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IMPAIRMENT TESTING –

How can you estimate your discount rates correctly?

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Simon Dalgarno is now the Executive Director of Leadenhall Corporate Advisory Pty Ltd after joining the practice in 1998. He has specialised in valuations and mid market transactions. Simon has provided structuring advice for an initial public offering, advised on the sale of businesses and has undertaken numerous evaluations to assist in capital expenditure and investment decisions for public and private sector clients.

Simon is a qualified Chartered Accountant, and also represents the Institute of Chartered Accountants on the Business Valuation Special Interest Group National Committee.

Last year, many businesses calculated their discount rates using imprecise or unverified data and some auditors overlooked the key assumptions. This is now a focus area for ASIC:

"ASIC continues to identify concerns regarding assessments of the recoverability of assets, including goodwill, and other intangibles. As a result of ASIC inquiries, a number of entities have made significant impairment write-downs and will improve their disclosures on matters such as key assumptions."

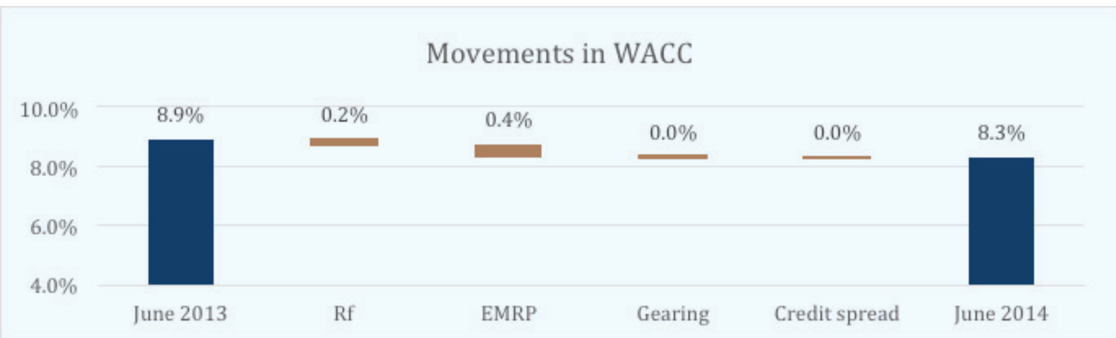
Commentary provided by ASIC following its review of 31 December 2013 financial reports.

This year, with ASIC signalling their intent, you will want to know what is required to be compliant – and why. This article provides a summary of key inputs into assessing the weighted average cost of capital (WACC) and how they have changed since June 2013.

Overview

The good news is that discount rates have generally moved downwards slightly since June 2013. The following chart shows that there has been a small decrease in the risk free rate, coupled with a slightly larger decrease in the equity market risk premium (EMRP). All other things being equal, this will lead to lower discount rates indicating increased asset values and reduced risk of impairment.

Figure 1 **Reduced risk of impairment as WACC fell over FY14**



Source: Leadenhall

The bad news is that impairment testing was done poorly last year and inappropriate discount rates are now a hot topic for ASIC. The question is: did you calculate your discount rate correctly last year? This article helps you understand the assumptions we make when assessing discount rates.

Framework

We've used the same framework to 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		Capital Asset Pricing Model	
$WACC = K_e \times (E/V) + K_d \times (D/V)(1-t)$		**$K_e = R_f + \beta(R_m - R_f)$**	
Components			
WACC	Weighted average cost of capital	K_e	Cost of equity
K_e	Cost of equity	R_f	Risk free rate
E/V	Proportion of equity in capital structure	β	Beta, a measure of exposure to market risk
K_d	Cost of debt	R_m	Required return from investing in the market
D/V	Proportion of debt in capital structure	$R_m - R_f$	Equity market risk premium
t	Corporate tax rate		

The discount rates herein are expressed in nominal post-tax terms.

Risk free rate (Rf)

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. AS a result the yield on ten-year Commonwealth Government bonds is commonly used as a proxy for the risk free rate:

Table 1 Risk free rates have remained low

Jun 2013	Jun 2014	Change
3.76%	3.54%	0.16%

Source: Reserve Bank of Australia Statistical Table F2

The decrease in the risk free rate over the last twelve months would lead to a slight reduction in discount rates, all other things being equal.

