

AUDIT COMMITTEE INSTITUTE IRELAND

# Accounting in an uncertain economic environment and related challenges for audit committee members

9 December 2008

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A blue-tinted photograph of a stone building. On the left, there is a large, arched doorway with a decorative stone frame. To the right, there is a window with a similar stone frame. The building's facade is made of large, rectangular stone blocks. The overall scene is dimly lit, with the blue tint giving it a formal and professional appearance.

**Welcome**

*Kevin O'Donovan*  
*Chairman*

*Audit Committee Institute Ireland*

The background is a blue-tinted photograph of a stone building. On the left, there is a large, arched doorway with a decorative keystone. To the right, there is a window with a decorative frame. The overall scene is dimly lit, with the blue tint giving it a somber or professional appearance.

# **Impairment**

*Jim Calvert*  
*KPMG Corporate Finance*

# Setting the scene

- ◆ Big decline in share prices, ISEQ down 75% versus highs, 65% YTD



Source: Bloomberg

- ◆ Multiples have contracted (P/Es at 5.1x versus 17.7x in 2007)



Source: Bloomberg

# Setting the scene

- ◆ Many companies trading below book value (ISEQ at 0.76x book value versus a high of 3.51x in 2006)



Source: Bloomberg

# Impairment Issues

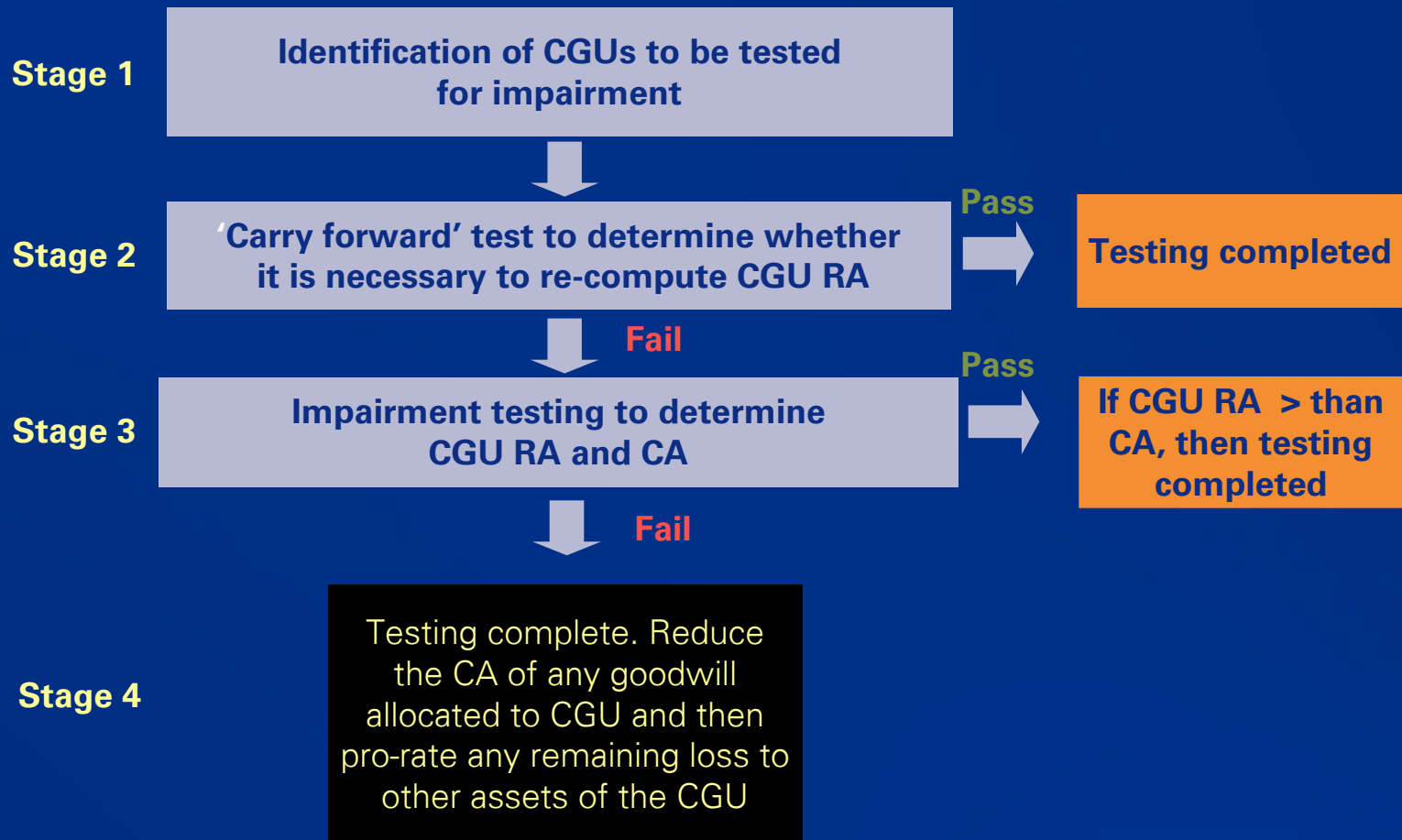
## ◆ User reaction

- Effect on share price/company valuation
  - Investors may have already anticipated the impairment
- Debt provider reaction
  - Effect on covenants, etc.
- Interpretation, e.g., market movement, overpayment, integration issues, management, etc.

## ◆ Effect on management incentive arrangements

## ◆ Proactive communications

# Impairment Testing Process



# Accounting Requirements

## ◆ Frequency of testing/Timing of Charge

- At least annually for goodwill and intangible assets with an indefinite life
- Otherwise on an “events and circumstances” basis

## ◆ Impairment if carrying value exceeds recoverable amount. Recoverable amount is greater of fair value less costs to sell or value in use

- Essentially, impairment exists if the carrying value is greater than the present value of what could be recovered from use or sale of the CGU
  - Fair value is based on market pricing or valuation techniques
  - Value in use based on present value using DCF

# Market Prices

- ◆ **Current prices though depressed are often the best indicator of fair value**
  - Forced transactions are rare
    - General relate to bankruptcy situations where there is insufficient time to market the asset
