (or annually where required)

ROU ASSETS

LEASE LIABILITIES:

- Generally LL are ignored and the lease payments excluded unless buyer would assume the liability (IAS 36.78)

LEASE LIABILITIES ASSUMED BY BUYER:

- FVLCD (sales price must allow for buyer taking on liability)
- VIU must deduct LL

ROU ASSETS

PRACTICAL IMPLICATION

- Since ROU asset and LL now included in B/S debt/value and other ratios have changed this should change WACC

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ROU ASSETS

EY EXAMPLE

EY publication: Applying IFRS Impairment considerations for the new leasing standard November 2018

2.2.1 Pre-IFRS 16

CUR '000		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		1,000	1,100	1,200	1,300	1,000
EBITDA before operating lease costs		120	140	150	150	100
Operating lease costs		-30	-30	-30	-30	-30
EBITDA		**90**	**110**	**120**	**120**	**70**
Depreciation		-64	-64	-64	-64	-64
EBIT		**26**	**46**	**56**	**56**	**6**
Free cash flows	Pre-tax return	**90**	**110**	**120**	**120**	**70**
Discount period	12.0%	0.5	1.5	2.5	3.5	4.5
Discount factor		0.9	0.8	0.8	0.7	0.6
Discounted cash flows		85	93	90	81	42
NPV/ VIU		**391**				
Carrying value		370				
Headroom		21				

Carrying value				Return	Weighting	Discount rate
Goodwill	50	Equity	370	12.0%	100.0%	12.0%
Fixed assets	320					
Right-of-use asset	0	Lease Liab.	0	5.0%	0.0%	0.0%
TOTAL	370		370			**12.0%**

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ROU ASSETS

EY EXAMPLE

EY publication: Applying IFRS Impairment considerations for the new leasing standard November 2018

2.2.2 Post-IFRS 16, same discount rate as pre-IFRS 16

The example below is based on the same information and the same date as the example in paragraph 2.2.1, but now applying the accounting principles of IFRS 16:

CUR'000		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		1,000	1,100	1,200	1,300	1,000
EBITDA before operating lease costs		120	140	150	150	100
Operating lease costs		0	0	0	0	0
EBITDA		120	140	150	150	100
Depreciation		-64	-64	-64	-64	-64
Added depreciation right-of-use asset		-27	-27	-27	-27	-27
EBIT		**29**	**49**	**59**	**59**	**8**
Free cash flows	Pre-tax return	**120**	**140**	**150**	**150**	**100**
Discount period	12.0%	0.5	1.5	2.5	3.5	4.5
Discount factor		0.9	0.8	0.8	0.7	0.6
Discounted cash flows		113	118	113	101	60

	Without lease liability	Lease liability	With lease liability
NPV/ VIU	**505**	**-133**	**372**
Carrying value	503	-133	370
Headroom	2		2

Carrying value				Return	Weighting	Discount rate
Goodwill	50	Equity	370	14.5%	73.7%	10.7%
Fixed assets	320					
Right-of-use asset	133	Lease Liab.	133	5.0%	26.3%	1.3%
	503		503			**12.0%**

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ROU ASSETS

EY EXAMPLE

EY publication: Applying IFRS Impairment considerations for the new leasing standard November 2018

2.2.3 Post-IFRS 16, adjusted discount rate

CUR'000		Year 1	Year 2	Year 3	Year 4	Year 5
Revenue		1,000	1100	1200	1300	1000
EBITDA before operating lease costs		120	140	150	150	100
Operating lease costs		0	0	0	0	0
EBITDA		120	140	150	150	100
Depreciation		-64	-64	-64	-64	-64
Added depreciation right-of-use asset		-27	-27	-27	-27	-27
EBIT		**29**	**49**	**59**	**59**	**9**
Free cash flows	Pre-tax return	**120**	**140**	**150**	**150**	**100**
Discount period	10.2%	0.5	1.5	2.5	3.5	4.5
Discount factor		1.0	0.9	0.8	0.7	0.6
Discounted cash flows		114	121	118	107	64

	Without lease liability	Lease liability	With lease liability
NPV/ VIU	**524**	**-133**	**391**
Carrying value	503	-133	370
Headroom	21		21

Carrying value				Return	Weighting	Discount rate
Goodwill	50	Equity	370	12.0%	74.6%	8.9%
Fixed assets	320					
Right-of-use asset	133	Lease Liab.	133	5.0%	25.4%	1.3%
	503		503			**10.2%**

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ROU ASSETS

TERMINAL VALUE

- Do you need to continue to use leases in the future?
- Replacement of ROU asset must be assumed as capex

- Super hard in practice:
  - When does lease end versus cash forecast period
  - Multiple leases
  - How do you factor in the reinvestment in leased assets?

