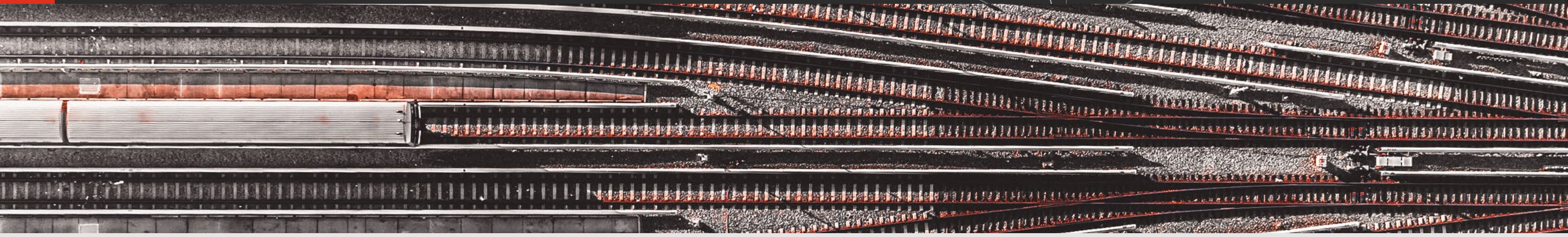
COVID-19: Impact on Goodwill Impairment Testing

April 2020



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Annual impairment test is required for goodwill. More frequent testing shall be performed if circumstances change, indicating that it is more likely than not that an impairment loss has been incurred (i.e., a triggering event).

Is the global pandemic classified as a triggering event?

It depends on the extent of the impact of the global pandemic on the reporting unit. Financial and operational challenges brought by the current environment may suggest potential triggers for impairment of goodwill for most industries.

Indicators include:

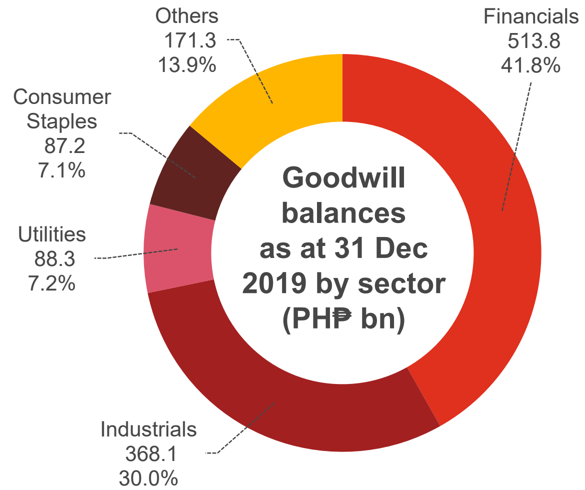
- Significant decline in the market capitalization of the company, particularly if it falls below the book value of net assets
- Reduction in the ability and/or increase in the risk to generate expected cash flows due to:
  - Decrease in the expected growth of the economy and industry where the reporting unit operates in;
  - Disruption in the supply chain;
  - Increased credit risk due to decline in the ability of customers to pay obligations; and/or
  - Closure of stores and facilities.

Evaluation of whether COVID-19 is a triggering event shall be company-specific, and shall be evaluated holistically.

Did you know?

PH₱1.2 trillion

is the total amount of goodwill recognized by all companies listed in the Philippine Stock Exchange as at 31 December 2019.



Source: S&P Capital IQ
Note: Goodwill amount is subject to change upon completion of year-end financial statements of the listed companies. Goodwill balances may include those reported by locally-listed companies that operate internationally, hence may not be solely attributable to local operations.

Which industries are generally likely to be vulnerable to COVID-19?

Most likely → Least likely

Tourism, Airlines | Manufacturing | Retail | Real estate | Energy & Utilities | Logistics | Education | Agriculture & Food | Healthcare

Shall I consider potential impact of COVID-19 in testing goodwill for impairment?

Yes → For fiscal year end 11 March 2020 onwards for most industries.

No → For 31 December 2019 cut-off, but disclosures are required if it is classified as a triggering event.

Since the WHO declared a pandemic and governments mostly started taking significant measures only on 11 March 2020, COVID-19 outbreak is generally not considered as a recognized subsequent event for companies reporting as at 31 December 2019. Disclosures will, however, be required, if the impact is expected to be material.

Who shall I involve in the evaluation process?

- **BOD, Management Committee and Unit heads** who can help come up with business continuity plans and realistic cash flow projections reflecting a wide range of expected impact of COVID-19
- **Your banks, legal and other advisors, and auditors** to assess the potential impact of COVID-19 on financing, operations, and regulatory and financial reporting requirements

What shall I consider in estimating the potential impact of COVID-19 on projected cash flows?

- Several scenarios considering the range of potential impact of the outbreak on expected cash flows, instead of compressing all possibilities in one scenario. These scenarios may include:
  - A **base case scenario** reflecting most likely impact of the length and severity of the current circumstances, and government measure to contain the virus and reopen the economy;
  - An **optimistic scenario** with short- to medium-term impact of the disruption considering potentially shorter and less severe impact of the pandemic; and/or
  - A **pessimistic scenario** reflecting potentially more severe impact and longer disruption in operations.
- Impact on the supply chain, including stability of supplier operations and flexibility on credit terms
- Impact on distribution and collections, particularly collectability of receivables in terms of timing and amount
- Working capital and financing requirements while implementing measures for business recovery, including compliance with debt covenants
- Medium- to long-term growth rates of the company and the industry given potential changes in demand, consumer behavior, competition and regulations

How do I select appropriate discount rate assumptions?

- Obtain risk-free-rate using long-term government bonds as at the valuation date and estimate cost of debt using most recent incremental borrowing rate and updated credit rating of the subject entity
- Estimate cost of equity by calculating implied return on relevant index (e.g., PSE), implied earnings yield, and/or implied premium brought by increased market volatility as at the valuation date
- Add company-specific risk premium given unusually low interest rate environment and to consider risks specific to the ability of the reporting unit to realize forecasted cash flows
- Assess optimal and/or sustainable level of the debt-to-equity ratio given potential need to increase borrowings during business recovery

How can PwC help?

Our valuation professionals can perform an independent assessment of the potential impact of COVID-19 on the expected cash flows and the appropriate level of discount rate to be used in quantifying any impairment risks relating to goodwill and other intangible assets with finite and infinite lives.

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