# *Are you ready for a major test of impairment?*

Considerations for this audit season


Ben Powers, Partner


June 2020


Pitcher Partners Advisors Pty Ltd
ACN 052 920 206

## What will be covered today

**Ben Powers**

**Current issues and uncertainty**

**Regulatory matters** to consider

**AASB 136 Impairment** Overview of accounting impact

**Rebecca Spencer**

**Understanding the business** in greater detail

**Cashflows** and in particular the detailed assumptions supporting the forecasts

**Historical results / trend vs forecasts / budget**

**Liesl Malcolm**

**Discount rate**

***Uncertainty regarding***

Long term impact of COVID-19

Roll back of government support measures

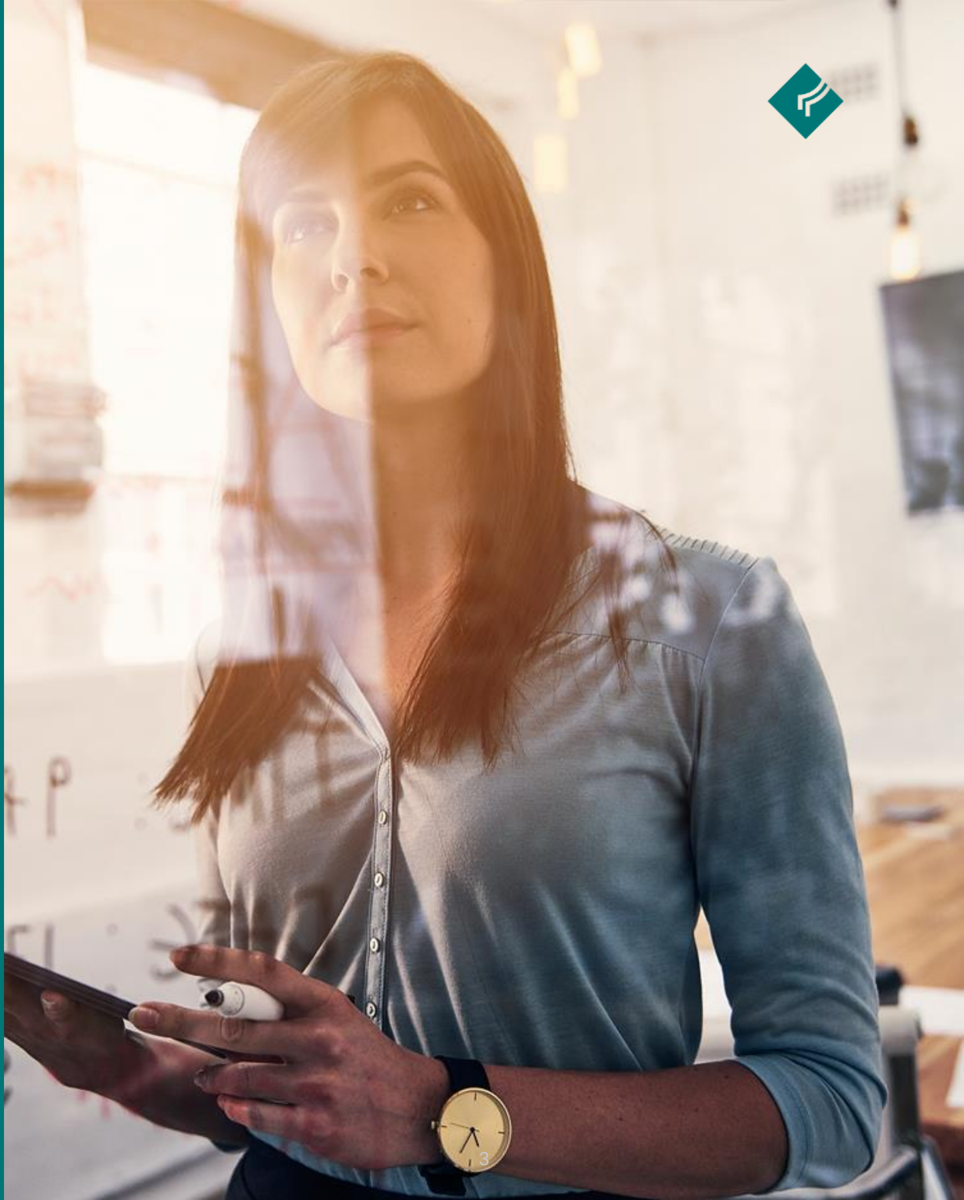
Implementation of new government measures

Overseas trading relationships

Access to markets and suppliers

Disrupted business models

***How does it impact you?***



# What does ASIC expect?

ASIC
Australian Securities & Investments Commission

## COVID-19 implications for financial reporting and audit: Frequently asked questions (FAQs)

The FAQs below are about financial reporting and audit matters relating to the impact of the COVID-19 pandemic. These FAQs may be updated in response to emerging issues and changing circumstances.

