Impairment asset/liabilities under COVID-19 situation

---- Management accounting estimate is difficult? What is needed for investors? ----

IFRS Digital Reporting Workshop 17

Date and time : 27th May 2020, 18:30-20:30 JST

Impairment

In the spring of 2020, COVID-19 pandemic has been spread globally. Companies face a huge crisis they have never had before. Many economic activities were stuck globally, and made it difficult for company management to forecast revenue, nor evaluate assets and liabilities. However, such an important timing, many companies delayed publishing the financial statements because audit and accounting closing operation had troubles under the emergency declaration situation.

IASB is taking public consultation Discussion Paper "Business Combinations—Disclosures, Goodwill and Impairment ".
There have been long discussions, however, this is something fate, this year many people are interested in "impairment" under COVID-19 situation.
How could management make accounting estimates under this situation? How banks and other financial institutions can continue to provide finance, which is the most important for companies? What is ASBJ, IASB and other regulators / standard setters are saying about it now? This is great timing to think about this topic.

	workshop on
Guest from oversea	2 from UK, 3 from Hong Kong
Attendees (Japan)	19 Investors, 10 Investor(Analysts) organization & sellside analyst, 3 pension & insurance & bank, 3 Information providers/Researchers, 6 Company side (include Independent non - executive director , support service), 6 Auditor, 1 Academic, 9 Regulator, Accounting setter & stock exchange,

Global investors view about the issue of impairment.

- CFA Institute shared global investors discussion about impairment

CFA Institute

Most investors support fair value and impairment. There seems to be a problem with application. The standard setters can’t alone address it. We have been advocating for changes in audit report to cover underlying subjectivity. I support the IASB's current consultation for better disclosure.
Reasons for supporting amortisation – some regulators favour amortisation due to the fact that it is difficult to timely recognise impairment and auditability issues around it. Another reason cited is low interest rates is encouraging manager to acquire businesses for hefty premiums. In the UK, it was pointed out that when Carillion went bankrupt, but it still had unimpaired goodwill balance. Also, as most jurisdictions transitioned from local GAAP (goodwill amortisation) to IFRS, there seems to be discomfort around IFRS concept and a preference to move back to local GAAP. Another criticism is that impairment results in a lot of cost and still companies can’t get it right so better to move back to amortization approach.
We are in process of conducting a global surveys on intangible assets and have already spoken with regulators (FRC, JFSA, FRC Hong Kong) and standard setters (IVSC, IASB and FASB).
A minority view was to write-off goodwill on day 1, but a broad consensus is around improving disclosures.
Another issue of current standards is about internally generated intangible assets. Companies incur significant cost in R&D and in creating internally generated assets but there is no information about such assets on financial statements. This does not reflect the economic substance. (Note: There is an argument that it is not fair that such value is included in the price of acquisition and appears in BS as intangible assets under acquisition accounting but not reflected when businesses create them organically.

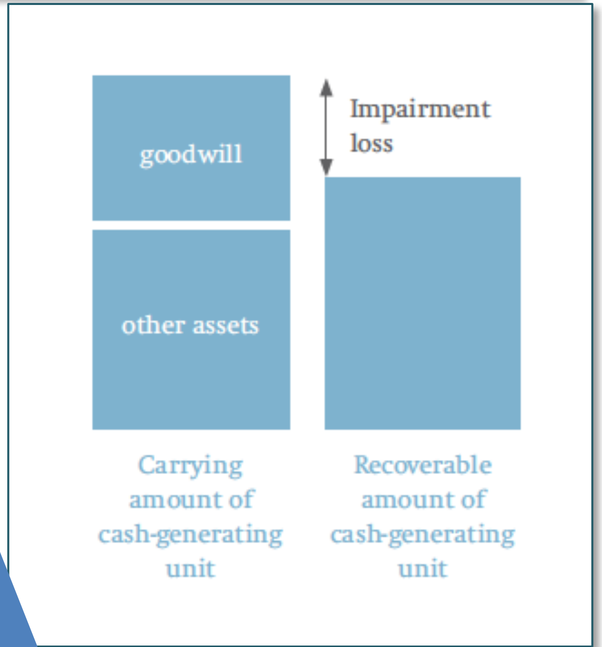
Impairment is not perfect but it is better than a mechanical amortization approach. Impairment is helpful in performing due diligence. Any past impairments may be untimely but provides useful information as to management judgement or external events that caused the investments to be impaired. If amortisations are useful then any analyst can do it themselves. It does not provide any information value.
The Prudential Regulators are pushing amortization from regulatory capital angle. We disagree with this approach – if they want to regulate capital then it should be done separately under regulatory capital guidance not via accounting changes.

