Backing precision

ACCOUNTING ALERT

NOVEMBER 2016

COMMON ERRORS IN ACCOUNTING FOR IMPAIRMENT – PART 2C

FMA STANDARD LICENCE CONDITIONS FOR INDEPENDENT TRUSTEES

CORPORATE GOVERNANCE DISCLOSURES REVIEWED

BDO PUBLICATIONS

Connect with us

www.bdo.nz

COMMON ERRORS IN ACCOUNTING FOR IMPAIRMENT – PART 2C: ERRORS IN DETERMINING DISCOUNT RATE

The essence of this "common errors" series is to highlight instances where, despite the accounting standards being very clear on a particular accounting treatment, preparers regularly ignore the clear requirements, resulting in financial statements being potentially materially misstated.

In previous articles we have looked at the following "common errors" relating to impairment testing:

- Not testing for impairment when NZ IAS 36 *Impairment of Assets* clearly requires it – Part 1
- Basic errors in determining value in use – cash flows - Part 2a and Part 2b

In this article we look at common errors when determining the discount rate to be used in a value in use (VIU) model.

Basic requirements

NZ IAS 36, paragraphs 55 and 56 summarise the requirements for the discount rate to be used when calculating value in use of an asset or cash-generating unit (CGU).

Some errors relating to the discount rate include:

- Using a group weighted average cost of capital (WACC) to test a single asset or CGU
- Double counting adjustments for variability in future cash flows
- Applying bias (optimism) to discount rates
- Using an unadjusted incremental borrowing rate as the discount rate
- Not adjusting WACC for security over assets that are not being evaluated for impairment, or the impact of other revenue streams of the entity
- Not using a pre-tax discount rate
- Incorrectly calculating a pre-tax discount rate

Discount rate

The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:

a. the time value of money; and

b. the risks specific to the asset for which the future cash flow estimates have not been adjusted.

NZ IAS 36, paragraph 55

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is 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 those that the entity expects to derive from the asset.

This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flow estimates have been adjusted. Otherwise, the effect of some assumptions will be double-counted.

NZ IAS 36, paragraph 56

Using a group WACC to test a single asset or CGU

The first type of common error you could make when determining the discount rate of a specific asset or CGU is using your unadjusted weighted average cost of capital (WACC) when your group has multiple assets and projects.

Although NZ IAS 36 does refer to WACC, this can only be used for a single asset company because NZ IAS 36 requires that the discount rate must reflect the risks specific to the asset.

Example

Entity A has three business lines:

- Business line X is a steady annuity business that Entity A is a market leader in this area
- Business line Y is a profitable business line three years into its estimated product lifecycle of ten years
- Business line Z is in the start-up phase and represents the use of innovative and unproven technology to enter a new market sector.

It would be inappropriate to use Entity A's WACC as the discount rate to test Business Z for impairment.

Common Error 1

Using the unadjusted WACC as the discount rate in a value in use calculation for a specific asset or CGU that does not have the same risk profile as the rest of the entity.

Double counting adjustments for variability in future cash flows

In Part 2a we discussed the two available methods used to address the risk of variations with cash flows, i.e. either:

- Adjust the cash flows to reflect the uncertainty and ranges of cash flows, or
- Use a discount rate that incorporates the risk of uncertainty.

A common error is to incorporate uncertainty into both the cash flow forecasts and adjust the discount rate for this uncertainty.

When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. Appendix A provides additional guidance on estimating the discount rate in such circumstances.

NZ IAS 36, paragraph 57

The techniques used to estimate future cash flows and interest rates will vary from one situation to another depending on the circumstances surrounding the asset in question. However, the following general principles govern any application of present value techniques in measuring assets:

a. *...for example, a discount rate of 12 per cent might be applied to contractual cash flows of a loan receivable. That rate reflects expectations about future defaults from loans with particular characteristics. That same 12 per cent rate should not be used to discount expected cash flows because those cash flows already reflect assumptions about future defaults.*

Extract of NZ IAS 36, paragraph A3(a) of Appendix A

Appendix A is an integral part of NZ IAS 36.

