

Update on Market Discount Rates

As at 30 June 2015

**NOW YOU KNOW WHY ASIC  
CONTINUES TO FOCUS ON  
IMPAIRMENT TESTING  
AND HOW YOU CAN  
ASSESS YOUR DISCOUNT  
RATES RELIABLY**



Now you know

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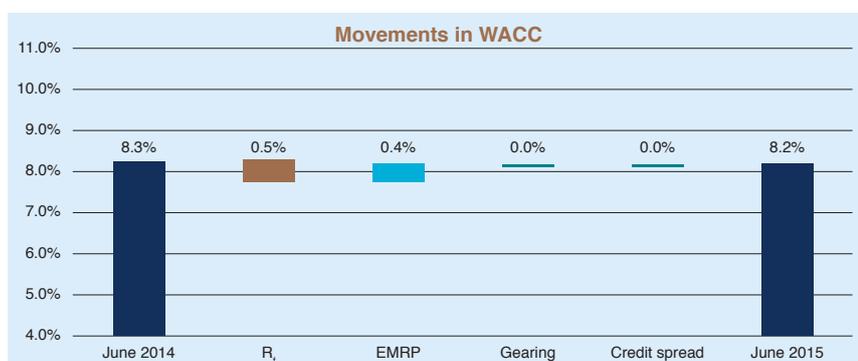


## 1. Introduction

With impairment testing and asset values once again a key focus for ASIC in relation to the 30 June 2015 reporting period, you and your board will want to ensure the process is robust including selecting discount rates that are reasonable.

The following chart presents a summary of the overall change in weighted average cost of capital (WACC) for the market as a whole.

### Market discount rates remain stable



Source: Leadenhall

This chart shows that there has been a decrease in the risk free rate, offset by a similar increase in the equity market risk premium (EMRP). All other things being equal, this will lead to similar discount rates and therefore little change to asset values over the period. With the stability of market discount rates for the past few reporting periods the focus has now moved towards other aspects of the impairment analysis including the cash flow assumptions.

Notwithstanding the regulator's understandable change of focus, we observed many businesses that based their impairment testing on unreliable and/or unsupported assessments of discount rates last year. An important issue for you and your board is therefore whether the discount rates adopted for impairment testing will be a problem for you? This update helps you understand the assumptions we make and why, as recognised experts, you can rely on Leadenhall for a justifiable outcome.

**Leadenhall Solution:** It is important to understand and be able to justify changes that are occurring in your projected cash flows and WACC as well as ensuring cross-checks to market metrics are undertaken where observable. Leadenhall can assist with this analysis.

**“Directors and auditors should continue to focus on values of assets and accounting policy choices. We continue to see instances where companies have used unrealistic assumptions in testing the value of assets”**

**ASIC – focus areas for 30 June 2015 financial reports**



## 2. Framework

We have used the same framework as our previous analysis, to allow easy comparison between periods – based on the standard WACC and capital asset pricing model formulae.

### Weighted Average Cost of Capital

#### Model

$$WACC = K_e \times (E/V) + K_d \times (D/V) (1-t)$$

#### Components

WACC	Weighted average cost of capital
$K_e$	Cost of equity
$E/V$	Proportion of equity in capital structure
$K_d$	Cost of debt
$D/V$	Proportion of debt in capital structure
$t$	Corporate tax rate

### Capital Asset Pricing Model

#### Model

$$K_e = R_f + \beta(R_m - R_f)$$

#### Components

$K_e$	Cost of equity
$R_f$	Risk free rate
$\beta$	Beta, a measure of exposure to market risk
$R_m$	Required return from investing in the market
$R_m - R_f$	Equity market risk premium



### 3. Selecting the risk free rate ( $R_f$ )

The risk free rate should be in the same currency as the asset being valued and its maturity should best match the life of the investment. In Australia, the most common proxy for the long term risk-free rate is the yield on ten-year Commonwealth Government bonds:

#### Risk free rates remain close to historical lows

June 2014	June 2015	Change
3.54%	3.01%	-0.53%

Source: Reserve Bank of Australia Statistical Table F2

The decrease in the risk free rate over the last twelve months would lead to a reduction in overall discount rates, all other things being equal. However, this is offset by an increase in the EMRP.

Risk free rates are still near historically low levels. Rather than adopting current market observed risk free rates, some valuers are adjusting observed risk free rates to reflect a long-term average rate. However, some are then not adjusting other parameters accordingly – leading to inconsistent and unreliable discount rate conclusions.

**Leadenhall Solution:** We avoid the dangers of normalising by using market observed risk free rates coupled with a contemporaneous assessment of the EMRP. This better reflects the current views implicit in capital markets and responds to changes in market pricing.

#### 4. Assessing Beta ( $\beta$ )

Beta is a measure of the relative riskiness of a business compared to the market as a whole. An appropriate beta needs to be selected for each cash generating unit (CGU), based on the relative riskiness of that business.