Solving the problems we see

Risk free rates are at 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 – but not adjusting other parameters – leading to 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 operation of financial markets and responds to changes in market pricing. This approach is also consistent with AASB 13 which requires the maximum use of observable inputs.

[1] *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.*

Beta (ß)

Beta is a measure of business risk and should be selected based on the riskiness of the specific investment or project being evaluated (not on the company making the investment).

Table 2 No industries have seen a significant increase in beta

Sector	Jun 2013	Jun 2014	Change
Materials	0.92	0.71	-0.21
Commercial services	1.27	1.09	-0.18
Automobile & components	1.04	0.87	-0.17
Health care	0.57	0.42	-0.15
REITs	0.66	0.51	-0.15

Source: SIRCA Limited – Risk Measurement Service

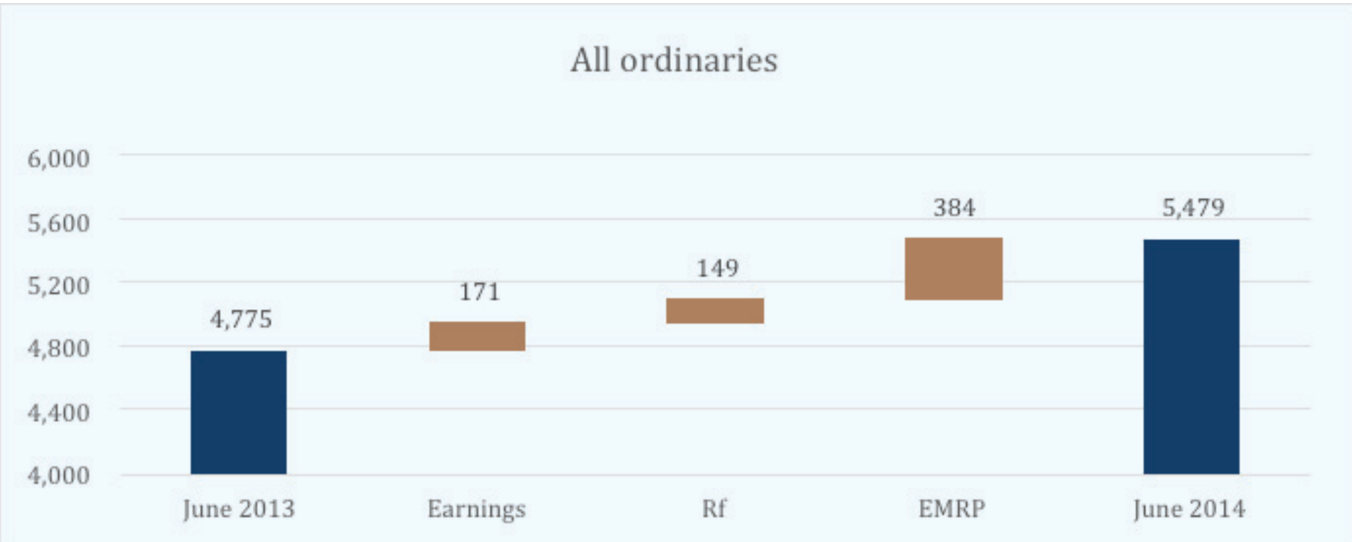
There have been only a handful of moderate changes over the past year and, out of 24 discrete industries reported, only five showed a change in beta of 0.15 or greater.

However, rather than simply adopting an industry beta, it is important to undertake a detailed analysis of the companies in a sector that have comparable risk to the business being valued. The betas for comparable companies may also need to be 'ungeared' to remove the impact of actual debt levels and subsequently 're-geared' to the efficient debt level (which is not necessarily the actual debt level).

Equity Market Risk Premium (Rm – Rf)

We've dropped our EMRP from 6.5% last year to 6.0% this year, to reflect our analysis of movements in major market indices. This is highlighted in the figure below which shows that the growth in the ASX all ordinaries index can primarily be attributed to a decrease in the EMRP.

Figure 2 Index growth primarily driven by reduction in market risk premium



Source: Leadenhall

A lower EMRP is the main contributing factor to the changes in index levels, and should be reflected in your assessed discount rates.

Cost of Debt (Kd)

Instead of historical borrowing costs, the cost of debt should be based on the current borrowing cost – as if someone was financing the business in the current market at 'efficient' gearing levels.