https://www.accountingweb.co.uk/community/blogs/kazim-razvi/standard-setters-please-dont-deflate-asset-bubbles
https://www.cfainstitute.org/-/media/documents/comment-letter/2020-2024/20200113.ashx

What IASB trying to do

- Improve disclosure of impairment

The purpose of this discussion paper is to "provide better information to investors" and is not just an accounting matter. It is to provide information that could help investors to make appropriate decisions. Financial statements (FS) must provide sufficient information for investors to make good judgment.
With respect to discussion about amortisation, we must consider whether it provides good information. Some people point out that the management could pay higher price for acquisition because of the lack of amortisation. Still, providing better information will be more important than accounting issues. The current FS does not provide the information that investors want to know, for example, acquisition strategy, the metrics used to make the decisions. What investors want is to decide whether the acquisition is good or not, and whether the impairment test works or not.
To improve disclosure, the IASB made the following proposals: Companies will disclose their monitoring metrics and achievements. What metrics can companies disclose? IFRS is the management approach. So the management should already have the metrics.
By the way, it was also pointed out that the current accounting has significant drawback. It's Shielding Effect. The acquired assets are measured as the cash generating unit (CGU), which include assets acquires already had. If such assets have headroom, it would be difficult to make impairment accounting. This is a serious drawback of current accounting, it makes difficult to improve the impairment information. It is one of the cause of too little too late impairment accounting.
The other issue is about management's judgment. “Estimates of future cash flows are too optimistic, but this is best addressed by auditors and regulators, not by changing accounting standards” I think that this is realistic.



https://www.ifrs.org/projects/work-plan/goodwill-and-impairment/#project-history

Next, regarding the problem of IFRS9 and COVID19. On March 27, the IASB published the paper. What this means is that management should exercise significant judgment. And IASB told not to apply IFRS9 mechanically. It doesn't provide good information.
IASB says that the company should consider future government support, all factors and circumstances. Also, because accounting is principle-based, regulators may provide guidance. The IASB says the company should pay attention to them well. This is consistent with what IASB has been saying about impairment and goodwill. Accounting standards cannot play a significant role in situations like COVID19.

https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-9/#education

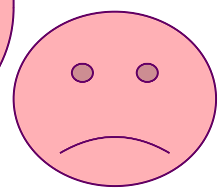
Cases Too late, too little

(billion yen)

Items	One-time loss on consolidated net profit (after tax)	
	Forecast as of Mar-25-2020	FYE 3/2020 actual
Total Q1-Q3 FYE 3/2020	Approx. -29.0	Approx. -29.0
Q4 FYE 3/2020	Approx. -375.0	Approx. -394.0
Oil and gas E&P	Approx. -145.0	-131.3
Impairment loss on oil and gas E&P in the US Gulf of Mexico	Approx. -80.0	-76.2
Impairment loss and reversal of deferred tax assets on oil and gas E&P in the UK North Sea	Approx. -65.0	-55.1
US Grain Business	Approx. -100.0	-98.2
Impairment loss on grain business in Gavilon	Approx. -80.0	-78.3
Impairment loss on grain export business on the US West Coast	Approx. -20.0	-19.9
Impairment loss on Chilean copper mining business	Approx. -60.0	-60.3
Impairment losses on overseas power business and infrastructure related business	Approx. -40.0	-45.7
Impairment loss on Aircastle	–	-39.2
Others	Approx. -30.0	Approx. -19.0
Total FYE 3/2020	Approx. -404.0	Approx. -422.0

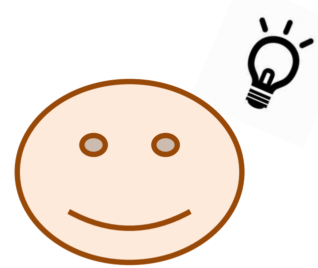
*As some figures are displayed as approximate numbers, the total may differ from the sum of individual numbers.

