Impairment assessment

Considerations related to valuations amid COVID-19
Advent of COVID-19 may trigger impairment testing

Advent of COVID-19 from January 2020 onwards has resulted in adverse economic environment for many businesses.

As per ICAI and other valuation bodies, companies may have to test their respective assets/CGUs for impairment/revisit fair valuation given the impact of COVID-19.

Companies are to test for impairment if any of the following indicators exist:
- temporary ceasing of operations, immediate decline in demand or prices
- Disrupted supply chains and workforce arrangements
- Legal issues (force majeure clauses being invoked by vendors, customers)
- Working capital (lower probability of receivable recovery) and other funding issues
- Trade with countries significantly affected by COVID-19

Since COVID-19 cases were identified in January 2020 and caused economic impact thereafter, only disclosures in the financial statements of 31 March 2020 would not suffice.

This presentation covers impairment testing pertaining to CGUs (including goodwill and intangible assets)/equity instruments.
Key takeaways from valuation bodies and regulators’ guidance

ICAI and valuation bodies (such as IVSC, RICS, IPEV*) issued various guidance on navigating the challenges in estimating FVLCS or VIU. The following are the key takeaways from the same:

- There is significant valuation uncertainty due to the impact of COVID-19.
- Management of companies need to consider multiple methods and scenarios (e.g., base case, optimistic case, pessimistic case) for cash flows to arrive at value.
- Despite volatility, prices quoted in active market are still relevant for listed securities.
- Assumptions are to be made basis the best estimate of events/scenarios that are likely to occur.

*IVSC: International Valuation Standards Council, RICS: Royal Institution of Chartered Surveyors, IPEV: International Private Equity and Venture Capital

Sources:
ICAI Accounting and Auditing Advisory March 2020, Impact of Coronavirus on Financial Reporting and the Auditors Consideration
Letter from the IVSC Technical Boards Regarding Valuation and Uncertainty, March 2020
International Private Equity and Venture Capital Valuation Guidelines, IPEV Board, Special Valuation Guidance - 31 March 2020
Impact of COVID-19 on valuation, UK guidance for RICS-regulated members, 27 March 2020
Possible red flags for impairment testing amid COVID-19

The following areas may raise red flags for impairment:

- High acquisition premium paid in the past
- Low headroom in past impairment studies
- Aversely impacted industries (travel, airlines, hotels, etc.)
- Companies with high financial leverage (i.e., higher insolvency risk)
- Businesses with high operating leverage
- Companies involved in international trade with countries significantly impacted by COVID-19
Economic impact in India and globally

According to the International Monetary Fund’s *World Economic Outlook* report (April 2020), global economy is projected to contract by 3% in 2020, much worse than what it was during the 2008-2009 financial crisis. Assuming that the pandemic fades in the second half of 2020, the global economy is likely to grow at 5.8% in 2021.

**Revised economic growth**

<table>
<thead>
<tr>
<th>Agencies/institutions</th>
<th>Previous forecast (%)</th>
<th>Revised forecast (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fitch Ratings (FY21)</td>
<td>5.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Moody’s Investors (CY20)</td>
<td>5.3</td>
<td>2.5</td>
</tr>
<tr>
<td>S&amp;P Global Ratings (FY21)</td>
<td>5.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Oxford Economics</td>
<td>6.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>Goldman Sachs (FY21)</td>
<td>3.3</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Sources: Fitch Ratings forecasts, sourced from Fitch Rating’s Global Economic Outlook Datasheet (March-April); Moody’s Investor’s growth forecasts, Global Macro Outlook Reports (November 2019 and March 2020); Oxford Economics forecasts from “Global Economic Updates” database; Forecasts of S&P Global Ratings and Goldman Sachs, sourced from media publications.

**Insights from FICCI Survey** (Report titled *Impact of Coronavirus on Indian Businesses, March 2020*) of 317 companies (conducted between March 15-19)

- 53% indicated marked impact on business operations even at early stages
- 80% experienced decrease in cash flows
- 66% felt big reduction in order books
- 63% cited reduction in supply chain

Source: Oxford Economics (based on a survey conducted on 23-24 March 2020)
The pandemic crisis will impact most industries negatively, albeit some themes may have a positive impact

► Immediate lockdown along with ensuing recession will imply negative impact on almost all industries.

► Government stimuli may only help in reducing the pain, and may not be independent positive drivers.

► Some themes may play out positively for some industry segments such as:
  
  ► **Work from home culture** with positive impact on Internet, communication and Technology (ICT) services, virtual education, home automation products, etc.

  ► Increased focus on **essential/new essential services** such as agriculture, health food/immunity foods, processed foods, personal hygiene, low cost housing.

  ► Changes in **consumer behavior and lifestyle** with focus on OTT platforms, e-commerce with last mile delivery, insurance (especially health), digital payments, etc.