No industries have seen a significant change in beta

Sector	June 2014	June 2015	Change
Food Beverage & Tobacco	0.31	0.48	0.17
Commercial Services & Supplies	1.09	0.94	-0.15
Transportation	0.81	0.67	-0.14
Real Estate Investment Trusts	0.51	0.64	0.13
Food & Staples Retailing + Household & Personal Products	0.56	0.68	0.12
Automobile & Components	0.87	0.76	-0.11
Telecommunication Services	0.32	0.42	0.10

Source: SIRCA Limited – Risk Measurement Service

There have been only a handful of moderate changes over the past year and, out of 24 discrete industries reported, only 7 showed a change in beta of 0.10 or greater.

**Leadenhall Solution:** Rather than simply adopting an industry beta, we undertake a detailed analysis of the companies in a sector that have comparable risk to the business being valued. The betas for comparable companies generally need to be ‘ungeared’ to remove the impact of actual debt levels and then ‘re-gearred’ to the optimal debt level (which is not necessarily the actual debt level of the company being valued).



## 5. Cost of debt ( $K_d$ )

The cost of debt is generally related to the risk free rate, with the difference being a credit spread. The following table shows that overall lending rates have fallen very slightly over the past year.

### Lending rates remain low and stable

Indicator rates	June 2014	June 2015	Change
Small business	6.70%	6.35%	-0.35%
Large business	4.55%	4.20%	-0.35%
Corporate bonds (BBB 5 years)	4.72%	4.41%	-0.31%

*Source: Reserve Bank of Australia Statistical Tables F3 & F5. Note: Small business and large business as at 31 March 2015, being the latest available data*

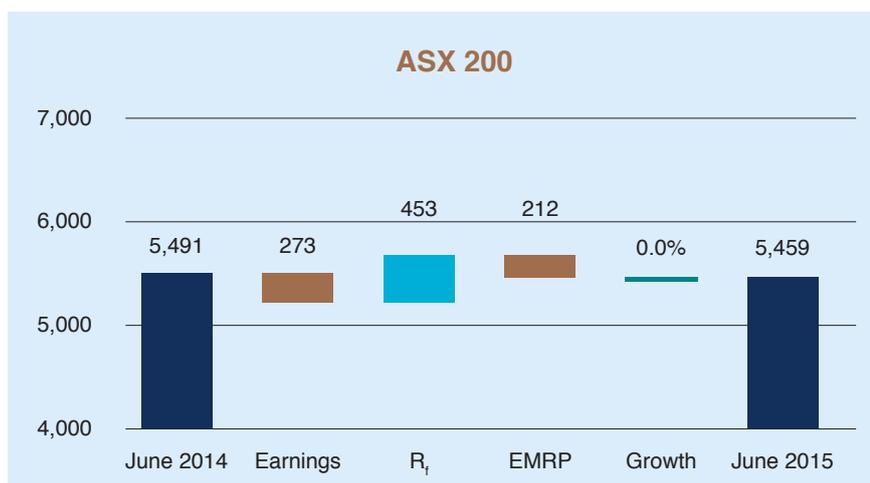
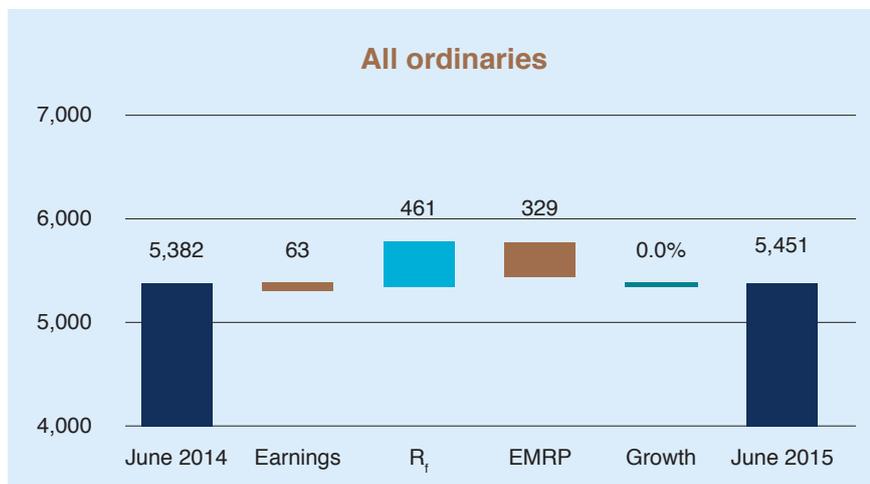
**Leadenhall Solution:** Instead of historical borrowing costs, the cost of debt should be based on the *current* borrowing cost – as if the business were to be refinanced in the current market at ‘optimal’ gearing levels.