Common Error 2

Double counting adjustments for variability in cash flows (and not reading Appendix A of NZ IAS 36 - This appendix is an integral part of the Standard).

Applying bias (optimism) to discount rates

Appendix A expressly states that discount rates are to be free from bias.

The techniques used to estimate future cash flows and interest rates will vary from one situation to another depending on the circumstances surrounding the asset in question. However, the following general principles govern any application of present value techniques in measuring assets:

b. *Estimated cash flows and discount rates should be free from both bias and factors unrelated to the asset in question.*

Extract of NZ IAS 36, paragraph A3(b) of Appendix A

Example

Entity B has a pre-tax WACC of 10%.

It has three business units, two profitable and in well-established sectors (X&Y), and a third business sector (Z) that is only marginally profitable, in a highly competitive market and in a sector that is experiencing declining demand.

It would be wrong to apply a 10% discount rate to business line Z.

As a starting point in making such an estimate, the entity might take into account the following rates:

a. *the entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;*
b. *the entity's incremental borrowing rate; and*
c. *other market borrowing rates.*

NZ IAS 36, paragraph A17 of Appendix A

However, these rates must be adjusted:

a. *to reflect the way that the market would assess the specific risks associated with the asset's estimated cash flows; and*
b. *to exclude risks that are not relevant to the asset's estimated cash flows or for which the estimated cash flows have been adjusted. Consideration should be given to risks such as country risk, currency risk and price risk.*

NZ IAS 36, paragraph A18 of Appendix A

Common Error 3

Applying bias to discount rates by not making appropriate adjustments for specific risks associated with an asset.

Using an unadjusted incremental borrowing rate as the discount rate

In many cases, an entity's borrowing rate will be reduced, either because the lender has security over assets that are not being evaluated for impairment, or because of the impact of other revenue streams of the entity. Unless an entity is a single asset entity, it is unlikely the incremental borrowing rate reflects an asset specific discount rate.

Common Error 4

Using an unadjusted borrowing rate as the discount rate for entities that are not single asset entities.

Not adjusting WACC for security over assets that are not being evaluated for impairment, or the impact of other revenue streams of the entity

Entity C has two operating businesses - one is to operate as an investment property business, renting out commercial buildings, and the other is a retail operation in the garden centre sector.

Entity C's borrowings are fully secured against all of its properties and it therefore has a reduced cost of borrowings because of the security given to the lender.

It would be wrong to apply an unadjusted WACC to the garden centre business because of the impact on the borrowing rate of the security given on the investment properties.

Common Error 5

Using an unadjusted WACC where the input for the cost of borrowings has been inappropriately reduced by the impact of securities given against borrowings.

Not using a pre-tax discount rate

Paragraph 55 requires the discount rate used to be a pre-tax rate. Therefore, when the basis used to estimate the discount rate is post-tax, that basis is adjusted to reflect a pre-tax rate.

NZ IAS 36, paragraph A20 of Appendix A

Example

Entity D is a single asset business and has a WACC of 10%. Entity D uses 10% as the discount rate in the VIU model.

This is not in line with the requirements of NZ IAS 36 to use a pre-tax discount rate because WACC is a post-tax discount rate.

Common Error 6

Using WACC, which is a post-tax rate as the discount rate for the VIU model.

Incorrectly calculating a pre-tax discount rate

Example

Entity E is a single asset business and has a WACC of 10%.

Entity E calculates the pre-tax discount rate (assuming a corporate tax rate of 30%) to be 14.28% (10%/0.7) as the discount rate in the VIU model.

Unfortunately, calculating a pre-tax discount rate is not as simple as grossing up the post-tax discount rate. If a post-tax borrowing rate or WACC is used as a starting point for determining a pre-tax discount rate, a two-step process needs to be adopted, i.e.:

1. Determine the post-tax cash flows by modelling out the quantum and timing of tax payments to arrive at post-tax cash flows, which can then be discounted using the WACC (post-tax discount rate) to arrive at 'recoverable amount', and then
2. Use the 'recoverable amount' and pre-tax cash flows to determine the internal rate of return/pre-tax discount rate.

Common Error 7

Doing a simple gross up of the WACC/post-tax discount rate to arrive at a pre-tax discount rate.

