Art'o'val Advisors

True Art of Valuation

Valuation Series

9 – Valuation under Impairment Testing

September 2023

Impairment Testing

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Introduction to Ind AS 36

- Ind-AS 36 was introduced as the Indian Accounting Standards equivalent for IAS 36 (IFRS), covering Impairment of Assets.
- Transition from limited impairment testing under previous Indian GAAP to broader application under Ind AS
- Significance and relevance of Ind AS 36 in the Indian accounting landscape
  - ✓ Overview of applicability, requirements, and methodologies for implementing Ind AS 36
  - ✓ Practical approach to conducting impairment assessments and testing under Ind AS 36

Applicability of Ind AS 36

- This standard must be applied in accounting for the impairment of all assets, unless they are specifically excluded from its scope.
- To assess impairment of assets or intangible assets, a CGU approach is used i.e., recoverable amount is assessed for each cash-generating unit (CGU) and compared with the carrying amount of the CGU, then drilled down to asset level.

Assets to which IND AS 36 is commonly applied are

- Investment in Subsidiaries, Joint Ventures and Associates,
- Plant, property and Equipment,
- Intangible Assets including Goodwill

Assets to which IND AS 36 does not apply are

- Inventories
- Contracts recognized in accordance with Ind AS 115
- Deferred Tax Assets
- Financial Assets
- Non-Current Assets classified for sale (Ind AS 105)
- Biological Assets related to agricultural activity
- Assets arising from the employee benefits

Definitions

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Recoverable amount	Recoverable amount for an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.
Fair value	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date .
Costs of disposal	Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.
Value in use (VIU)	Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.
Impairment loss	An impairment loss is the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount.
Cash-generating unit (CGU)	A cash-generating unit (CGU) is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.
Corporate assets	Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.

Indicators of Impairment

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Indicators of Impairment as per Ind AS 36

- In assessing whether there is any indication that an asset may be impaired, an entity shall consider the

Internal Indicators such as:

- Obsolescence or physical damage of an asset
- Under-performance of an asset compared to expectations
- Reassessing the useful life of an asset as finite rather than indefinite, etc.

External Indicators such as :

- Changes in regulations
- Adverse effects in the technological, economic or legal environment
- Increase in market interest rates, etc.

The following must be done annually whether or not there are indications of impairment

- Impairment testing of intangible assets with an indefinite useful lives and intangible assets not yet available for use
- Impairment testing of goodwill and/or intangible assets acquired in a business combination

Testing of Impairment

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All other in-scope assets other than goodwill (If impairment indicators exist)

- Impairment testing for all assets, other than goodwill, should be carried out on an individual basis, wherever possible.
- If it is not possible to determine the recoverable amount for the individual asset, then determine recoverable amount for the asset's cash-generating unit (CGU).

Goodwill (periodically irrespective of indicators)

- Impairment testing for goodwill is always carried out in the context of a CGU or a group of CGUs because goodwill does not generate cash flows independently of other assets.

To arrive at the impairment loss, the following steps need to be followed

Impairment methodology

Estimating Recoverable Amount (RA)

Comparing Recoverable Amount (RA) and Carrying Amount (CA)

Recognising Impairment Loss

Impairment Methodology

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Estimating Recoverable Amount

- Recoverable amount is the higher of the following for a CGU or asset:
  - ✓ Fair value less costs of disposal (FVLCOD)
  - ✓ Value in use (VIU)
- It is not always necessary to determine both an asset's FVLCOD and VIU. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired.

Fair Value less Costs of Disposal (FVLCOD)

- Fair Value is the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties.
- Fair value estimate takes market participants' perception of the price of an asset into account. FVLCOD would consider future developments only if they are publicly known, supportable and are considered by other market participants as well.
- Examples of costs of disposal are -
  - ✓ Legal costs
  - ✓ Stamp duty
  - ✓ Transaction taxes
  - ✓ Costs of removing the asset
  - ✓ Direct incremental costs to bring an asset into condition for its sale.

Value in Use

- Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.
- VIU is usually estimated by using the Discounted Cash Flow (DCF) method, in the following steps:
  - ✓ Estimating the future cash inflows and outflows derived from continuing use of the asset
  - ✓ Estimating the terminal period cash flows or cash flows from its ultimate disposal, as applicable
  - ✓ Applying the appropriate discount rate to those future cash flows

Impairment Methodology

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Step 1 | **Forecast Cash Flows**

- Cash flows are prepared based on reasonable and supportable assumptions that represent management's best estimate, most recent financial budgets/forecasts approved by management. Projections should cover a maximum of 5 years unless a longer period can be justified.
- Future cash flows will be operating cash flows only based on current status of the business and will not include:
  - ✓ Improvement or enhancement of performance
  - ✓ A future restructuring to which an entity is not yet committed
  - ✓ Income tax receipts or payments
- VIU should reflect the present value of future cash flows. In practice, present values are computed either by a 'traditional' or 'expected' cash flow approach.
  - ✓ Under a 'traditional cash flow approach', a single set of estimated cash flows and a single discount rate are used.
  - ✓ Under an 'expected cash flow approach', all expectations about possible cash flows are used instead of the single most likely cash flow.
- Discount rates must therefore also be pre-tax rate and varied to reflect the risk within each set of possible cash flows.

