

VALUATION BULLETIN

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SPECIAL VALUATION CONSIDERATIONS IN LIGHT OF COVID-19 – IMPAIRMENT OF ASSETS



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Introduction

The global outbreak of the novel coronavirus disease (COVID-19) has led to unprecedented disruptions to economies and business operations. Governments around the world have implemented significant measures to control the COVID-19 crisis, including social distancing policy, travel restrictions and various degrees of lockdowns. Financial markets have reacted with an upsurge in volatility during the first quarter of 2020 from the disruptions and uncertainties.

The virus outbreak is considered as a non-adjusting subsequent event as at 31 December 2019. However, the impact from COVID-19 and corresponding government interventions should be considered for all financial reporting with a year-end date of 31 March 2020 or beyond¹ given it has become a 'knowable event'. Due to the pandemic and continued market turmoil, management of companies and their auditors are facing significant challenges in updating and reviewing financial projections and valuations for financial reporting purposes. In particular, the carrying values of assets will need to be assessed for any impairment in light of the market disruptions.

Highlighted below are some of the key considerations when assessing impairments for financial reporting purposes amid the virus outbreak. Please note that this newsletter has been prepared for discussion purposes only and is not meant to prescribe solutions and/or conclusions for valuation issues mentioned herein. No liability is assumed if readers choose to rely on it for any decision making.

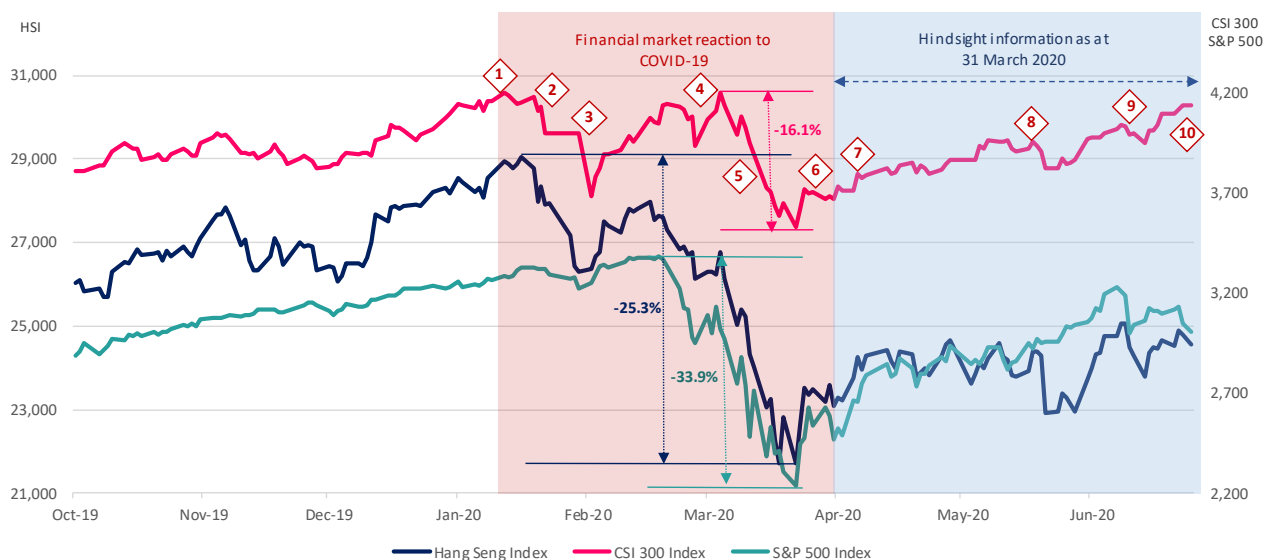
Impact to the financial markets

After the outbreak of COVID-19 in Wuhan City in China, it spread quickly to other nations. Europe and the US have become the most severely affected regions since late February. The World Health Organization (WHO) announced on 11 March 2020 that the classification of COVID-19 would be upgraded to a pandemic². Business operations and economic activities have since been severely disrupted due to lockdowns imposed by governments. Major stock markets

collapsed at the end of the 1st quarter and corporate credit spread increased due to rating downgrades and investors' flight to quality actions.