  ► Increase in **mobility services** such as food delivery (vs. eating out), private transport (e.g., possible demand uptick for two-wheelers and mid range cars in long run)
Evaluation criteria can vary depending upon the extent and timeline of impact

<table>
<thead>
<tr>
<th>Long-term negative impact</th>
<th>Short to medium-term negative impact when sales/cash flows are delayed</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Significant impact, although exceptional in nature</td>
<td>► Evaluate the steps considered by the company to ensure the continuity of the business</td>
</tr>
<tr>
<td>► One needs to evaluate the ability of the company to survive the impact</td>
<td>► Low risk of impact</td>
</tr>
<tr>
<td>► Companies with:</td>
<td></td>
</tr>
<tr>
<td>► Weaker operating and financial performance</td>
<td></td>
</tr>
<tr>
<td>► Marginal or small industry players in terms of market share, brand share, access to capital, etc.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Short to medium-term negative impact in case there is loss in revenue/cash flow</th>
<th>Positive impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Loss of revenues/cash flows in the interim period</td>
<td>► Essential commodity sector, e-commerce (business-to-business/business-to-customer), security industry, etc.</td>
</tr>
<tr>
<td>► Evaluate the capability of the company to survive through the interim period and take steps to minimize the losses</td>
<td>► May be a temporary impact that may reverse/stabilize with time</td>
</tr>
<tr>
<td>► Low to moderate risk of impact</td>
<td></td>
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</tbody>
</table>

There will also be some mitigating factors in form of government action/stimulus
Commodity price forecasts in the midst of the crisis reflect long-term views

Even visible in the commodity prices forecast: short-term forecast have reduced while long-term remains intact

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*CFR-Cost and Freight

Source: Consensus Economics Inc.
In the current times, DCF is a preferred approach over other valuation methods:

- It provides a more robust basis to analyze valuations than Comparable Multiples method or Asset values method:
  - It permits valuations after considering various scenarios.
  - Extreme uncertainties in the short to medium-term, however, impact and taper out over a period of time.
- Comparable Multiples has limited relevance since earnings collapse. Even future earnings for comparable companies are difficult to predict. However, Comparable Multiples should still be evaluated for a minimum reasonableness check.

Generally, control premiums increase during market crashes.
Evolving situation

Academic research shows that pandemics often have significant short-run impact and more uncertain long-run impact on GDP growth.

Difficult to assess long-run impact of pandemics on GDP growth. Countries generally recover from a pandemic situation, and there is often a catch-up period of growth following a pandemic.

Difficult to understand the impact of fiscal stimulus, liquidity provisions and financial support committed by governments.

Multiple expected paths of recovery and a likelihood of recession.

Uncertain macroeconomic outlook has led to higher estimation uncertainty, thus wider range of cash flow projections, with scenarios ranging from economic disruption for few months to disruption triggering significant recession.

Two approaches can be used to project cash flows:

- Traditional approach: Single cash flow projection, or most likely cash flow.
- Expected cash flow approach: Multiple, probability weighted cash flow projections. Uncertainty is reflected through probability weighted projections.

Given the high degree of uncertainty, it may be helpful to consider using the expected cash flow approach as opposed to the traditional approach.
## Cash flow scenarios: pre- and post-COVID-19

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Key cashflow assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-COVID-19 cash flow</strong></td>
<td>- A growing company with slightly higher than industry growth.</td>
</tr>
<tr>
<td><strong>Post-COVID-19 scenarios</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Scenario 1</strong> (Medium-term recovery)</td>
<td>Cashflows forecast may have a negative impact for the next two years; thereafter, growth rates are assumed to broadly restore to pre-COVID-19 levels.</td>
</tr>
<tr>
<td><strong>Scenario 2</strong> (Short-term recovery)</td>
<td>Cashflows forecast may have a negative impact for the first two quarters in FY21; thereafter, growth rates are assumed to broadly restore to pre-COVID-19 levels.</td>
</tr>
<tr>
<td><strong>Scenario 3</strong> (Long-term recovery)</td>
<td>Cashflows forecast may have a negative impact for the next three to four years; thereafter, growth rates are assumed to broadly restore to pre-COVID-19 levels.</td>
</tr>
</tbody>
</table>
Impact on discount rates would vary industry-wise and would be company-specific.

- Risk-free rate has adjusted downwards, given that repo rate has declined.
- Increase in market volatility is expected to push market risk premium upwards.
- Given betas are backward-looking and do not reflect the current volatility correctly, one may consider mid-higher end of the range, depending on the industry
- Alpha to be based on company-specific factors

It is important to holistically assess discount rate in context of subject industry and risk in prospective financial information.

- The expectation of falling risk-free rate and cost of debt does not automatically translate into a lower cost of capital.

- As per special guidelines of IPEV¹, “Greater uncertainty may translate into greater risk which may translate into greater required returns which may translate into lower asset values”.

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¹ International Private Equity and Venture Capital Valuation Guidelines - IPEV Board, Special Valuation Guidance - 31 March 2020
Uncertainty in the economic environment and volatility due to COVID-19 has triggered the need for impairment testing.

Disclosures not suffice, companies to test for impairment; red flags for impairment: low headroom, adversely impacted industries, weak operational/financial position.

Evaluation criteria can vary depending upon the industry, extent and timeline of impact. It may vary significant to low or even positive in some cases.

DCF is preferred instead of Comparable multiples or Asset value.

DCF with probability weighted cash flows seems to be a better approach given the uncertainty.

Discount rate to be evaluated holistically in context of subject industry and risk in prospective financial information.
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