The FAQs refer to financial reporting and audit requirements of Chapter 2M of the *Corporations Act 2001* (Corporations Act) unless otherwise stated.

The FAQs relate to:

- Financial reports and directors' reports
    1. What are ASIC's focus areas for companies, directors and auditors for financial reporting given the impact of the COVID-19 pandemic?
    2. What are some of the factors to consider for assets, liabilities and going concern assessments?
    3. What disclosures should be made in the financial report?
    4. What disclosures should be made in the OFR?

***Disclosure***

Will it be sufficient?

Will it be clear?

Is it supportable?

# *Reporting matters*

**Prepare** early

**Document** assumptions as at 30 June 2020

**Consider** sensitivities and scenario analysis

**Engage** with experts and your auditors

# AASB 136 Impairment of Assets

## Key principles

**Scope**

Applies to all assets other than those in the scope of other specific accounting standards

**Assets tested at least annually**

Intangible assets with an indefinite life

Intangible assets not yet available for use

Goodwill

**Assets tested when there's an indication of impairment**

All other assets that are in the scope of AASB 136

# *AASB 136 Impairment of Assets*

## *Key principles*

**Recoverable amount**

Individual assets and CGUs: higher of its ‘fair value less costs of disposal’ and its ‘value in use’

**Level at which recoverable amount is determined**

Individual asset level if possible (except goodwill, which is always tested in the CGU)

If not possible, recoverable amount is determined for the CGU to which the asset belongs

**Allocating the impairment loss**

**For an individual asset** - reduce the asset to its recoverable amount

**For a CGU** – reduce goodwill first, then apply the impairment loss to other assets in the CGU on a pro rata basis (however, an individual asset cannot be reduced below its recoverable amount)

# *AASB 136 Impairment of Assets*

## *COVID-19 considerations*

| | |
|---|---|
| **Indicators of impairment** | Observable decline in asset values or decline in market capitalisation<br>Significant changes in market / economic conditions that adversely impact entity<br>Change in market interest rates, credit spreads, risk premiums, etc. that impact VIU discount rate |
| **Budgets and forecasts** | Must be based on reasonable and supportable assumptions. Consider disruption to supply chain, shutdowns, trade restrictions, suspension or reduction in operations, loss of customers, recovery timeframe etc. |
| **Discount rates (and other economic assumptions)** | Must reflect a current market assessment<br>Consider changes in market interest rates, credit spreads, risk premiums, etc.<br>Consider changes in inflation outlook, business growth rate, terminal growth rate (into perpetuity) |

# AASB 136 Impairment of Assets

## *COVID-19 considerations*

| | |
|---|---|
| **Risk and uncertainty** | Consider the impact of increased risk, uncertainty and volatility<br>Reflect risk and uncertainty in the estimated future cash flows or the discount rate (but not both)<br>Discount rates are expected to be higher to reflect increased risk and uncertainty |
| **Experience to date** | Businesses were experiencing impacts as early as Jan / Feb 2020. Make use of actual results (i.e., historical experience) through to 30 June 2020 |
| **Conditions that existed at reporting date** | Must reflect current market conditions that existed at the reporting date. Applies to both ‘FVLCD’ and ‘VIU’ calculations. Use guidance from AASB 110 Events after the Reporting Date |

# Are you ready for a major test of impairment?

## Considerations for this audit season

Liesl Malcolm, Client Director and Rebecca Spencer, Manager

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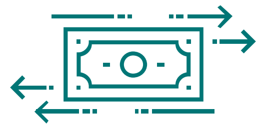
Pitcher Partners

bakertilly
NETWORK MEMBER

# *Our valuation services*



**Valuation**

### Financial reporting
Acquisitions

Impairment testing

Purchase price allocation

Share based payment remuneration

### Litigation
Matrimonial matters

Shareholder disputes

Loss of profits

### Acquisition & restructuring
M&A

Negotiations

Restructuring

### Taxation
Stamp duty

Capital gains

Transfer pricing

Consolidations

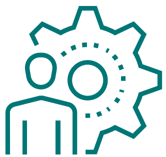
### Corporations Law
Takeovers

New share issues

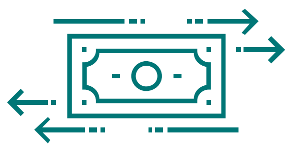
ASX listing rules

ASIC regulations

## The key focus areas for impairment testing this audit season include



**Understanding the business**
in greater detail



**Cashflows**
and in particular the detailed assumptions supporting the forecasts

**Historical results / trend vs forecasts / budget**

**Discount rate**

## *Business operations*

Ideally a **meeting with management** to discuss the key developments in the business over the past 12 months