Company M decided to acquire a US aircraft leasing company in November 2019. Already had 29%, but decided to increase this to 75%. This was a good deal right before COVID-19. Unfortunately, in this situation, they announced an impairment loss of 39.2 billion yen in early May. This was predictable and rational. At the same time, M announced a big impairment on the oil industry at the end of March. At that time, the analyst thought it's going to happen. The assumption of impairment of M is $37 at WTI. It seems like a reasonable price now, but at the time it looked very conservative. Perhaps M's management wanted to "eliminate the negative factors now". Over the last few years we have thought M should be impaired much earlier. Even when the WTI Oil Price was $60 a barrel, M was deficit but they didn't. So we wondered that they didn't want to lower their BPS to keep their rating or wanted to keep their net D/E ratio.



Analyst

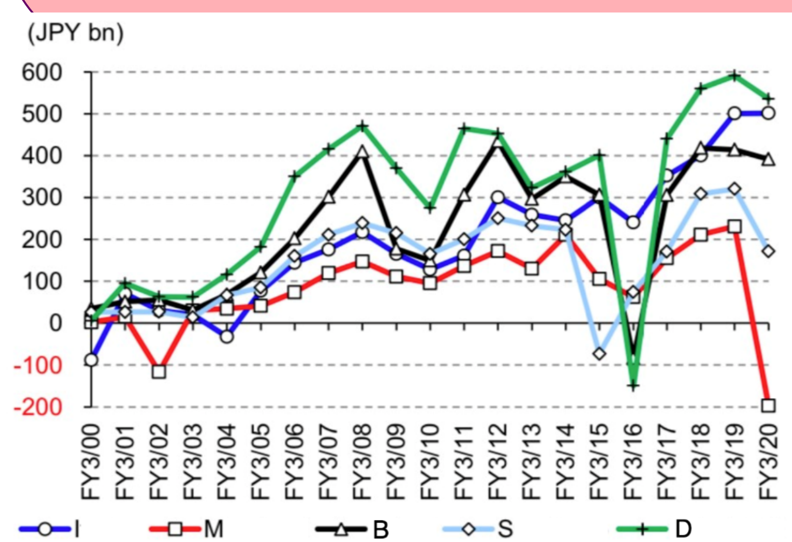
In other words, you cannot trust management's judgment... So, what kind of information can make you convinced that the judgment is appropriate



M's disclosure provided a wealth of information necessary to judge impairments, such as crude oil price and production volume assumptions, asset contents, and so on. We could have judged whether it was reasonable if we got this much before the impairment. But they used to not. I think I could have trusted if they provides those information before.

Cases　Is it an adjustment of the net profit?

Although most trading companies and energy companies, including M, have impaired their crude oil and gas businesses, D didn't. D said that they haven't changed their long-term assumptions because they can't make a reasonable assumption. I understand that. But I want companies to provide guidance under specific assumptions. It can be optimistic or pessimistic. If you have an assumption, we can discuss it, and check my thoughts. I wondered if D wasn't able to make an impairment by comparing with its rival I's net profit. D posted a plus on deferred tax assets of 77 billion yen in the current term. Before that, analysts said that they might have been overtaken by I. But when the result came out, D won. They recorded deferred tax assets and did not impairment. If D had any impairment this year, D would have lost.



Companies say that COVID-19 will cause poor business performance so that "we cannot provide guidance". Interestingly, bad news is now much more valuable than good news. Lack of information, lack of explanation about management's assumptions and impact on strategy make investors only increase concerns.

Investors from London

As a universal tendency, company management always want to hide bad decisions. Under these circumstances, COVID-19 seems to be a good excuse for bad results. In other word, it may be a good chance to bury all the bad decisions of the past.

I think the bad news is better than nothing. At least the shareholders will know the status of the company. In Australia, companies are regularly updating reasonably with the impact of COVID-19 to its shareholders. So I haven't seen a case where the stock price went down. Rather, it's up. Of course, some argue that it is too optimistic. Many companies do capital lasing. Therefore, it is better to disclose well now. It's a difficult situation, and voluntary disclosure of material is important. The regulator also provides guidance. The Singapore guidance is also quite good. There seems to be some in Japan, but very good guidance came out in Hong Kong. I think I need communication anyway.

