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Impairment Testing in COVID-19 Environment

INTRODUCTION

As period of this pandemic has coincided with the Financial Year closing of most of the companies in India, one of the key aspects to be considered by the management, CFOs, Financial Controller as well as the auditors is the potential impact of the pandemic on the Financial Statements. In current regulatory environment both the Management as well as the auditors are critically reviewed for appropriate documentation and audit procedures. Hence, one of the main questions required to be answered is whether there is any impairment in the value of the assets or investments of the company (pure financial investments as well as Subsidiaries/ Associates). Several aspects need to be considered to arrive at 'is there a triggering event'?

IS IMPAIRMENT EVALUATION REQUIRED?

Some people are of view that the event is exceptional in nature and it doesn't require testing or that it is a short-term correction. It is important to note that United Nation is of view that we are entering the phase of recession. Further, we expect the recovery to be U or a W Curve instead of V curve. In such a situation to justify it to be a short-term correction and ignore the same may be inappropriate.
Whether there is a triggering event is determined based on IND AS 36 or Accounting Standard 28 or equivalent standards in other GAAPs. Some of the indicators of impairment are as follows:

- Decline in company's market cap below its net assets.
- Current period operating or cash loss.
- Change in the extent or manner of asset use
- Adverse change in technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
- Capital and financial resource effects, including liquidity risk.
- Earning expectations well below forecasted levels or downward quarter-by-quarter earnings revisions.
- Decrease in the market value of an asset.
- Store/ business closures or slowdowns, whether permanent or temporary of the company or competitors which can have significant impact on cash flows.
- Projected cash flow losses or net losses.

These events are some of the potential signals that indicate a **triggering event**. In current environment most of the companies has one or more of the above-mentioned indicators. Further, it is important to remember that impairment testing for goodwill is required irrespective of indicators.

Moreover, in several cases where management has been relying on **'Fair Value less cost to Sell'** as the value may now be vitiated. Asset or broker valuation reports which were being relied upon may not be relevant anymore as it relied on their being an **'active market'** which in a large number of cases do not exist at the moment.

If the answer to the above is affirmative the management needs to apply the **Value in Use** method and conduct a discounted cash flow of the future projections. Several companies have begun to engage external valuers to conduct a detailed impairment analysis for their comfort as well as for the auditors to assess the impact if any of Impairment on the financial statements.

The next step is to prepare the projections for which we would be required to understand the impact of COVID-19 and the duration for which its impact shall last.

The impact assessment of the COVID-19 is the tricky part. It is very difficult to answer this question. The company can however analyze the impact on basis of industry it operates in, the major buyers of its ultimate produce, spending on the ultimate produce is essential or discretionary, location of major consumers, etc. if the industry in which business operate is essential in nature for example FMCG, education, consumer durables, etc. than the impact can be considered to be short term or immediate in nature. Industries such as chemicals, sugar, retail, etc. shall have medium term impact. Whereas companies in industry which are dependent on discretionary spending such as tourism, automobiles, real estate, etc. or government spending such as infrastructure shall has longer impact.

KEY FACTORS TO BE CONSIDERED WHILE CONDUCTING IMPAIRMENT STUDY

The management, auditors and the valuers need to consider the following important points:

- **Critical Review of Financial Projections**:

  - **Revenue assumptions** (both volume and pricing) need to be critically reviewed with detailed clarification obtained from the management. This would depend on industry to industry. For example, the travel industry or the restaurant industry maybe severely impacted and the pace of revival needs to be critically examined and appropriate adjustment to the projections may be needed.
  - **Cost assumptions and working capital requirement** needs to be reviewed given the actions taken by the company. One needs to consider whether the revised cost projections and working capital requirement factor in normalcy linked to the movement in revenues. Counter Party credit terms and ability to honor the credit terms of key

contracts need to be assessed and factored into the projections.

- **Capex review** – The capex plans would probably undergo change, especially if there are projects under implementation or planned immediately.
- **Government support and incentives -** Some of the businesses affected by the pandemic may be eligible for government incentives or support. The impact of such government incentives should be thoroughly assessed and considered in the financial projections.

- **Terminal Growth rate**: Standard historic growth rate models may not be the best guidance for the future now. Similarly, the current year IMF expected GDP growth rate of ~2% may not be appropriate. Estimation of the long term normal would depend on the sector, management and of course the macro economic factors and will require a careful evaluation. Overall, there will be a dip in the Growth rates that were considered till earlier periods across most industries.

- **Change in consumer or consumption pattern**: There shall be migration of value from one industry to another. It is expected that the use of technology shall increase. So, there may be positive impact on online shopping, online media service providers, online productivity tools, increase in work from home culture etc. Whereas business or assets such as shopping mall, multiplex, commercial space, etc. may have a long-term impact from the pandemic and in some cases, they may not be able to reach the past value levels again. So, it is important to consider this factor while preparing the financial projections.

