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Valuation uncertainty- A side affect of COVID 19

The mankind has till date witnessed a number of deadly pandemics and has suffered the after impact of the same till years. Right from deadliest Black death or Bubonic plague in around 1347 taking toll of more than 200 M lives to small pox, Spanish flue, great plague, Asian flu, HIV, swine flu, yellow fever, Ebola and the list is too long. The intensity and impact had been different on mankind and on the economy depending upon the geographical spread and the affected areas and RO (R Naught) number which is a measure of the number of people each affected person will infect.

The recent COVID -19 is an addition to the list of deadly pandemics which as on date has taken life of around 900k worldwide and the number is rising with each passing day.

Financial Impact of COVID

The pandemic has created huge challenges in preparation of financial statement and financial report thereby creating a big onerous on the management as well as the finance professional.

The major challenges may be summarized as under:

1. Going concern and liquidity positions
   The biggest task in front of the management would be to understand the position of the organization and in that the Key would be cash flow.
   The business will have to analyze if they are enough cash rich to survive for next 6-12 months. The management will have to make assessment if the company can continue as a going concern.
   Relevant disclosures ought to be made while preparation of statements
2. Restructuring and contract modifications
   The companies may experience a crunch in cash flow due to drop in revenue, higher operating cost due to disrupted operations. Hence, they may need the additional finance in form of debts. Further they may also seek waivers to the extent possible if they are not able to satisfy the debt covenant. This may require restructuring of finance
3. Impairment of assets:
   An asset is impaired when a company is not able to recover the carrying cost either by using or selling the asset. The closure of manufacturing units, drop in

export/import, labor issues all may be an impairment indicator indicating the need of asset impairment.

4. Fair Value assessment:
   With more and more companies going for IND AS, the fair value assessment will again pose a big question. In Fair Value Measurement the company has to consider all the factors and assumptions which is known to market participant. Depending on the severity on the assumption date, the valuation would be reasonably affected.
5. Government policies:
   The financial institution will be impacted by the direction of Government /Apex Bank for loan waivers/relaxations. This may require institution to think about their loan portfolio and credit losses
   The various relief packages, in form of subsidies, tax exemptions, rental reductions etc will also make a great impact on financial reporting.

Impact on valuation:

For valuers, the uncertainty which permeates all markets will inevitably lead to challenges, not just in terms of carrying out valuations and determining value, but also in the reporting of those values in a way that is both helpful and informative to users. So, in that sense a more responsibility has come on valuers to adopt such practices which gives a true and fair view of the asset being valued.
Keeping in view the emerging scenario the International Valuation standard Board (IVSC) technical board has issued advisory on valuation under COVID scenario.

The major extracts are as under:

1. Reporting- IVS 103
   'Reporting' requires the valuation report to disclose a number of matters, including any significant uncertainty or limiting conditions that directly affect the valuation.
   Section 10 para 10.1 and para 10.2 states;

   "10.1. It is essential that the valuation report communicates the information necessary for proper understanding of the valuation or valuation review. A report must provide the intended users with a clear understanding of the valuation.

   10.2. To provide useful information, the report must set out a clear and accurate description of the scope of the assignment, its purpose and intended use (including any limitations on that use) and disclosure of any assumptions, special *assumptions (IVS 104 Bases of Value, para 200.4), significant uncertainty or limiting conditions that directly affect the valuation."*

Valuation is a matter which is always subject to risk and uncertainty

Risk

Risk is the exposure that the owner of an asset has to potential future gains or losses. Risk can be caused by various factors affecting either the asset itself or the market in which it trades.

Risk can often be quantified and is therefore normally reflected in market price.

Uncertainty

Valuation uncertainty is concerned only with uncertainties that arise as part of the process of estimating value on a specific date.

Reasons of valuation uncertainty may include

- market disruption,
- input availability,
- choice of method or model.

These factors are interdependent on each other. Like the market disruption may lead to lack of input data which may create uncertainty for the appropriate method or model to be used.

Let us understand the above factors in detail:

1. **Market disruption:**

Valuation uncertainty can arise when a market is disrupted at the valuation date by current/ or very recent events,

For example, through panic buying or selling (as we are seeing in recent COVID-19 time), or a loss of liquidity due to a disinclination of market participants to trade, disruption of supply chain etc.