Next month

In next month's article we look at common errors made when determining 'fair value less costs of disposal'.

For more on the above, please contact your local BDO representative.

STANDARD CONDITIONS ISSUED FOR INDEPENDENT TRUSTEE LICENCES (FOR CORPORATES)

Late in 2015 the Financial Markets Authority ("FMA") consulted on proposed variations to standard conditions for market service licences. The FMA has now completed the consultation process and issued updated information on standard licence conditions for independent trustees (licensed as a corporate).

The standard licence conditions are:

Condition 1: Skills and expertise	An independent trustee, or any authorised body covered by its licence, must inform the FMA whenever there is a change in its key people (these are the people in the independent trustee's corporate entity that have, or will have, a material impact on any action taken in the performance of the independent trustee's functions; the FMA would have been told about these people during the licence application process and this requirement means that the relevant information is kept up to date).
Condition 2: Independence	An independent trustee must: ► Ensure that only those of its directors and staff who are independent (as defined in section 131(3) of the Financial Markets Conduct Act 2013 ("FMC Act")) have a material role in the performance of the independent trustee's functions ► For each scheme for which it serves as the licensed independent trustee, confirm to the FMA at the end of the scheme's financial year that it is still independent (as defined in section 131(3) of the FMC Act) ► Notify the FMA as soon as practicable if its ceases to be independent (as defined in section 131(3) of the FMC Act) in relation to any scheme for which it serves as the licensed independent trustee.
Condition 3: Outsourcing	An independent trustee must not outsource any function that is reasonably likely to have a material impact on any action it takes in performance of its role as an independent trustee.
Condition 4: Ceasing to act	An independent trustee must notify the FMA as soon as practicable if it has to vacate the office of licensed independent trustee for any scheme for any reason, including if it resigns, becomes insolvent, is removed from office or can no longer performs its duties for any reason.
Condition 5: Professional development	An independent trustee must annually provide the FMA with a copy of its continuing professional development plan (which should include learning objectives and the plan to achieve those objectives), and a description of any training courses taken, for all individuals who will have a material impact on any action taken in performance of the independent trustee's functions.
Condition 6: Compliance	An independent trustee must, at all times, have adequate and effective systems, policies, processes and controls that are likely to ensure that it will meet its market services licensee obligations in an effective manner.
Condition 7: Governance arrangements	An independent trustee's governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time the independent trustee applied for its licence (or any subsequent change advised to the FMA). An independent trustee must notify the FMA of material changes to its governance and compliance arrangements as soon as practicable (which the FMA would ordinarily consider to be within five working days of the change taking effect).
Condition 8: Professional indemnity insurance	For each new licensed independent trustee appointment that is accepted, an independent trustee must notify the FMA of the level and scope of the professional indemnity insurance cover that it considers appropriate and must have cover at or above that level and scope.

The full standard licence conditions for independent trustees are available here.

CORPORATE GOVERNANCE DISCLOSURES REVIEWED

In the October 2015 edition of Accounting Alert, we examined the Financial Markets Authority's ("FMA's") handbook, Corporate Governance in New Zealand: Principles and Guidelines ("the Guidelines"). The Guidelines outline nine principles of good corporate governance and provide information on how to apply those nine principles.

The FMA has recently undertaken a review of corporate governance disclosures against the principles in the Guidelines. The review examined the annual reports and websites of a selection of both listed and unlisted companies. In total, 45 companies were reviewed – 26 of those companies had securities registered on an NZX exchange and the remainder were unlisted companies selected from the Financial Service Provider Register. For each company reviewed, the FMA sought answers to questions related to each of the nine principles identified in the Guidelines.

Overall, the FMA found that companies listed on the NZX provided substantially more corporate governance information than unlisted companies. On average, listed companies disclosed 67% of all the information recommended in the Guidelines, while unlisted companies only disclosed, on average, 24% of the information.

More detailed information on the questions posed in relation to each principle, and the FMA's findings for each question, is provided below.