- **Liquidity and solvency**: It is expected that there shall be liquidity crisis and solvency issue in the market at least for a short term. It is very important to review the current liquidity position of the company. Further, it is important to assess the solvency position of major buyers and suppliers because it can materially impact the financial position and projection of the business if few of the major buyer and supplier face the solvency crisis.

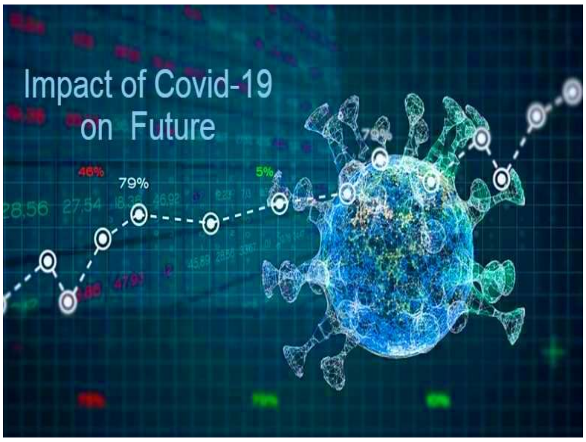
KEY ASSUMPTIONS FOR IMPAIRMENT TESTING

Once the business projection has been prepared the following key assumptions are required to be assessed by the management for testing of impairment:

- **Cost of Equity:** The financial health of the business is one of the critical considerations when computing a discount rate. The Capital Asset Pricing model has a factor for the Market rate of Return and given the sharp changes in the stock indices post 20th March it would be important to determine the manner in which beta is computed.

- **Discount for lack of marketability (DLOM):** Extreme volatility of the market may signal a higher DLOM. A prolonged volatile market affects the DLOMs.

- **Avoid double counting of risk:** The basis on which cash flows projection of a business have been prepared should be matched with the basis of determining the corresponding discount rate. Business-related risk factors should be incorporated either into cash flows projections or discount rate, but not both.



SUMMARY

Impairment analysis will be a key element in Financial Statement Preparation for the year for the management and for the auditors while conducting their audit procedures, if there exist impairment indicators. Reliance on 'Fair Value' basis asset valuation reports or broker reports may be limited. Hence, external valuers to conduct 'Value in Use' studies may be needed for Audit Committee, Management as well as auditors' comfort. Careful analysis of key assumptions in both the financial projections as well as Discount rates would be needed involving significantly higher judgments.

In summary, there are no shortcuts in analyzing the indicators of impairment, estimating the risk and the impact on projected cash flows, selecting a company-specific risk factor, etc. The indicators and risk are here to stay for at least few quarters and it is important to have a through and detailed impairment analysis so that it is realistic and achievable for periods to come.

With the accounting and valuation requirements, companies should assess the impact of the current business disruptions on assets and plan an appropriate action. The action often involves various valuation and accounting challenges in relation to analysis and documentation. If required, the businesses may consider seeking professional guidance.

DISCLAIMER

MOORE Singhi

TOUCH POINTS

KOLKATA

161, Sarat Bose Road,
Kolkata – 700026.
T: +91 (0) 33 2419 6000
Email: services@singhico.com

MUMBAI

B2 402B, Marathon Innova,
Off Ganpatrao Kadam Marg,
Lower Parel, Mumbai - 400 013
T: +91 (0) 22 2495 2881
Email: mumbai@singhico.com

NOIDA / NCR (DELHI)

Unit 1704, 17th Floor
World Trade Tower - Tower B
Sector -16, Noida - 201301.
T- +91 (0) 120 2970005
Email: newdelhi@singhico.com

AHMEDABAD

05 P B Parekh Tower,
Near Diwan Ballubhai School,
Kankaria
Ahmedabad – 380022
T: +91 (0) 79 2547 1562
Email: ahmedabad@singhico.com

CHENNAI

Unit-11-D, Ega Trade Centre, 809,
Poonamallee High Road,
Kilpauk, Chennai - 600 010,
T: +91 (0) 44 4291 8459
Email: chennai@singhico.com

BENGALURU

No.28, R V Layout, V S Raju road,
Kumara Park West
Bangalore- 560 020
Ph. No.: +91 80 23463462/65
Email: bangalore@singhico.com

HYDERABAD

5-4-187/3 & 4 Soham Mansion,
2nd Floor, M. G. Road,
Secunderabad - 500 003
T: +91 (0) 40 2754 2635

NAGPUR

1st Floor, VCA Complex, Civil Lines
Nagpur - 440001
T: +91 (0) 71 2664 1111

For any further information feel free to reach out to us at services@singhico.com or connect to us at any of our aforementioned addresses.

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