**Discussion around how COVID has impacted the business** and how it is likely to continue to impact the business in the short and medium term, if at all

What are the **key business drivers** and discussion around the strength and weaknesses of the business

# *Cashflows*

## Cashflows are intended to represent the underlying business operations

- What **key assumptions** are driving the cashflows?
- If COVID is impacting the business, when is the business expecting to return to 'normal'?
- Is there normal? Will there be a **new normal**?
- Are there **other underlying issues** COVID is hiding?
- What **industry** is the business in? Are the results of the business in line with the industry?
- Who are the **customers**? How have our customers responded to COVID?
- What **costs have been cut**? How have they been cut? Especially important when **thinking about CAPEX and the effect of growing the business**. Will CAPEX spend need to be 'caught up' in the future?

## *In support of the cash flows*

Valuers and auditors will want to analyse:

**Historical financial summaries** for the last three to five years

**Budget vs actual results** for the last three to five years

Has **scenario analysis** been undertaken? What do the worst case scenarios look like?

Compiled AASB Standard AASB 16

# Leases

This compiled Standard applies to annual periods beginning on or after 1 January 2020. Earlier application is permitted. It incorporates relevant amendments made up to and including 19 December 2019.

Prepared on 2 March 2020 by the staff of the Australian Accounting Standards Board.

Compilation no. 2

Compilation date: 31 December 2019

## Has this standard been adopted and reflected in the cash flows?

The right of use (ROU) asset is included as net operating assets, where the liability is excluded

# Discount rate

**The forecast cash flows are required to be discounted to their present value**

AASB 136 requires that the discount rate is a pre-tax rate which reflects

The **current market assessment** of the time value of money

The **specific risks** to the asset for which the future cash flow estimates have not been adjusted

The rate reflects the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to that of the asset / CGU

# Discount rate

## *WACC of a listed entity*

The rate is estimated from the rate implicit in market transactions for similar assets or from the weighted average cost of capital (WACC) of listed entities that have a single asset (or portfolio of assets) similar in terms of service potential and risks to the asset / CGU

**The WACC reflects**

| | | |
|---|---|---|
| Current lending rates | Cost of capital | Risk premiums |
| Country and currency risk | Risk inherent in asset / CGU | Optimal level of gearing |

The WACC is not perfect, and there are a number of issues with it, but it’s the best measure we have!

# Discount rate

## *The WACC formula*

$$WACC = ke[E/V] + kd(1-t)[d/v]$$

ke = cost of equity capital
(shareholders required rate of return)

kd = cost of debt

t = tax

E = market value of the equity of the Company

D = market value of the debt

V = E+D = total market value of the company

**The WACC is a post tax rate**

While **AASB 136 specifies a pre-tax rate**, it is common valuation practice that a post tax rate is adopted to post tax cash flows, with the implied pre-tax rate determined for financial reporting purposes

Using a pre-tax rate is not common valuation practice

# Discount rate

## *Discount rate considers the risks associated with the cashflows*

SETTING

Last year we used discount rate of 11%. The rate of 11% is considered high given the significant drop in interest rates over the last 12 months.

A **declining risk free rate** may not necessarily mean a lower discount rate

**Discount rates we use** for valuations are nominal, and therefore reflect inflation expectations

**Inflation** – RBA is still indicating long term is expected to be between 2% and 3%

# Discount rate

## *Discount rate considers the risks associated with the cashflows*

SETTING

The Parent company apparently uses 8% for impairment testing, so given we are smaller and they have stronger EBITDA margins 11% seems ok.

- How much bigger is the parent?
- Are they are comparable company?
- Have you seen the financials?
- Is 8% discount rate pre or post tax? Did they use a the same growth rate in the forecasts?
- What is the growth profile of the forecasts?