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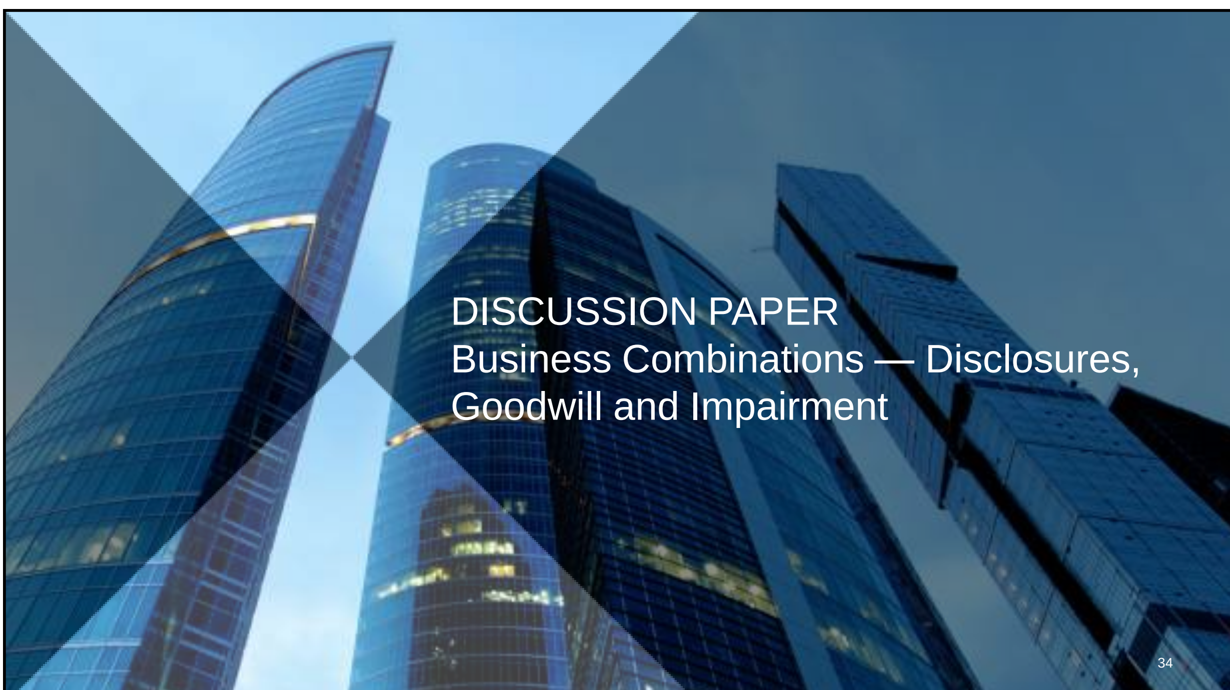

DISCUSSION PAPER

- Mergers and acquisitions—referred to as business combinations in IFRS Standards—are often large transactions for the companies involved.
- These transactions play a central role in the global economy, with deals announced in 2019 totalling in excess of $4 trillion.
- Goodwill amounted to $8 trillion for all listed companies worldwide, accounting for around 18% of their total equity and 3% of their total assets.

DISCUSSION PAPER

- The International Accounting Standards Board (Board) is carrying out a research project on Goodwill and Impairment, considering issues identified in a Post-implementation Review of IFRS 3.
- The purpose of a PIR is to identify whether a Standard is working as the Board intended.
- The project's objective is to explore whether companies can, at a reasonable cost, provide investors with more useful information about the acquisitions those companies make.

DISCUSSION PAPER

THE PROJECT CONSIDERS THE FOLLOWING TOPICS IDENTIFIED IN THE PIR OF IFRS 3:

a) Disclosing information about acquisitions;
b) Testing goodwill for impairment—effectiveness and cost;
c) Whether to reintroduce amortisation of goodwill; and
d) Recognising intangible assets separately from goodwill.

DISCUSSION PAPER

THE BOARD'S PRELIMINARY VIEWS ARE THAT IT:

- Should develop proposals to enhance the disclosure objectives and requirements in IFRS 3 to improve the information provided to investors about an acquisition and its subsequent performance;
- Cannot design a different impairment test for cash-generating units containing goodwill that is significantly more effective than the impairment test in IAS 36 at recognising impairment losses on goodwill on a timely basis and at a reasonable cost;

DISCUSSION PAPER

THE BOARD'S PRELIMINARY VIEWS ARE THAT IT:

- Should not reintroduce amortisation of goodwill;
- Should develop a proposal to help investors better understand companies' financial positions by requiring companies to present on their balance sheets the amount of total equity excluding goodwill;

DISCUSSION PAPER

THE BOARD'S PRELIMINARY VIEWS ARE THAT IT:

- Should develop proposals intended to reduce the cost and complexity of performing the impairment test by:
  - Providing companies with relief from having to perform an annual quantitative impairment test for cash-generating units containing goodwill if there is no indication that an impairment may have occurred; and
  - Extending the same relief to companies for intangible assets with indefinite useful lives and intangible assets not yet available for use;

DISCUSSION PAPER

THE BOARD'S PRELIMINARY VIEWS ARE THAT IT:

- Should develop proposals intended to reduce cost and complexity, and to provide more useful and understandable information by simplifying the requirements for estimating value in use by:
  - Removing the restriction on including cash flows from a future uncommitted restructuring or from improving or enhancing an asset's performance (Section 4); and
  - Permitting the use of post-tax cash flows and post-tax discount rates; and
- Should not change the range of identifiable intangible assets recognised separately from goodwill in an acquisition.

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Impairment of Financial Assets

KOON MIN WONG

October 2020

GUEST SPEAKER

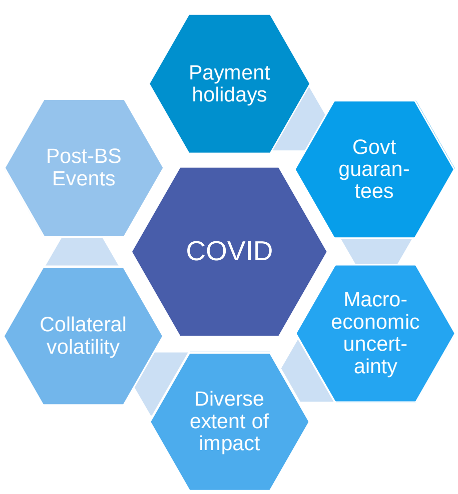
WONG KOON MIN

Head of Technical, Compliance and Financial Services at Moore Singapore

With over twenty years of professional experience in auditing and financial reporting advisory services, Koon Min's experience encompasses a wide variety of industries including financial, real estate, manufacturing, trading, commodities, and transportation. He presents widely in public presentations and private client seminars.

Koon Min currently serves in the Financial Reporting Committee within the Institute of Singapore Chartered Accountants. He is also a member of the Institute of Singapore Chartered Accountants, Chartered Accountants Australia & New Zealand, and the Institute of Chartered Shipbrokers.

COVID-19 ISSUES



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PAYMENT HOLIDAYS

- Payment holidays granted in many countries, especially by banks and financial institutions.
- IASB/ BCBS: Utilisation of payment deferral program, would not, by itself, automatically trigger SICR/ Default

BUT:

- Lender still needs to assess SICR/ Default, albeit more judgmental.
- Even if no impairment, may require debt modification accounting.

GUARANTEES

- Credit enhancements, such as guarantees, have been provided by some governments.
- ESMA: Credit enhancements accounted for as reduction of ECL not limited to explicit contractual terms; include "*public guarantee… provided in conjunction with broadly applicable ex-lege debt moratoria or economic support and relief measures*".
- Guarantee may reduce PD or LGD

MACROECONOMIC UNCERTAINTY

- Challenges with forward-looking assessment
  - Uncertain pandemic trajectory
  - Unprecedented impact => historical references not available
- Past models and assumptions should be reassessed for continued applicability.
- Multiple scenarios should be considered more critically.
- Adopt a “best-efforts”, responsive approach to dealing with uncertainty.
- Consider forecasts from experts such as OECD (e.g. see https://doi.org/10.1787/0d1d1e2e-en) and World Bank.
- Certain regulators such as ESMA have issued statements emphasizing the longer-term stable outlook as evidenced by past experience.
- Disclosure is important for better understandability of financial statements.

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DISPARATE IMPACT ON VARIOUS SECTORS

- COVID 19 impacts different industries in different ways and to different extent.
- Consider need to re-segment debt assets, with greater granularity, to reflect COVID effects on different sectors.

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IMPACT ON COLLATERAL VALUE

- Collateral value can impact ECL by reducing LGD.
- Valuation of collateral also subject to COVID considerations e.g. uncertainty, assessment of scenario probabilities.
- Parameters should be internally consistent.

POST-BALANCE SHEET EVENTS

- Identifying causation for debt losses can be challenging.
- Adjusting or non-adjusting?

KEY TAKEAWAYS

1. IFRS 9 impairment should not be applied mechanistically.
2. The longer-term outlook should be considered in an ECL assessment.
3. Consider a multi-scenario approach to ECL estimation to deal with COVID uncertainty.
4. Consider re-segmenting debt assets for more accurate assessment of ECL.
5. Remain watchful for post-balance sheet events.