As shown in the Chart 1 below, the market indices of Hong Kong (HSI Index), China (CSI 300 Index) and the US (S&P 500 Index) declined by 25.3%, 16.1% and 33.9% respectively between February and April 2020 as a result of COVID-19. By the end of 2nd quarter of 2020, the indices have recovered.

Chart 1: HSI, CSI & S&P 500 Indices



Sources: Capital IQ and news

Notes for Chart 1:

No	Date	Key event
1	11 Jan 2020	First death attributed to COVID-19 was reported in China ³
2	23 Jan 2020	City of Wuhan placed on lockdown ⁴
3	30 Jan 2020	WHO declared COVID-19 a global health emergency ⁵
4	28 Feb 2020	WHO assessed the risk of spread and impact of COVID-19 at a very high global level ⁶
5	16 Mar 2020	Confirmed COVID-19 cases outside China exceeded the confirmed cases in China ⁷
6	26 Mar 2020	US overtook Italy and China as the country with most confirmed COVID-19 cases ⁸
7	7 Apr 2020	IMF projected the global economy to contract by -3% in 2020 ⁹ Wuhan's lockdown limits eased ¹⁰
8	21 May 2020	Global coronavirus cases surpassed 5 million ¹¹
9	11 Jun 2020	Beijing authorities confirmed the first local COVID-19 infection in almost two months ¹²
10	24 Jun 2020	IMF expected a more negative impact from COVID-19 pandemic and projected the global economy to contract by -4.9% in 2020 ¹³

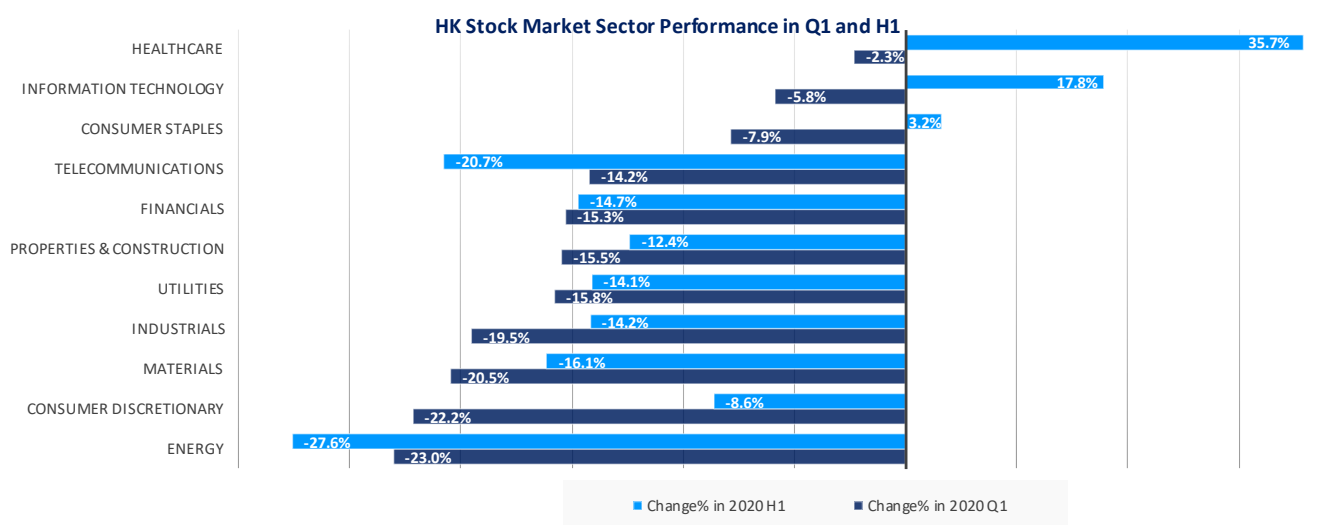
Information available as at: 31 March 2020