Investors

Cases Impairment before COVID-14

N had a significant impairment this year, which does not include the impact of COVID-19. The situation in the industry is getting worse and N shut down the factories with a long history. But they haven't said anything about the guidance of revenues for the next year, they just say "I promise the profit in any circumstance!". I can't check if this is appropriate. In addition, this impairment of the property is different from impairment of goodwill because management decision of restructuring is the requirement of impairment. So, they would have to predict its impact. Several companies used COVID-19 this year as excuses, seem to say it's "unquotable" even though it doesn't really matter.

The disclosure of N is "honest". I think they didn't forecast the level of revenue because it was not so important. Operating profit and cost reduction targets are more important because their business is based on the difference between steel prices and raw material prices. In addition, What N said "Profit is secured no matter what", I think, "COVID-19 or later" is probably a few years later…

Do you find the impairment information useful? Or is depreciation less noise and useful?

Financial Highlights

4

1. Business Environment

World economy has been rapidly slackening due to the spread of COVID-19 since mid-4Q, causing deterioration of steel demand. However, there is a time lag in the impact on our steel production, shipment, steel prices, and business results. Though the impact on our business results was minimal for FY2019, it will be full-scale from FY2020 1Q.

2. Earnings Summary

(JPY bn.)	FY2018	FY2019 1H	FY2019 4Q	FY2019 2H	FY2019	Prev. Forecast (as of Feb. 7th, 2020)
Before Impairment Losses etc.	336.9	73.1	4.4	3.4	76.5	54.0
ROS (%)	5.5%	2.4%	0.3%	0.1%	1.3%	0.9%
Impairment Losses etc.	—	—	(9.5)	(360.9)	(360.9)	(364.0)
Business Profit (Consolidated)	336.9	73.1	(5.1)	(357.5)	(284.4)	(310.0)
Additional Line Items	(71.8)	—	(28.5)	(121.7)	(121.7)	(126.0)
Net Profit*	251.1	38.7	(74.1)	(470.2)	(431.5)	(440.0)

* Profit attributable to owners of the parent

Total impairment losses etc. (482.6) bn. JPY : refer to P. 6

FY2019 Consolidated Business Profit (Before Impairment Losses etc.) Variance

From prev. FY2019(f) (as of Feb.7): +22.5 bn. JPY (54.0⇒76.5)

1) Volume, steel prices, product mix, raw material prices: +3.0
2) Cost reduction : +10.0
3) Inventory valuations : +4.0
4) Group companies : +3.0
5) Others : +4.0

From FY2018: -260.0 bn. JPY (336.9⇒76.5)

1) Volume : - 70.0
2) Steel prices, product mix, raw material prices : -119.0
3) Cost reduction: : + 60.0
4) Inventory valuations : - 40.0
5) Group companies, Non-steel: : - 58.0
6) Disasters : - 7.0
7) Others: : - 26.0

3. FY2020 Forecast

Economic activity is rapidly slowing down due to the impact of COVID-19, and demand for steel products is sluggish, and it is expected that there will be a significant impact on the business performance (decrease in production and shipment volume, increase in variable cost, deterioration of steel product market price, etc.). At this point, it is impossible to formulate an earnings forecast for FY2020 with any realistic degree of accuracy.

If the impairment has enough information, I think it's better than amortization. We can analyze it ourselves. However, in reality, such information cannot be obtained sufficiently, so it is necessary to test whether the management is honest. In such situations, depreciation is more helpful to analysis

Cases Where are the effects of COVID-19?

When I asked the registrants of this workshop beforehand ""What do you think about companies disclosure this year?", Some people said, "This year's financial statements (FS) look not so bad. I don't know why", "It's something weird, but the impact of COVID-19 wasn't seen on the FS." So, I chose Company T and asked several registrants for their opinions about T's FS. The reason to choose T was that it is a manufacturing company that could make profits even it was lower than last year, and could pay dividends, and published the earning digest as scheduled.

(1)T's FS is very simple. If T sell 8 million units globally, T is committed to securing operating profit and to produce 3 million units in Japan. The production volume is a message to stakeholders such as subsidiaries. T said that it would continue to pay dividends to shareholders in this situation. But they haven't made any forecasts other than operating profit. T also doesn't say the possibility of impairment. And T does not describe the assumptions of those forecasts and the impact if the assumptions change. Therefore, it is not enough for investors. T just says, "We keep profits."