Step 2 | **Terminal Cash flows**

- Terminal Value can be calculated either by Gordon Growth model or Exit Multiple method, in case of ongoing businesses.
- In the Gordon Growth model, the terminal value is calculated by capitalizing the final year's cash flows at a rate that is derived as the difference between the discount rate applicable to the business and the terminal growth rate.
- In the Exit Multiple method, the terminal value is calculated by applying a market multiple to the company's final year EBITDA or EBIT, to arrive at enterprise value at the end of the cash flow period.
- The chosen market multiple is usually an average of recent exit multiples for listed companies or private transactions.
- Whether Gordon Growth model or Exit Multiple method is used, the resent must be presented in present value terms.

Impairment Methodology

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Step 3 | **Applying the appropriate discount rate to future cash flows**

- As per Ind AS 36, the discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.
- However, in practice the Capital Asset Pricing model (CAPM) is used, which takes the post-tax discount rate into account.
- In such as situation, the cash flows should be post-tax cash flows as well, to ensure consistency.
- The CAPM method requires multiple inputs from market data, of which the key ones are:
  - ✓ Risk Free rate derived from government bond yields
  - ✓ Beta which calculates the volatility of a specific industry
  - ✓ Equity market risk premium is the risk premium of the stock market
  - ✓ Specific risk premium is the risk premium specific to the company and its cash flows
  - ✓ Cost of debt of the company and the tax rate it is subject to
  - ✓ Industry gearing ratios i.e. the capital structure of companies in the same sector

Comparing Recoverable Amount and Carrying Amount

- Subsequent to estimation of the asset's recoverable amount, the next step is to compare the same to the carrying amount.
- Where the carrying amount exceeds the recoverable amount, the entity will record an impairment loss.
- Goodwill and Corporate Assets relating to a Cash generating unit (CGU) would be allocated to it while calculating carrying amount.

Impairment Methodology

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Recognizing Impairment Loss, if any

- An impairment loss shall be recognized immediately in the P&L account, unless the asset is carried at revalued amount in accordance with another standard.
- The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:
  - ✓ First, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
  - ✓ Then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).
- The carrying amount of an asset will never be reduced below the higher of its individual recoverable amount and zero.

Cross Checks and Sensitivity of Impairment Results

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Recoverable Amount Calculation Methodology

- Recoverable amount is usually calculated using a VIU approach. This means that the result is based on a DCF method which uses the CGU or company cash flows,
- But does not factor in market multiples or movements therein.
- It is therefore necessary to cross-check recoverable amounts against market multiples

Cross-Check with Market Multiples

- This is done by calculating the implied multiple (RA/EBITDA or RA/PAT) and comparing it to the trading multiples of listed companies and/or transaction multiples of private companies in the same sector.
- Significant divergence, if any, from market multiples, should be justifiable - if it is not justifiable then a review of cash flows or discount rates is usually necessary

Sensitivity Analysis

- Assess the impact of key input variations on recoverable amounts.
- Key inputs include revenue growth, EBITDA margins, discount rate, and terminal growth rates.
- Identify if minor changes in inputs could potentially trigger asset impairment, prompting conservative recognition of impairment.

Complexity of Impairment Testing

- Especially challenging for initial assessments.
- Audit requirements necessitate a comprehensive impairment memo outlining the testing process.
- Many companies prefer to enlist valuation professionals with expertise in this area for assistance.

Common Errors While Performing Impairment Testing

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Insufficient definition / incorrect identification of CGUs and allocation of goodwill	Goodwill should be allocated to a CGU or group of CGUs that are expected to benefit from the synergies of the business combination [IAS 36.80]. Often allocation of goodwill does not fully reflect this requirement and the determined level of CGUs is not conforming to IAS 36.68.
Insufficient allocation of corporate assets to CGUs	Corporate assets are a special case of allocating assets to CGUs. Corporate assets generate benefits and costs for more than one CGU (e.g., headquarter function, R&D department). Corporate assets have to be allocated to CGUs on a reasonable basis.
Change in CGU composition between reporting periods	Ideally, the initial allocation of goodwill recognized in a business combination to CGUs should be completed before the end of the annual period in which the business combination is affected. Unless the entity is reorganizing its reporting structure or disposing parts of its CGUs, the initial goodwill allocation cannot be changed for future impairment testing
Errors in carrying amount calculation	The carrying amount should be determined on a basis consistent with the way the recoverable amount of the CGU is determined. Often, assets are included in the carrying amount that are not part of the cash flow generating process reflected in the CGU's recoverable amount.
Insufficient consideration of the market participant view	The FVLCD assumes a hypothetical buyer (called the "market participant") which puts each asset (CGU) to its highest and best use. The underlying cash flows need to be ''cleaned'' from entity specific synergies and unusual items (e.g. excessive compensation).

Reversal of Impairment Loss

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- The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized for the asset in prior years.

- Para 119 says that "A reversal of an impairment loss for an asset other than goodwill shall be recognized immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Indian Accounting Standard (for example, the revaluation model in Ind AS 16)

- Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Indian Accounting Standard".

- A reversal of an impairment loss on a revalued asset is recognized in other comprehensive income and increases the revaluation surplus for that asset . However, to the extent that an impairment loss on the same revalued asset was previously recognized in profit or loss, a reversal of that impairment loss is also recognized in profit or loss.

- After a reversal of an impairment loss is recognized, the depreciation (amortization) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

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Thank You

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