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CORPORATE RECOVERY- THE SEMANTICS

ABSTRACT

Significant impairment of assets may be a prelude to corporate collapse. Accounting standards provide a framework within which to measure this loss of value thereby enabling key stakeholders in restructuring negotiations make the right calls

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Undertaken by finance professionals, **corporate recovery** is the attempt to assist top-level management, in companies facing financial and other difficulties, get the business back on track.

A company may ail for a number of reasons- from those precipitated by external market forces beyond its control to internal operational pressures surrounding obsolescence and high costs and extending to governance failure. However, the main trigger of corporate insolvency is the inability to meet short-term commitments- either to creditors or in working capital requirements. Here we look at impairment of a company's asset base that is so significant as to signal the advent of corporate failure. This will invariably lead to a considerable decline in the value of the company and/ or its asset base resulting in the mismatch between book value (or carrying amount) on the Asset side on the one hand and Capital and Liabilities on the other in the company's Statement of Financial Position.

The IAS/ IFRS regime

For the **balance sheet equation** or **accounting equation (Assets = Capital + Liabilities)** to continue to hold true and following the requirements of International Accounting Standard (IAS) 36 *Impairment of Assets,* an impairment loss (or expense) will have to be recognised on the company's Statement of Comprehensive Income to reflect this loss of value; unless the expense relates to an impaired asset(s) that had been revalued at an earlier period in which case the impairment loss is treated as a revaluation decrease.

IAS

In the company's Statement of Financial Position, the carrying amount of the impaired Asset(s) will equally need to be adjusted for impairment to reflect recoverable value. Equity (Capital & Reserves) will also be impacted by the decrease in current year profit as a result of the impairment charge.

IAS 36 *Impairment of Assets* recognises the following as indicators of impairment.

External sources

- Market value declines
- Negative changes in technology, markets, economy or laws*
- Increases in market interest rates
- Net assets of the company higher than market capitalisation

Internal sources

- Obsolescence* or physical damage
- Asset is idle, part of a restructuring or held for disposal
- Worse economic performance than expected
- For investments in subsidiaries, joint ventures or associates, the carrying amount is higher than the carrying amount of the investee's assets

*Sources in asterisk are signs of either a deeper malaise in the company or significant external threat to the company

According to IAS 36 *Impairment of Assets* a company's assets are not to be carried at more than their recoverable amount. The recoverable amount is the higher of fair value less costs of disposal and value-in-use. Value-in-use is the present value (PV) of future cash flows. Companies are required to conduct impairment tests where there is an indication of impairment of an asset.

If the level of impairment is significant, the company will need to determine whether it can continue to trade (in which case it will draw up a recovery plan) and if so whether more finance will need to be raised or not. If the decision is that further finance is required the company will need to determine the amount of finance required, in what form this will be required and from whom- shareholders or creditors (debt-holders and/ or bank lenders) or both.

A balancing act

The recovery plan will invariably involve a balancing act by key company stakeholders. For shareholders, the consideration will include balancing the attraction of a low share price following recognition of the impairment in the first instance and the low exercise price of a rights issue to fund the recovery in the second against the risk of continuing to invest in a company whose future as a going concern may be in serious doubt.

For creditors, these will be required to reduce the level of debt owed by the company ('taking a hair-cut' in financial jargon) in order to participate in the company's recovery plan.

Creditors may also be offered a conversion of their debt to (preference) shares as an incentive to participate in the recovery. This will buy them some level of influence in deciding the direction and/or management of the company where common equity is taken up instead of preference shareholding. Further, where conversion is to ordinary shareholding there is the added attraction of a share in profits (dividend and capital growth) were the recovery to be successful. Other creditors, in particular suppliers, may agree to a reduction in outstanding payables in order to protect existing supply contracts and safeguard future business.

It is important, however, that the recovery plan does not leave the original (ordinary) shareholders with little or no stake in the company as they will be required to participate in future issues of equity. By the same token, however, and since ordinary shareholders have the most to gain if the company performs well it is only fit that they should bear the greatest loss if the company fails.

For creditors, fears of a further reduction in the value of the company's assets as collateral (on further impairment), or equally continued downgrade in the credit-rating of the debt-issuer will serve as a major challenge towards their participation in any recovery plan. However, on the other hand, any indication that liquidation of assets or sale of the business will result in them unable to recover all or part of the debt owed to them will induce them to accept the recovery plan.

The size of the write-off and the amount of further finance required to fund business continuation will be key considerations taken into account by the business directors and their providers of finance in determining how the burden of recovery will be shared. In furtherance of proper corporate governance, the views and concerns of other key stakeholders, in particular suppliers and employees, will also need to be taken into account by senior leadership and any third-party negotiators.

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Avoiding calamity
The consequences of a non-adherence to relevant GAAPs or accounting standards become apparent when one considers the situation of the company going into liquidation. Had the Asset side of the company's Statement of Financial Position been held at carrying amount, rather than recoverable value, the decision to liquidate would have given a false sense of security to ordinary shareholders who would have, in the event, overestimated the security of their nominal capital. A fire sale of their company assets at recoverable amount would, however, leave them out-of-pocket.

Holding assets at recoverable amount, following (significant) impairment in asset value of the company, therefore, has a practical relevance to deciding the way forward in a recovery plan.

Most companies avoid this uncertainty in outcome by appointing the services of a liquidator well-versed in the nitty-gritty of insolvency legislation.

The moratorium enforced following a company going into administration does, however, accord all stakeholders the time to take a considered view of the situation they find themselves in and chart the best way forward.

Ultimately, however, it will not be enough for the ailing company to merely conduct a financial restructuring. It will be necessary for them to assess the wider business implications of attempting to stay afloat. This will typically involve a rethink of their business model, corporate strategy as well as the market environment they operate in. Only such restructuring, at this higher level, will enable the company return to long-term profitability.

In any event, it is this long-term view that will convince senior owners of the company (preference shareholders) and creditors to accept a reduction in their claims, a conversion of debt or preference shareholding to common equity and/ or a refinancing of the business. Usually, it is the ordinary shareholders who come off the worse for wear in the event the recovery stalls but this is inevitably a product of the very nature of their shareholding which, by the same token, entitles them to the greatest profits were the recovery to succeed.

Caveat
IAS 36 applies to all assets except:

- Inventories (see IAS 2)
- Assets arising from construction contracts (see IAS 11)
- Deferred tax assets (see IAS 12)
- Assets arising from employee benefits (see IAS 19)
- Financial assets (see IAS 39)
- Investment property carried at fair value (see IAS 40)
- Agricultural assets carried at fair value (see IAS 41)
- Insurance contract assets (see IFRS 4)
- Non-current assets held for sale (see IFRS 5)

Therefore, IAS 36 applies only to:

- land buildings
- machinery and equipment
- investment property carried at cost
- intangible assets
- goodwill

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- investments in subsidiaries, associates, and joint ventures carried at cost
- assets carried at revalued amounts under IAS 16 and IAS 38

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