Information available as at: 30 June 2020

While COVID-19 impacted most industries, some were more severely affected than others. As summarised in Chart 2 below, energy and consumer discretionary indices were the most affected sectors, declining by 23.0% and 22.2% in the 1st quarter, due to the economic slowdown and worsening consumer confidence. The decline of energy sector even enlarged in the 2nd quarter. Healthcare and information

technology indices were the outperforming sectors, only decreased by 2.3% and 5.8% respectively in the 1st quarter. These two sectors recorded significant increases in the 2nd quarter, somehow supported by the expected higher demand for their products/services in light of the virus outbreak and social distancing policies.

Chart 2: Sector indices



Special considerations under the COVID-19 situation

The accounting standards that need to be considered in the current situation include fair value measurement under HKFRS13, impairment of assets under HKAS36 and expected credit loss (ECL) under HKFRS9. In this newsletter, we will only discuss fair value measurement and impairment assessment and ECL issues will be discussed in our next valuation newsletter.

Set out below are the various types of assets covered under the aforesaid accounting standards.

HKAS36 Impairment of assets	HKFRS9 Financial instruments
Goodwill	Financial assets classified at amortised cost
Intangible assets	Debt instruments classified at fair value through other comprehensive income
Property, plant and equipment	Trade receivables and lease receivables
Right-of-use assets	Contract assets

In view of the extensive fallout on global economies and financial markets, the key considerations for performing valuations for financial reporting purposes as at 31 March 2020 or beyond under the COVID-19 environment are as follows:

Key considerations for fair value measurement

<p>General</p>	<ul style="list-style-type: none"> • Valuation date: As a general principal, a valuation conclusion is specific to the valuation date which means only the information that is 'known' or 'knowable'¹⁴ from a market participant perspective on that date should be reflected in the valuation. The valuer should exercise their judgment in determining what information is relevant to the valuation. • No one-size-fits-all solution: While most industries and businesses are being significantly affected by the outbreak, this does not mean the same valuation adjustment eg a value discount or an additional risk premium in discount rate, etc., can be directly applied to the valuation without a detailed analysis. This is because the degree of impact to each industry and business might be different, as shown in the Chart 1. Therefore, a valuer should perform a comprehensive analysis on the valuation subject and consider any applicable valuation adjustment for COVID-19. This should be based on the characteristic of the subject business, adopted valuation approach and "knowable" information from a market participant perspective. • Going concern assumption: Some industries and businesses have been badly hit by governmental lockdowns which have led to liquidity issues or cash flow problems. Management in these industries should regularly evaluate whether the going concern assumption is still applicable to their companies in the current situation. An Asset-based approach which is not commonly used for valuation of going concerns may be relevant if a liquidation scenario is probable. • Valuation uncertainties: The virus outbreak has created significant economic uncertainties which lead to challenges in performing valuations. Where the uncertainties are critical to the valuation, valuers should make the necessary disclosure on the significant assumptions applied for the valuation and quantify such uncertainties, where possible¹⁵.
<p>Market approach</p>	<ul style="list-style-type: none"> • Relevance of comparable transaction: Under the Comparable Transaction Method (a.k.a Guideline Transaction Method), a valuer should be cautious in using the comparable transactions completed in 2019 given these transactions were completed pre-COVID-19. Further evaluation of their relevance to the valuation and any appropriate valuation adjustment to the transaction multiple are highly recommended. • Consistency of financial metrics: When performing a valuation under the Market Approach, a valuer should make sure the financial metrics of the comparable companies and subject company are consistent and for the same time period. For example, if the valuation multiple is based on the 12-month net profit ended December 2019 but applied to subject company's 12-month net profit ended March 2020, this will likely result in an understated value. This is because the subject company's financial results for end March 2020 has reflected the impact of COVID-19 while the valuation multiple did not. • Forward valuation multiple: The merit of using a forward valuation multiple (ie the multiple derived based on forecasted results rather than historical) is that the valuation is based on the projections of the comparable companies and the subject company. Therefore, the projections would have incorporated the expected impact from COVID-19 to the business operations. However, a valuer should make sure the projections adopted in the valuation are for a similar time period as mentioned above, and the comparable companies' projections have included the COVID-19 impact.