Table 3 Lending rates remain low and stable

Indicator rates	Jun 2013	Jun 2014	Change
Small business	7.05%	6.70%	-0.35%
Large business	4.95%	4.60%	-0.35%
Corporate bonds (BBB)	5.73%	4.72%	-0.99%

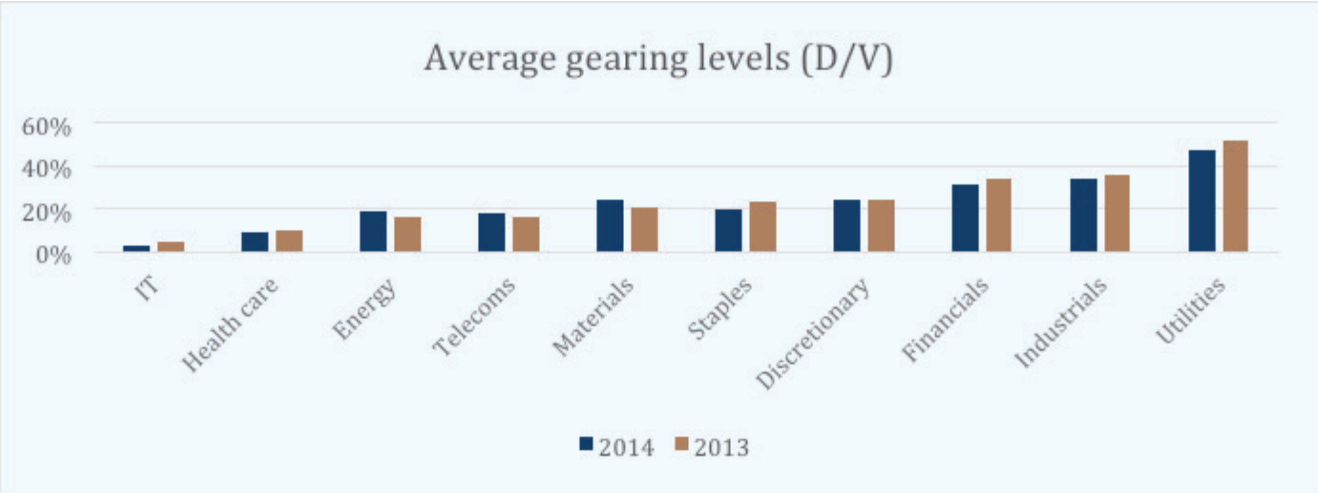
Source: Reserve Bank of Australia Statistical Tables F3 & F5

Lending rates have fallen slightly over the past year, leading to a modest rise in asset values, all other things being equal.

Capital structure

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

Figure 3 Industry gearing levels



Source: Leadenhall

'Through the cycle' debt levels vary significantly across industries but have remained stable over the past year, thus changes in optimal gearing are unlikely to significantly impact your discount rates.

Alpha (a)

Discount rates may also need to be adjusted for alpha, or specific risk. Three common situations which require an alpha factor are:

- **Size** – small companies require higher discount rates to compensate investors for additional risks
- **Different risk** – if the level of risk for a business if different to the level of risk facing comparable companies used for assessing beta an adjustment may be required
- **Biased cash flows** – if a valuation is based on optimistic cash flow forecasts an increase to the discount rate is required. It is however preferable to use unbiased cash flow forecasts with an unadjusted discount rate.

These factors are often overlooked in assessing discount rates for impairment testing.

Other concerns that may attract attention

This article has focussed on the discount rate. As well as inappropriate discount rates, some other issues we have observed related to impairment testing include:

- The use of a single discount rate for different businesses or CGUs with different risk profiles
- Overly complex financial models with material errors
- Optimistic forecasts with inadequate allowance for capital investment
- Failure to adjust calculated enterprise values for net tangible assets used in the business before drawing a conclusion on the carrying value of intangible assets (including goodwill)
- Failure to reconcile the assessed value with market observed indicators of value such as the company's market capitalisation, the price the business was acquired for, or EBIT multiples for comparable businesses.

Further information on impairment testing in general can be obtained from *'Audit committee guide to impairment: Key concepts for directors June 2014'* a joint publication between Leadenhall and Chartered Accountants Australia and New Zealand. Download your copy at **www.leadenhall.com.au/downloads.**

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