(2) I wanted to know what kind of assumptions T has against the impact of COVID-19. How management thought about it, companies disclosed their forecasts but assumption behind the forecasts, such as when covet 19 outbreak to subside, (some consider till next year, some till this September and that may vary) should be explained. If they did, it would be helpful for understanding.

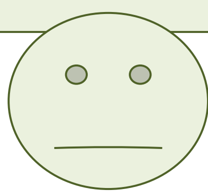
On the other hand, there are other opinions. (3) "It is not fair to ask companies to evaluate their assets at this difficult time right now. Even if they do so, it would not be such a powerful tool under the present circumstances. Rather, I want the company to disclose the details of the cash flows statement. T disclosed cash flows separately for the financial business and other business. Such disclosures are rarely seen in Japanese companies." Next (4) "T changed the depreciation method this year, some doubted to adjust the profit because of COVID-19. But T's explanation is much better than N which had similar changes. This change has allowed T to produce the same products in the same way in all factories around the world, T said. I think it's a good explanation for the future under the current circumstances. T also disclosed the financial results as originally scheduled. I want to highly evaluate it."

Cases Message from ASBJ

- Incorporating the Effects of the Novel Coronavirus Pandemic when Making Accounting Estimates under Japanese GAAP

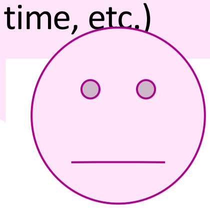
https://www.asb.or.jp/en/wp-content/uploads/20200413_e.pdf
https://www.asb.or.jp/en/wp-content/uploads/20200511_e.pdf

The ASBJ (Accounting Standard Board of Japan) issued the Summary of Discussion on the Board Meeting on May 11, 2020. which is the supplement of the Summary of Discussion on the Board Meeting on April 9, 2020 (Document 4). The supplement issued in May clarifies that for accounting estimates made in the circumstances under the COVID-19 pandemic, the entity should disclose the information about the assumptions used in its accounting estimates, including how the pandemic will develop in the future and when it will be brought under control, if such accounting estimates are not only material in the current year, but also are not material in the current year but have a significant risk of resulting in a material effect within the next financial year. This is a similar disclosure requirement as required in the paragraph 125 of IAS 1.



The message from ASBJ in April was directed to companies and auditors about how companies should make accounting estimates and how they should disclose them. The ASBJ's conclusion is that companies can make accounting estimates based on all available information, even under these uncertain circumstances. This is similar to the IASB's message at the end of March. The auditor accepts the assumption unless it is unreasonable or biased, but in such situation with high uncertainty, the results may differ from the estimates. Because of the inherent nature of FS for the fiscal year ending March 31, 2020 due to uncertainty, ASBJ requested that certain assumptions for accounting estimate be disclosed in the notes. The difference between the actual result and the accounting estimate can be material. However, the earning digests that were published already did not disclose about this part sufficiently. So ASBJ decided to reissue the second paper in May and encourage companies to disclose their assumptions. This information is also essential for users to understand the FS. Therefore, the Securities Analysts Association Japan (SAAJ) also issued a statement and encouraged companies to disclose it. I joined this discussion today, and realised that the assumptions used to make accounting estimates for BS and the forecast used to make earnings digests(guidance) are conceptually different, but they may be easily confused. I didn't think the former corresponds to financial information, but the latter is closely related to non-financial information (risk, convergence time, etc.)

https://www.saa.or.jp/news/pdf/news_200508_mitumori.pdf



Cases Accounting Estimation by management

I think there is a natural tendency for managers to be optimistic as they are risktakers. I recently researched "commercial properties" where valuation write-downs were explained as temporary blips. Whereas, if you listen to other sectors, the managers are mentioning secular trends that will have long lasting impact – for e.g. BP said that oil peak demand may be earlier in late 20s instead of 30s because of more working from home and less flying in future. This is why we have been consistently asking for forward-looking business models. There needs to be a disclosure around how ageing population, technological changes, deglobalization (US versus China trade frictions) will impact the businesses.