  - The expected benefit from holding an asset is not fair value
    - Model or “fundamental” value is not fair value
  - Guidance from IASB Expert Advisory Panel, FASB (e.g. FSP 157-3)

# Discounted Cash Flow Techniques

- ◆ **DCF techniques may be used to calculate either value in use or fair value**
  - Value in use is based on entity specific factors while fair value is based on marketplace participant assumptions
  - Directions given on calculating value in use versus fair value, e.g., the period covered by the cash flows, restructuring assumptions, terminal growth rates, etc.
  - Discount rate a key issue

# Discount Rates

- ◆ **Wide range of “supportable” assumptions for components of cost of capital calculations**
- ◆ **Small changes in discount rates can have a large effect on value**
- ◆ **Discount rate reflects operating and financial risk**
  - Further adjustment may be required for forecasting risk

# Discount Rates

- ◆ **If the values under a DCF do not appear reasonable, then an adjustment to the discount rate may be required**
  - Cost of capital cannot be viewed in isolation from other information in a forecast
  - Market pricing should be used to assess the reasonableness of DCF value conclusions and assumptions
- ◆ **Post tax discount rates used to value a business; pre-tax disclosed**

# Cash Flow Forecasts

- ◆ Has the business unit been involved in the preparation of the forecasts?
- ◆ Have forecasts been updated to reflect the most up-to-date expectations?
- ◆ Are short term assumptions consistent with other information, e.g., budgets
- ◆ What assumptions have been made for longer term
  - Shorter term assumptions easier to test but terminal value often accounts for most of the value
- ◆ Tax assumptions

# Reasonableness Tests

- ◆ **Are values consistent with current market pricing?**
  - Comparable company multiples
- ◆ **Reconcile aggregate CGU values to the market capitalization, where applicable**
- ◆ **Where assets were acquired at market peaks, consider current value estimates relative to subsequent market movements**

**Does it make sense in the context of all the information about the business and market?**

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*John Hennessy, SC  
Chairman, CPL Resources plc*

A blue-tinted photograph of a stone building. On the left, there is an arched doorway with a decorative keystone. To the right, a window with a pointed arch is visible. The building's facade is made of large, rectangular stone blocks. The overall scene is dimly lit, with the blue tint giving it a somber or historical feel.

**Questions?**

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