## *Impact of recent volatility of capital markets*

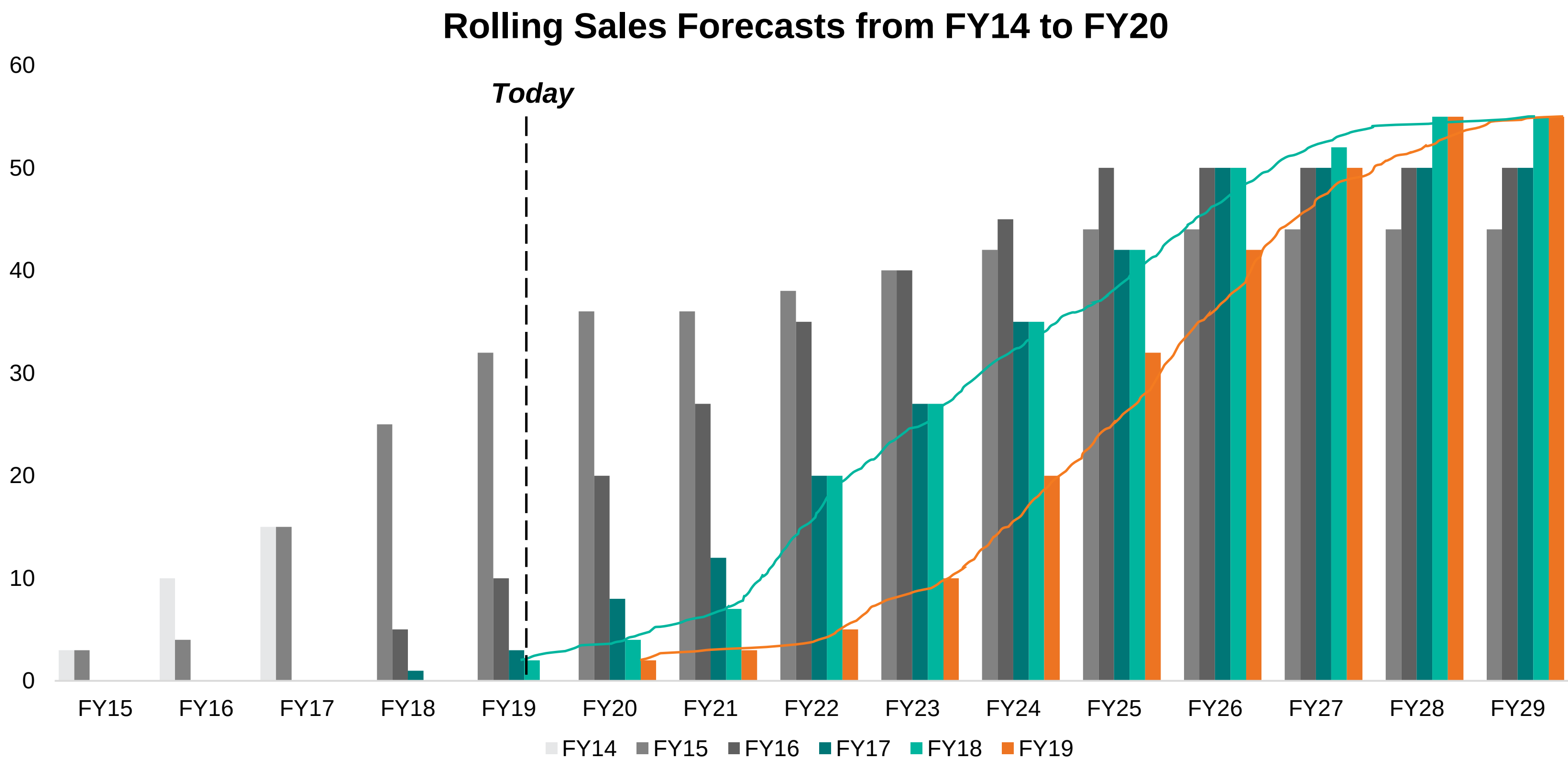
**Beta for the entity** may increase as a result of increased risk related to forecasts due to uncertainty

**Cost of equity** may increase

May be **further adjustments required specific to COVID factors** if not already incorporated in the cash flows, need to be careful that the impact is not double counted

# Discount rate

## *Discount rate considers the risks associated with the cashflows*



## Key considerations for discount rate

Does it reflect the **current market conditions**?

Is it consistent with the **assumptions adopted** in the cash flows?

Does it **double count any risks already adjusted** in the cash flows?

# Does it make sense?

## Key considerations for impairment calculations this audit season

**Cash flow forecasts** are key

Ensure the assumptions are fully supported

**Undertake sensitivity analysis** of the cash flow forecasts to see the full impact

Ensure the **discount rate** takes into consideration the market conditions as well as the specific risk factors of the asset/CGU

Ensure that **terminal value assumptions** make sense, especially the long term growth rate

**Assess net operating assets** having regard to normal levels of working capital

# *Contact us*

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# Important information

## Pitcher Partners Advisors Pty Ltd

Making business ***personal***