Principle 1: Ethical standards

Principle statement: Directors should set high standards of ethical behaviour, model this behaviour, and hold management accountable for delivering these standards throughout the organisation.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a code of ethics ("COE") exists?	96	22	67
Does the company disclose that the COE covers all matters outlined in the Guidelines?	40	17	30
Is the COE published?	60	17	42
Is the COE communicated to employees?	68	18	48
Does the Company disclose a process for monitoring COE adherence?	48	11	33

Principle 2: Board composition and performance

Principle statement: To ensure an effective board, there should be a balance of independence, skills, knowledge, experience and perspectives.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a board charter exists?	73	22	52
Is there a suitable test of independence?	92	25	66
Is the chair independent?	77	11	50
Is the chair different from the chief executive officer ("CEO")?	96	59	81
Are board appointment procedures explained?	73	33	57
Are there written expectations of non-executive directors?	50	6	33
Is there disclosure of board training?	48	25	39
Is there a process for evaluating board performance?	58	11	39
Is board experience disclosed?	92	74	84
Is suitable succession planning and director tenure disclosed?	62	13	44

Principle 3: Board committees

Principle statement: The board should use committees where this will enhance its effectiveness in key areas, while still retaining board responsibility.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that there is a charter for all committees?	65	12	44
Are charter(s) and committee membership published on a website?	42	6	27
Does the company disclose that committee proceedings are reported back to Board?	85	13	57
Is there an audit committee?	100	44	77
Is the audit committee made up of only non-executive directors?	81	19	57
Does the audit committee have a majority of independents?	88	13	60
Does one of the members of the audit committee have accountancy experience?	88	19	60
Is the audit committee chair different from the board chair?	85	35	65

Principle 4: Reporting and disclosure

Principle statement: The board should demand integrity in financial reporting and in the timeliness and balance of corporate disclosures.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Is there a process for ensuring the quality of financial statements?	85	24	60
Are there internal controls for reliable financial statement reporting?	92	18	63
Is the directors' responsibility for preparing financial statements explained?	88	42	69
Are governance documents available on a website?	73	28	55
Are procedures for continuous disclosure regime disclosed (listed only)?	72	N/A	72
Are financial statements certified by CEO and chief financial officer?	56	18	40

Principle 5: Remuneration

Principle statement: The remuneration of directors and executives should be transparent, fair and reasonable.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a remuneration policy exists?	58	47	41
Is a remuneration policy published?	31	6	21
Is distinction made between executive and non-executive remuneration?	64	6	41
Is executive director remuneration linked to company and individual performance?	42	13	31
Does a remuneration committee exist?	65	29	51

Principle 6: Risk management

Principle statement: Directors should have a sound understanding of the key risks faced by the business. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a risk management policy exists?	69	42	58
Does the board regularly review risk reports?	77	28	57
Does the board report annually on its risk management strategy?	46	22	36

Principle 6: Risk management

Principle statement: Directors should have a sound understanding of the key risks faced by the business. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a risk management policy exists?	69	42	58
Does the board regularly review risk reports?	77	28	57
Does the board report annually on its risk management strategy?	46	22	36

Principle 7: Auditors

Principle statement: The board should ensure the quality and independence of the external audit process.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Is auditor independence confirmed?	85	61	75
Is a suitable level of interaction between the audit committee and auditor disclosed?	81	28	59
Is a maximum term of auditors disclosed?	52	13	38
Are auditor quality controls explained?	54	22	41
Is there a report of fees paid to the auditor?	96	53	79
Is there an explanation of non-audit work undertaken?	71	40	59

Principle 8: Shareholder relations

Principle statement: The board should foster constructive relationships with shareholders that encourage them to engage with the entity.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a shareholder relations policy exists?	31	17	26
Does the company publish a shareholder relations policy?	27	8	21
Does a website contain information on business description, goals, performance, etc?	81	61	73
Does a website contain information released to the stock exchange (listed only)?	72	N/A	72
Are steps for participation at meetings disclosed?	50	9	38

Principle 9: Stakeholder interests

Principle statement: The board should respect the interests of stakeholders, taking into account the entity's ownership type and its fundamental purpose.

