

ASSET TEST

Current market turmoil may not have impaired the vision for your business, but what about your assets? **Fergus Condon** considers the issues of value and valuation

As of time of writing (the end of October), it looks as though some of the liquidity issues in the market place may be overcome as LIBOR interest rates for interbank lending are reduced and credits spreads begin to contract. However, even with this good news we are seemingly heading for a prolonged period of economic and financial uncertainty that will adversely impact most, if not all, sectors of the economy. The focus has now moved from liquidity to economic activity and reduced consumer and business spending. In this context, the issue of whether a company's assets are worth their carrying amount will require the attention of both preparers and auditors alike as we head towards the next year end period in December.

Indicators

Notwithstanding subtle differences, whether you are an Irish GAAP or IFRS reporter, the fundamentals of an impairment review are the

same: to work out the recoverable amount of an asset being the higher of value in use (VIU) or fair value less cost to sell (or NRV). If the higher of these numbers is an amount below the carrying value of an asset, then an impairment charge must be recorded. Both standards provide a list of indicators of impairment, for example if a company is making losses or if there has been technological advance in respect of an asset. But even without reviewing an accounting standard, impairment is reasonably easy to spot. If a company has plant that has been mothballed because there is no business to service or if a company has a bank of development land or is in the course of developing a site, common sense would suggest that, in the current climate, one would have to question whether the initial investment can be recovered.

Reference

Fair value less cost to sell should, in the first instance, be determined by reference

to an active market. Before current market difficulties, that may have been possible for financial assets, but for most property, plant and equipment (PPE) assets there is no active market. Take a crane, for example, or some other piece of specialised plant: if no active market exists then one would consider recent market transactions where similar items were sold. The current challenge here, of course, is that with merger and acquisitions activity being fairly non-existent, it is very difficult to identify any recent market transactions at the present time.

As a result, most impairment calculations are likely to be based on the VIU concept which is, in essence, a discounted cashflow model. Those cashflows should be based on the most recently approved budgets for the entity. The cashflows should be on a pre-tax basis and should exclude costs associated with restructuring or amounts not in the normal course of business. Accounting standards generally require that the cashflow period is limited to five years unless longer can be justified. For any period after this,

the growth in the cashflows should only reflect a normal economic growth factor unless another incremental amount can be justified for a particular industry, such numbers being in the region of two to three percent. Where possible, it is important to be industry specific as, for example, growth in manufacturing in the UK and Ireland during that period has been zero per cent while certain sectors of telecommunications can still demonstrate annual increases of six to eight per cent. Finally, for cashflows, remember to include any amount received for the sale of the asset, or in respect of goodwill, the terminal value.

Cashflows

The theory of what cashflows should be included in an impairment model is fine, but in reality, how does one identify cashflows for a particular asset? Take our earlier example of a crane. If a company is in the business of buying cranes and then renting them to construction companies, rental inflows and associated outflows for the asset will be reasonably easy to identify. However, if the crane is used in the course of construction as part of a larger fleet, then it will be necessary to review the larger fleet at a cash or income generating unit (CGU) level. A CGU is a group of assets for which cashflows that are independent of each other can be identified. For a crane, it may not be possible to identify independent cashflows at any level other than for a category of plant or indeed for the entire fleet, in which case cashflows identified may be for the business as a whole. In such instances, any impairment loss recorded would be spread pro-rata across the fleet.

Provisioning

For other assets such as development land, write-downs may be more often referred to as provisioning, but the concept is the same: identification of net cashflows. Many companies include this land in the inventory category and add stage payments made to a constructor or the cost of construction where undertaken in-house. When trying to identify any impairment, some entities take the view that a company should compare this carrying amount to the proceeds received if the land was sold in the market place at current market values. Such a mark-to-market approach may be suitable for financial instruments, but it is more questionable whether such an exit price model should be used for inventory of development land. Another approach would be to model forward the expected proceeds from the sale of the residential or commercial units, of course reflecting current market conditions and realistic assumptions. From this landbank,



construction and sales costs are deducted and the associated net cashflows are discounted to present value amounts. To the extent that this discounted cashflow amount is lower than current carrying value, then a provision will be necessary. Discussion among preparers and auditors alike might suggest that there is diversity in practice but it can be assumed that an exit or liquidation based approach is more difficult to sustain in an entity that considers itself to be a going concern.

Which discount rate?

The discount rate applied to these cashflows should reflect the return which an investor would expect to get for putting their cash into an equally risky asset. As such, to the extent possible, the rate should be asset-specific and this may well be possible for an asset such as commercial property or development land. Otherwise, an entity should use its weighted average cost of capital (WACC) amount. The WACC should be independent of the entity's gearing structure and should be adjusted to reflect the effective tax rate even where a company is not paying tax. For less sophisticated businesses, the incremental borrowing rate, plus a risk premium is sometimes used. Often preparers and auditors focus too much on the discount rate. Supportable accurate cashflows are, in many ways, more important, particularly year one cashflows. Unless the discount rate is unusually high, these cashflows fall to the bottom line almost euro for euro and will have a much more material effect on the VIU calculation than a few basis points will on a cashflow in year five.

Disclosures

Both Irish GAAP and IFRS have extensive disclosure requirements around impairments recorded and the impairment review process. A laundry list of those requirements is best kept for the standards themselves. Having spent much time on the numbers, many companies run out of steam when it comes to this part of the standard. However, in recent times regulators have indicated some disquiet about their application and they are likely to be the subject of their review again for upcoming calendar year ends. The IFRS requirement to provide sensitivity analysis of the assumptions and give an indication of headroom are those most often omitted or poorly presented. Although it may be too extensive for some companies, Vodafone disclosures around impairment could probably be considered best in class.

Conclusion

Surprises are the one thing that most senior finance people don't like, yet the fact that the impairment review process is undertaken at the eleventh hour in the financial statements close process means that surprises are often inevitable. Such reviews are generally best undertaken in the last quarter of the year and an initial investment in putting the cashflow model together should mean that in the coming year's workload should be limited to updating and validation of assumptions.

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