Asset Impairment Considerations

As we approach 31 December 2020, which can only be described as one of the most challenging years for businesses in recent history, we will start to see the impact of the pandemic reflected on profit and loss accounts and balance sheets on mass for the first time, given that the financial statements for the majority of Irish companies follow the calendar year.

In this series of 3 articles we will consider the implications for Directors and their companies under the topics of Asset Impairments, Post balance sheet events and provisions, and going concern, with the objective of providing important insights and illustrating the planning opportunities that business owners can avail of through early engagement now.

Asset Impairment Considerations

The economic environment created by the pandemic and the uncertainty it presents will require Directors to really consider the carrying value of assets on company balance sheets for 2020.

With that in mind, in this short article, we will provide some insight on the following key topics:

1. Demystifying impairment reviews – what assets do they effect, when are they required and a practical example of a Value In Use Calculation.
2. How other assets such as Investment Properties, stocks, debtors and intercompany receivables should be valued on company balance sheets.

Generally speaking, the need to perform impairment assessments will apply to the following asset classes:

1. Tangible fixed assets such as buildings, property, plant & equipment etc…
2. Intangible assets such as Intellectual Property, licences and goodwill etc…
3. Unlisted investments such as holdings in subsidiaries

where there is an indication that the asset might be impaired!

The basic principal is that an asset cannot be carried in the balance sheet at more than its recoverable amount. If recoverable amount exceeds the carrying amount then the difference, in most cases, will be booked as an impairment in the Profit and Loss Account.

The recoverable amount is the higher of:

1. Fair value less cost to sell
2. Value in Use

In simple terms, if 1. above was applied and the asset was externally valued with the result that it was worth more than its stated value on the balance sheet, then there is no impairment. However, it may not be possible or commercially practical to have assets externally valued – ***so what is Value in Use?***

Value in Use is, "The present value of the future cashflows expected to be derived from an asset". So in essence an impairment review requires us to:

- Compare the discounted future cashflows from an asset against its balance sheet value now to determine if it's impaired;
- Which requires cashflow projections to be prepared over the life of the assets and discounted at an appropriate rate which;
- Exclude debt and taxation amounts.

To better explain this concept and how this works in practice, we will consider an example case study.

Case Study – Online Sales Limited

In 2020, in response to changing consumer behaviour caused by the pandemic, a restaurant group established a company to specifically manage their online sales business.

Significant IP investment was required to establish a website platform that would manage the business, and set out below are the results for 2020:

Online Sales Limited			
Management Accounts for the year ended 31 December 2020			
Profit & Loss Account	2020	Balance Sheet	2020
Sales	€429,000	Intangible Assets	€750,000
Cost of Sales	(€176,000)	Debtors	€30,000
		Cash	€20,000
Administrative Expenses	(€980,000)		
Amortisation of Intangibles	(€150,000)	Creditors	(€1,676,000)
Tax	€0	Net Assets	(€876,000)
Loss for the year	(€877,000)		
		Reserves	(€877,000)
		Share capital	€1,000
			(€876,000)

The current economic environment coupled with the operating losses incurred caused the Directors to consider whether the Intangible Asset, in this case the IP, might be impaired. The IP cannot be easily valued externally and so consideration was given to applying Value In Use to assist in determining whether the IP was impaired for FY20. The Directors prepared detailed projections, which were then used as the basis to prepare discounted cashflow projections using an appropriate discount rate which are set out below.

Online Sales Limited					
	2021	2022	2023	2024	2025
Management Projections 2021 -2025	€	€	€	€	€
Sales	€800,000	€1,205,000	€1,518,000	€1,950,000	€2,524,000
Cost of Sales	(€224,000)	(€317,000)	(€441,000)	(€574,000)	(€714,000)
Administrative Expenses	(€717,000)	(€895,960)	(€1,088,000)	(€1,210,000)	(€1,330,625)
Amortisation of Intangibles	(€150,000)	(€150,000)	(€150,000)	(€150,000)	€0
Tax	€0	€0	€0	€0	€0
Loss for the year	(€291,000)	(€157,960)	(€161,000)	€16,000	€479,375

In this straightforward example we have assumed that the profit and loss result for each year equates to actual cashflow of the business with the exclusion of the Amortisation of Intangibles which is a non-cash expense.

Online Sales Limited								
	2020	2021	2022	2023	2024	2025	TV	
Value In Use Calculation	0	1	2	3	4	5	6	
Sales	€429,000	€800,000	€1,205,000	€1,518,000	€1,950,000	€2,524,000		
Cost of Sales	(€176,000)	(€224,000)	(€317,000)	(€441,000)	(€574,000)	(€714,000)		
Administrative Expenses	(€980,000)	(€717,000)	(€895,960)	(€1,088,000)	(€1,210,000)	(€1,330,625)		
Amortisation of Intangibles	(€150,000)	(€150,000)	(€150,000)	(€150,000)	(€150,000)	€0		
Tax								
Loss for the year	(€877,000)	(€291,000)	(€157,960)	(€161,000)	€16,000	€479,375		
Convert to EBITDA	(€727,000)	(€141,000)	(€7,960)	(€11,000)	€166,000	€479,375	€3,687,500	
Discount Cashflows (WACC 13%)	1	0.884955752	0.783146683	0.693050162	0.613318728	0.542759936	0.480318527	13%
	(€727,000)	(€124,779)	(€6,234)	(€7,624)	€101,811	€260,186	€1,771,175	€1,267,535

Having prepared detailed discounted future cashflow projections, the final step is to compare the discounted future cashflows calculated against the net asset value of the business now, remembering to again exclude debt and tax impacts.

Discounted Future Cashflows	**€1,267,535**
Carrying Value	
Net Asset Value at 31 December 2020	(€876,000)
Addback Debt financing (confirmed to be €950K)	€950,000
Adjusted Net Asset Value	€74,000
Conclusion	
VIU exceeds Carrying Value = Asset Unimpaired at December 2019	

In this case the conclusion drawn was that the IP was unimpaired, despite the losses incurred to date and projected in the short term, because the asset will generate cumulative positive cashflows over its life.

Of course, this example is not intended to address every aspect or requirement of Impairment accounting, but we hope it provides a useful overview to assist Directors with this challenging process.

A common question that also arises is how to assess subsidiary investments for impairment. When considering subsidiary investments on a parent company’s balance sheet for impairment, you should initially start by comparing the audited net asset value of the subsidiary to the Parent’s investment on its balance sheet. If the net asset value is less, consider valuation or impairment review.

How other assets such as Investment Properties, stocks, debtors and intercompany receivables should be valued on company balance sheets?

- **Investment Properties** – Normally recorded at Fair Value on the balance sheet calculated by an expert valuer, but possible for Directors to appraise themselves provided suitable expertise is available.
- **Stocks** – At a basic level, carry at the lower of cost versus selling price ***less*** costs to complete. This can get quite complex where long term contracts or development lands are involved.
- **Debtors and intercompany receivables** – At transaction amount less impairments. Significant level of judgment required by the Directors here to determine appropriate provision levels.
- Finally, consider adopting a revaluation or disclosure approach for fixed assets where the fair value might be considerably higher than the balance sheet amount.

In summary, asset impairment considerations, will be a significant part of preparing, and indeed auditing, financial statements for the year ended 31 December 2020, and so giving consideration to these as early as possible will really help to plan and manage any potential impacts with stakeholders such as shareholders, banks and other creditors.

For more information on how PKF can help, please contact us today;

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