Key considerations for fair value measurement

Income approach	<ul style="list-style-type: none"> • Incorporating impact to financial forecast: To incorporate the COVID-19 impact to the financial forecast, management should perform a thorough analysis on how its business will be affected by the virus outbreak and resulting government interventions. This should be based on the “knowable” information as at the valuation date, including both duration and severity of the impact, the effect on supply and demand of their products/services, how business operations will be affected by restrictions on transport, travel and quarantine measures, etc. Reference to researches and opinions from industry experts, central banks and other international organisations is highly recommended. • Scenario analysis: In light of the current economic uncertainties, it will be difficult for management to specifically account for all issues from COVID-19 in a financial forecast. As such, management is recommended to use multiple scenarios for the forecast to sensitise the company’s key business drivers. For example, the projections could be prepared under different set of assumptions such as V-shape, L-shape and W-shape recovery patterns. Using different scenarios could help reveal any liquidity problems to the business particularly under an adverse scenario. Management should reference assumptions applied to researches by industry experts and economists and exercise judgment when formulating the probability of the assumed scenarios. • Adjustments in discount rate: Due to the current economic uncertainties, management may find there is insufficient information and data to make a precise and supportable adjustment to the financial forecast. As an alternative to adjusting the financial projections, the additional risk from COVID-19 can be incorporated via an additional risk premium in the discount rate for the potential forecast risk. Since such an additional risk premium is a highly judgmental exercise, additional analyses and cross checks to justify the reasonableness of the premium is highly recommended. In addition, any adjustments in the financial forecast and discount rate should not be double-counted. Management should also be cautious when evaluating any increase in the long-term cost of debt as financial markets continue to be volatile. Appropriate adjustments to the cost of debt component in the discount rate should be made where appropriate.
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Key considerations for impairment of assets

General	<ul style="list-style-type: none"> • Indication of impairment: In accordance with HKAS36, goodwill, intangible assets with indefinite life and not yet available for use are required to be tested for impairment annually¹⁶. COVID-19 has caused various degrees of disruption to most industries and there are already numerous company closures and financial markets in turmoil. Management should determine whether there are any impairment implications and additional impairment testing on the assets are required for any interim or quarterly reports.
Value in use (VIU)	<ul style="list-style-type: none"> • Budgets/forecast used in VIU: As stated in HKAS36, the cash flow projection used in estimating its VIU should be based on the most recent budgets/forecasts approved by management. The standard also required that the budgets/forecasts should reflect reasonable and supportable assumptions and represent management’s best estimate of the set of economic condition that will exist over the remaining useful life of the asset¹⁷. As such, and if the budgets/forecasts approved by management have not reflected the impact of COVID-19, further adjustment to the budgets/forecasts might be needed.

Key considerations for impairment of assets

Value in use (VIU)

- **Potential restructuring:** Under the current adverse economic environment, companies might consider restructuring its business. According to HKAS36, VIU should be based on the asset's current condition and cash flows related to any uncommitted future restructuring plan as at the valuation date should not be considered in the VIU calculation¹⁸. Management should therefore exclude cash flows related to uncommitted restructuring plan in the projections.
- **Discounted cash flow method:** Given the VIU calculation is performed based on discounted cash flow method, the recommendations for the Income Approach above are also applicable and relevant to the VIU calculation.

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