Are you satisfied wit GM's disclosure of the management estimate of BS? Is this enough disclosure to make investors confident?

I'm also not happy with T's disclosure. The situation is very unclear, and consumer behaviour may change after the COVID-19 crisis. So it's fair if T can't decide now whether to impair the production facility. However, ideally, for financial services, the assumption is highly extrinsic.
It should be referring to external factors such as interest rates, default rate, and credit type. On the other hand, I think the disclosure materials of GM are very substantial. More information about their financial segment. For example, it explains whether the current credit situation is sufficient for a loss on a loan. It also explains how the decline in used car prices affects the residual value on the BS of the lease. In my opinion, T's disclosure is okay, but it only mentions revenue this year. It's better to refine the balance sheet way of thinking.

It is a very good disclosure. At the moment, they did not make impairment, but they explained that under which case they would be impaired, and made clear such the underlined factors. And here are some factors that indicate this is the best estimate right now.

As of March 31, 2020, GM Financial updated the forecast of economic factors for potential impacts from the COVID-19 pandemic. In addition, GM Financial lowered the forecast of expected recovery rates on repossessions. In aggregate, these updates resulted in an increase in the allowance for loan losses on the GM Financial retail finance receivables portfolio of $0.2 billion at March 31, 2020. Actual economic data and recovery rates that are lower than those we forecast would result in an increase to the allowance for loan losses.

GM Financial We believe that offering a comprehensive suite of financing products will generate incremental sales of our vehicles, drive incremental GM Financial earnings and help support our sales throughout various economic cycles. GM Financial's leasing program is exposed to residual values, which are heavily dependent on used vehicle prices. Used vehicle prices for the three months ended March 31, 2020 decreased slightly compared to the same period in 2019. Realized sales proceeds for the first two months of 2020 outpaced the same period in 2019; however, prices declined in late March, primarily due to impacts from the COVID-19 pandemic. GM Financial previously reported an expected decrease in used vehicle prices of 3% to 4% in 2020 compared to 2019; however, used vehicle prices have been significantly impacted as a result of the COVID-19 pandemic. Current industry forecasts project a decrease in used vehicle prices of 7% to 10% in 2020 compared to 2019, and a recovery sometime in 2021. GM Financial updated residual value estimates accordingly, and will increase the depreciation rate over the remaining term of the portfolio, the impact of which is most heavily weighted to leases maturing in 2020. In addition, the auctions GM Financial uses to remarket off-lease inventory are not currently operating efficiently. Sales proceeds from vehicles GM Financial has been able to remarket have decreased and may remain depressed when auction operations resume. Accordingly, GM Financial recorded an insignificant valuation adjustment to the carrying value of off-lease inventory held for sale. GM Financial cannot currently estimate the precise impact that the COVID-19 pandemic will ultimately have on used vehicle prices. If adverse economic impacts are sustained, used vehicle prices could decrease further, which could result in impairment of the GM Financial lease portfolio. The following table summarizes the estimated residual value based on our most recent estimates and the number of units included in GM Financial Equipment on operating leases, net by vehicle type (units in thousands):

Instead of our conclusion…

- I think the disclosure of GM is exactly what investors are looking for. There are concerns about the world after COVID-19, but I think companies have different views and different situations. The responsibility of analysts and investors is to determine whether a company's assumptions are reasonable. In order to do so, information on the assumptions made by management is important. Therefore, this information should be disclosed in as much detail as possible. Some companies just publish the forecast of revenue. Even in uncertain circumstances, management must have considered how to overcome it. Investor's voice is needed now. We have to deliver our ideas to companies, regulators and standard setters.

- The situation is unpredictable now. Investors want to know the strategy of a company, so that investors will be able to calculate themselves. That is the concept of the IASB's Discussion Paper. Sharing management strategies will improve disclosure. **There was an opinion today that "it might be a good opportunity to shuffle which companies we should invest in right now."** This is an opportunity to judge better communication. And when investors could figure out which companies were good, it becomes more interesting.

- As an older generation analyst, I've been thinking that if the company didn't disclose enough information, the analyst should tell the company to put it out. However, I am very grateful to investors for the efforts by the Financial Services Agency and ASBJ to strengthen disclosure that I heard today. Investors should use this information for engagement with companies.

Discussion is to be continued….