Directors shouldn't second-guess asset values: RSM Australia warns

Regardless of their size, past acquisitions are coming back to haunt the financial statements of a growing number of ASX-listed companies. This is one of the major conclusions within the latest annual Business Acquisition and Impairment Review (2016) by national accounting firm RSM Australia (RSM) which has been assessing the financial reporting impact of recent acquisitions on the financial statements of ASX-300 and non-ASX 300 companies since 2013.

While median acquisition size for all classes of ASX-listed companies has increased in line with the All Ordinaries index, the 2016 review reaffirms the need to reassess future business plans and profitability forecasts in light of post-acquisition financial performance of acquired businesses.

Impact on reported earnings

What's driving the need to reassess future business plans and profitability forecasts, advises Glyn Yates, Director and National Head of Corporate Finance at RSM, are rising impairment charges that significantly impact an entity's reported result and net asset position.

Due largely to Australia's economic recovery, and increased transaction multiples, the 2016 review also reveals a notable uptrend in the percentage of total consideration paid for intangible assets, from 74.1% in 2013 to 82.2% in 2015.

"Given that the bulk of purchase consideration relates to the acquisition of intangible assets – ie non-monetary assets, like goodwill, brands, trademarks, patents, customer contracts and software – the accounting treatment of these assets can and does have a profound impact on reported earnings," says Yates.

Appropriately recognise impairment

Given that indefinite life assets, like goodwill and brands – which consistently comprise over 80 percent of intangible assets – are not amortised, but instead assessed for impairment annually, the 2016 review identifies a greater requirement to identify intangible assets before acquisitions are made.

This is of particular relevance, adds Yates when companies negotiate banking covenants and the impact on an acquiring entity's earnings per share (EPS).

"With listed entitles unable to justify asset carrying values, impairment charges continue to be recognised in relation to acquired intangible assets," says Yates. "It's important to consider the potential financial reporting impact of these charges and consider downside sensitivity analysis before acquisitions are made to ensure there are no nasty surprises."

Impairment write-offs

Impairment charges can have a significant impact on an entity's reported position, and net asset position. Based on three years of review data, the percentage of impairments being recognised has increased from 24.2 percent in financial year 2013 to 30.0 percent in financial year 2015 for ASX-300 companies; and from 16.4 percent to 22.0 percent for non-ASX 300 companies respectively.

Having been an area of focus over the last three years, Yates expects impairment of goodwill and other non-current assets to again come up on ASIC's radar for the June 2016 reporting period.

Challenge assumptions

Like ASIC, Yates urges directors to exercise professional scepticism and challenge the appropriateness of asset values and assumptions underlying impairment calculations, especially where prior period forecasts haven't been met.

"The key to getting this right is accurately estimating future cash flows that will be generated by the cash generating unit and then discounting those cash flows at a discount rate that reflects the returns that an investor would require from cash generated unit, based on the related risk of that cash generating unit," advises Yates.

“While median impairment rates used across various industries don’t vary significantly from sector to sector, there is still a size premium evident in the discount rates applied to non-ASX 300 companies of around 1.6 percent.”