Such events causing market disruption may be macroeconomic or microeconomic.

In some cases, the microeconomic factor may lead to macroeconomic events. Like market disruption in COVID -19 may presently be seen as microeconomic but may have some macroeconomic implications in future.

If the valuation date coincides or falls immediately after such event, valuation uncertainty arises, since the data and inputs relate to "before event" which may not be significant for use in current scenario. Since the impact on the market participant as well as price cannot be quantified immediate after, hence uncertainty is not usually quantifiable.

2. **Input availability**

When the market is disrupted, it results into lack of reliable data. In case of lack of data, reliance is placed on inputs from directly observable price for similar assets or rely on unobservable inputs.

The use of extrapolation or unobservable inputs can be a source of uncertainty because of the difficulty of finding objective evidence to support either the adjustments or the assumptions made. The valuation method used may adjust for input uncertainty like adjusting the cash flow or the discount rates applicable. In some cases, the valuation uncertainty resulting from inconsistent or conflicting data can be estimated by the effect on the valuation of using possible alternative inputs.

3. **Choice of method or model**

The unavailability of reliable data may make a valuer choose the method or model which may not give the accurate valuation.

The IVS provides that where the valuer has high degree of confidence in the accuracy and reliability of single method in the existing situation, he is not required to choose more than one method. However, in case of insufficient factual or observable inputs for a single method to produce a reliable conclusion, more than one method or approach or multiple methods in single approach should be used.

The current climate is a situation where more than one approach should be used as the economic and political climate is such that "there are insufficient factual or observable inputs for a single method to produce a reliable conclusion."

4. **Significant uncertainty**

IVS 103 requires "significant uncertainty" to be disclosed in the valuation report.

Existence of significant uncertainty does not mean a valuation cannot be undertaken, but it does mean that significant assumptions within the valuation approach and methodology should be disclosed within the valuation report.

Significance is determined on the basis of two aspects:

a. whether the potential impact on the valuation figure is significant; and
b. whether it is of relevance to an intended user of the valuation.

The significance may be decided on the basis of professional judgment keeping in view the following aspects;

a. Whether the valuation is for internal purpose or for third party
b. the extent to which the value of a total portfolio is affected if the valuation uncertainty affects only certain assets within the portfolio.
c. whether the cause of the uncertainty was known to the commissioning party or to a third party relying on it when the valuation was commissioned;
d. whether the effect of the uncertainty could expose the commissioning party or a third party relying on the valuation to significant risk of loss

e. Whether the failure to disclose the uncertainty would affect the decision of person relying on it.

5. Measuring the valuation uncertainty

Uncertainty that arises either from the choice of model or method, or from a lack or inconsistency of input data, may be estimated by observing the effect on the valuation of using an alternative model or input. When alterative scenario is available, most likely scenario should form the base of valuation

Sensitivity analysis may be used in case where there are a sufficient number of reasonably possible alternative numeric inputs that could have been selected on the valuation date. However, in case of non-financial assets statistical analysis may not prove very useful.

Following should be kept in mind when quantifying the uncertainty

1. Valuers should clearly state the level of confidence when this approach is adopted.
2. A quantitative measure should always be accompanied with a narrative describing the cause and nature of the uncertainty.
3. Quantifying valuation uncertainty does not involve forecasting a worst-case scenario.
4. When choosing alternative assumptions to measure uncertainty within a business or tangible asset valuation, a selection needs to be made among possibilities that are not located in the tail of the distributions (where events are very unlikely to happen), but rather in their central areas (where events are likely to occur).
5. Primary objective of uncertainty analysis should be to provide information about the variability of the value at the specific valuation date.
6. When quantifying the impact of uncertainty, the interdependence or correlation between significant inputs needs to be considered, to the extent possible.

Important Notes:

1. Any non compliance of IVS 102 relating to investigation and compliance due to existing restrictions by government or regulatory authority should be disclosed in scope of work and the report and should be agreed with the client
2. If the valuer considers that it is not possible to provide a valuation on a restricted basis, the instruction should be declined.
3. Valuers should not apply pre-crisis criteria to their valuations based on the potentially erroneous assumption that values will return to their pre-crisis levels and there is no way of predicting that this assumption is in fact correct.

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