

## Guidance on valuation techniques for impairment testing

### Introduction

Accounting Standard AASB 136 – *Impairment of assets* seems to be taking centre stage in the recent reporting season. It requires the entity to assess at each reporting date whether there is any indication that an asset is impaired. If an indication exists, the entity shall estimate the recoverable amount of the asset. The standard also requires the annual testing for impairment of goodwill and other indefinite life intangible assets irrespective of whether there is any indication of impairment.

The recoverable amount is defined as the higher of an asset's or cash generating unit's (CGU):

- > Fair value less costs to sell
- > Its value in use.

It is not always necessary to determine both amounts, as if either of these amounts exceed the carrying amount, the asset is not impaired. However, this may provide an additional cross check to confirm the first value. If an asset is held for disposal, it is often the case that its value in use would not materially exceed its fair value less costs to sell and therefore its fair value less costs to sell may be used as its recoverable amount.

### Fair value less costs to sell (para 25-29)

In the absence of a binding sale agreement and if the asset is not traded in an active market, then the standard recommends using:

'the best information available to reflect the amount that an entity could obtain at the reporting date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.'

A common business valuation technique for private companies is the capitalisation of estimated Future Maintainable Earnings (FME) method. Under the FME method, the valuer applies an earnings multiple to the estimated future maintainable earnings of a business in order to derive its value.

### Value in use (para 30-57)

The standard specifies that:

'The following elements shall be reflected in the calculation of an asset's value in use:

- a) An estimate of the future cash flows the entity expects to derive from the asset
- b) Expectations about possible variations in the amount or timing of those future cash flows
- c) The time value of money, represented by the current market risk-free rate of interest
- d) The price for bearing the uncertainty inherent in the asset
- e) Other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Estimating the value in use of an asset involves the following steps:

- a) Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal
- b) Applying the appropriate discount rate to those future cash flows.'

### IFAC International Good Practice Guidance

In June 2008, the International Federation of Accountants (IFAC) released a good practice guide which addresses the use of discounted cash flow (DCF) analysis and net present value in evaluating organisation's investments. This guide is available from the IFAC store on their website free of charge <http://www.ifac.org/Store/>. This guide covers DCF analysis, and supports professional accountants in business who evaluate investments to support decision-making.

### Factsheets

As part of its series of factsheets on the Global Economic Downturn, the Institute will release three factsheets which deal with the valuation techniques:

- > Discounted cash flow analysis
- > Future maintainable earnings method
- > The choice of beta and discount rates.

Each of these factsheets considers how the elements within these valuation techniques may be impacted by the current economic environment. These factsheets are provided for general guidance purposes only to assist in a better understanding of the underlying issues. Where specific application is required it is recommended that members engage experts. Details of members who can provide guidance on business valuation topics can be found at:

<https://members.charteredaccountants.com.au/Member/Custom/FindCA/>