PANELIST

GEORGE DAKIS

Chairman Moore Australia Audit and Assurance Committee

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QUALITY OF ESTIMATES OF FUTURE CASH FLOWS

- Forecasts used in value in use models:
  - based on reasonable and supportable assumptions from a range of economic conditions
  - based on most recent financial budgets/forecasts approved by management
  - management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows
  - projections based on these budgets/forecasts shall cover a maximum period of five years

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QUALITY OF ESTIMATES OF FUTURE CASH FLOWS

- Forecasts used in value in use models:
  - future cash flows for periods longer than five years are generally not available or reliable
  - projections based on steady or declining growth rate for subject year after current year
  - growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates
  - when conditions are favourable, competitors are likely to enter the market and restrict growth. Market conditions need to be considered

QUALITY OF ESTIMATES OF FUTURE CASH FLOWS

- Forecasts should exclude future cash flows:
  - expected to arise from future restructurings
  - expected to arise from improving or enhancing the asset's performance
  - expected from financing activities
  - expected from income tax receipts or payments

QUALITY OF ESTIMATES OF FUTURE CASH FLOWS

Recent significant write offs

- Myer – large retail group – ASIC Media Release 18-087MR 28 March 2018
  - ASIC notes Myer decision to write down the value of its goodwill and brand name by AUD$515m in its financial report for the half-year ended 27 January 2018.
  - ASIC had raised concerns on the value of these assets in Myer's financial report, including the reasonableness and supportability of the cash flow forecasts used in testing the assets for impairment.
- Others
  - ASIC has issued media releases for 17 entities including: Genworth Mortgage Insurance Australia Limited, Medusa Mining Limited, Intrepid Mines Limited, Sequoia Financial Group Limited, Pacific Current Group Limited, Myer Holdings Limited, and Orica Limited
  - The total adjustments to profits because of the changes exceeded $750 million (not all impairment adjustments)
- Australian regulatory guidance
  - ASIC INFO Sheet 203 Impairment of non-financial assets: Materials for Directors

PANELIST

MICHELLE CHU

Assurance Director Moore Hong Kong

ECL for a Money-lender

Scenario :

- Customer A owns a property which is financed by a 5-year loan from Money Lender M
- The loan is secured by a first-priority charge over the property
- At initial recognition M did not consider the loan to be originated credit-impaired
- During 2020, revenues and operating results of A deteriorated significantly due to COVID-19 and repayment of loan could become tight or past due
- Value of the property also deteriorated by 30%

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ECL for a Money-lender

How to measure ECL at 30 June 2020 :

A. Recognise 12 month ECL

B. Recognise lifetime ECL considering the collateral

C. Recognise lifetime ECL without considering the collateral

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ECL for a Money-lender

How to measure ECL at 30 June 2020 :

- M's assessment at 30 June 2020 :
  - The credit risk of the loan to A has increased significantly because further deterioration in A's cash flows could result in A missing a contractual repayment
  - → recognise lifetime ECL on loan to A

- However, M should also consider the recovery expected from the collateral (value of property adjusting for the costs of obtaining and selling the property), which will result in the ECL being very small

ECL for a Money-lender

How to measure ECL at 30 June 2020 :

IFRS 9 – B5.5.55

For the purposes of measuring ECL, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity.

Impairment of goodwill with NCI

Scenario :

Company A acquired a 80% subsidiary M for US$1,600 on 1 Jan 2019. At that date, M's net identifiable assets had a fair value of US$1,500. A chose to measure the NCI as proportionate interest of M's net identifiable assets (US$1,500 x 20% = US$300). Goodwill of US$400 was recognised.
At 31 Dec 2019, A determined the recoverable amount of the cash-generating unit of M was US$1,400. The carrying amount of the net assets of M, excluding goodwill, was US$1,350.

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Impairment of goodwill with NCI

Impairment loss to be recognised

A. $450

B. $360

C. $350

D. $280

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Impairment of goodwill with NCI

Calculating impairment :

Goodwill of subsidiary at 31 Dec 2019
- $400 in books of A
- $100 (unrecognised NCI)
- Total goodwill $500

Net identifiable assets at 31 Dec 2019
- $1,350

Recoverable amount at 31 Dec 2019
- $1,400

Impairment loss = $1,350 + $500 - $1,400 = $450

~~Goodwill of subsidiary at 31 Dec 2019~~
~~$400 in books of A~~
~~Net identifiable assets at 31 Dec 2019~~
~~$1,350~~
~~Recoverable amount at 31 Dec 2019~~
~~$1,400~~
Impairment loss = $1,350 + $400 - $1,400 = $350

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Impairment of goodwill with NCI

Allocating impairment loss:

Firstly to goodwill of $360 (A's share)
$90 to NCI (not recorded)

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QUESTIONS?
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