## 6. Reduced market risk premium

Equity market movements can be broken down into changes in earnings, changes in growth expectations and changes in discount rates. We then disaggregate the change in discount rates into movements in the risk free rate and movements in the market risk premium in the following charts.

### Reduced interest rates offset by increase in EMRP



Source: Leadenhall

Both of the indices presented above show a decline in earnings, offset by multiple expansion. In this environment, ASIC's focus on cash flow forecasts used for impairment testing is unsurprising.

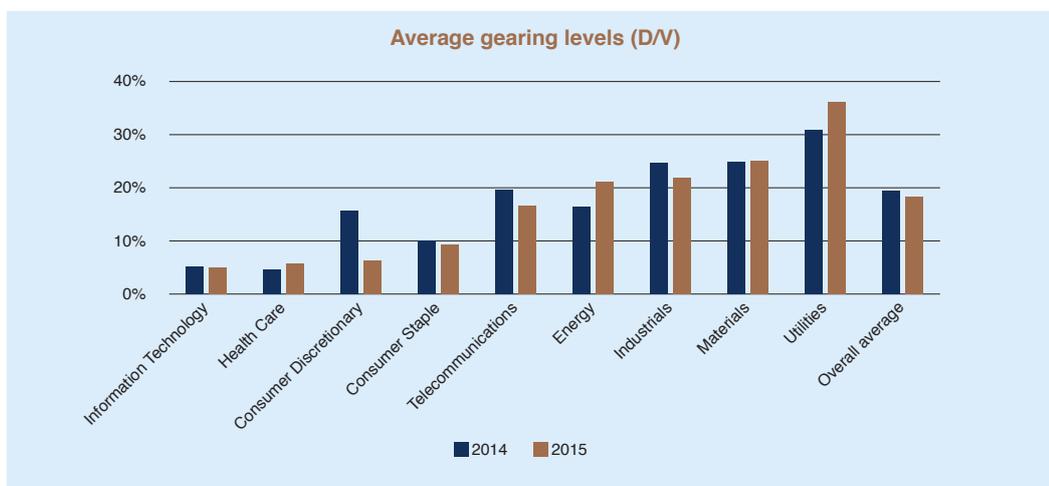
**Leadenhall Solution:** We've increased our assessment of the Equity Market Risk Premium from 6.0% at 30 June 2014 to 6.5% this financial year. This reflects a lack of movement in major market indices, despite a significant fall in risk free rates.



## 7. Capital structure

Debt levels across various industries have remained stable over the past year, thus changes in optimal gearing are unlikely to significantly impact your discount rates.

### Gearing levels also unchanged



Source: FactSet

The decline shown for consumer discretionary is primarily driven by the delisting of 21st Century Fox Inc, which had \$10.7 billion of debt represented in the 2014 figures.

**Leadenhall Solution:** As with the cost of debt, the proportion of debt used in the calculation of WACC should be based on an optimal capital structure. This is not necessarily the actual level of debt in the company. The efficient or optimal level of debt included in a discount rate should be an assessment of the level of debt that can be sustained by the specific business or CGU over the medium to long term.

## 8. Our other concerns that may attract attention

Given the stable discount rate environment it is not surprising that ASIC's attention has shifted from the discounts rates adopted to the cash flows themselves. Some of our key observations in relation to cash flows include:

- ◆ Overly complex financial models with material errors
- ◆ Optimistic forecasts with insufficient allowance for capital investment
- ◆ Failure to update forecasts to reflect changes in market conditions
- ◆ Inconsistencies between the discount rate and cash flows
- ◆ Inconsistencies between the carrying values of the CGU and the calculated value
- ◆ Relying on a single valuation methodology without considering any cross-checks
- ◆ Failing to explain movements in the value or key assumptions across periods

# NOW YOU KNOW WE CAN HELP YOU EXPLAIN THE RESULTS IN WORDS YOUR BOARD WILL UNDERSTAND

## Our difference

Leadenhall doesn't just offer thought leadership; it prides itself on *knowledge delivery*. Reports such as these contain the most recent, relevant information available, clearly presented to go beyond the maths and provide you with a deeper understanding of the critical issues.

This analysis is updated in December and June each year in line with full year and half year reporting for companies and the discount rates herein are expressed in nominal post-tax terms.<sup>1</sup>

Further information on impairment testing in general can be obtained from a joint publication published by Chartered Accountants Australia and New Zealand. Download your copy at <http://leadenhall.com.au/downloads/>

<sup>1</sup> Accounting standard AASB 136 – Impairment of Assets requires value in use to be assessed with a pre-tax discount rate (paragraph 55). However, market practice in Australia is to perform this analysis using a post-tax discount rate (and post-tax cash flows), with the implied pre-tax discount rate being disclosed in the financial statements.

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