Questions posed in relation to the principle	% listed that disclosed	% unlisted that disclosed	% of all reviewed companies that disclosed
Does the company disclose that a stakeholder policy exists?	31	11	22
Does the board assess adherence to a stakeholder policy?	24	6	16

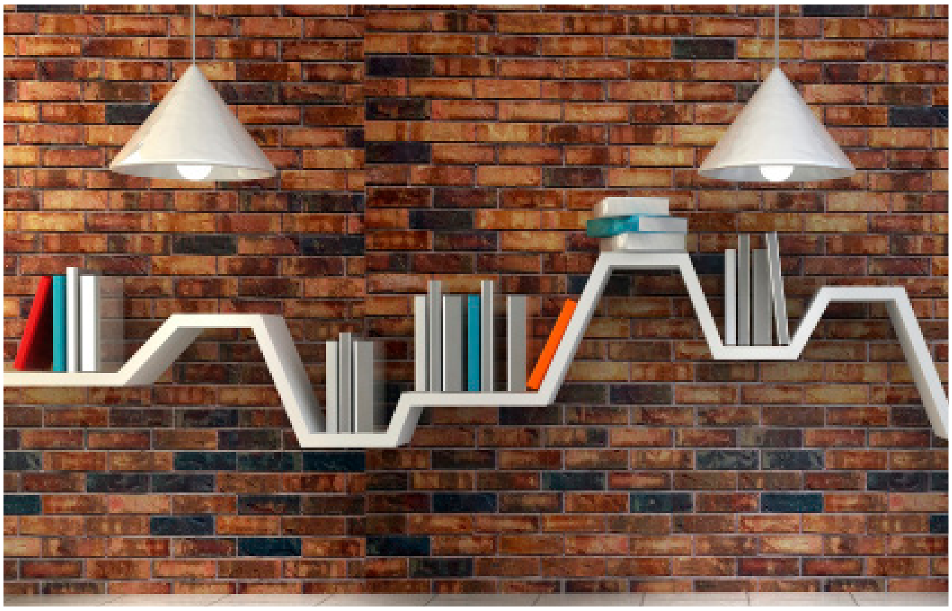
Of the nine principles outlined in the Guidelines, stakeholder interests had the lowest reporting (19%), followed by reporting on remuneration (37%).

As a result of its review, the FMA is encouraging:

- Unlisted companies to improve their corporate governance reporting
- All companies to improve their corporate governance in relation to stakeholder interests and reporting on remuneration.

The full review is available here.

For more on the above, please contact your local BDO representative.



BDO PUBLICATIONS

The **Audit** section of our website (**https://www.bdo.nz/en-nz/services/audit-assurance**) includes a range of publications on accounting standards issues. For example:

- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for-profit entities currently in effect in New Zealand.

The **Global** site includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 16 *Leases* (July 2016), IFRS 9 (2014) *Financial Instruments – Classification and Measurement* (April 2015), IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), and *Hedge Accounting* (IFRS 9 *Financial Instruments*) (Jan 2014).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 15 *Revenue from Contracts with Customers - Transition* (July 2016), IFRS 15 *Revenue from Contracts with Customers* (July 2016), IFRS 11 Joint Arrangements (Feb 2016), IFRS 9 *Financial Instruments* (Oct 2015), IAS 7 *Statement of Cash Flows, Distinguishing between a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include *The implementation of IFRS 9 requirements by banks*, IASB ED 2015-08 IFRS *Practice Statement: Application of Materiality to Financial Statements*, IASB ED 2015-11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts – Proposed amendments to IFRS 4*, IASB ED 2015-3 *Conceptual Framework for Financial Reporting*, ED *Proposed amendments to IAS 19* and IFRIC 14, IASB 2015-6 *Clarifications to IFRS 15*, IASB ED 2015-1 *Classification of Liabilities* and Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses.

For more on the above, please contact your local BDO representative.

KEY CONTACTS

NORTHLAND
Angela Edwards
T: +64 9 407 7250
Adelle Allbon
T: +64 9 430 0471

AUCKLAND
David O'Connor
Andrew Sloman
Chris Neves
Graeme Lynch
Wayne Monteith
Blair Stanley
Richard Croucher
T: +64 9 379 2950

WAIKATO
Bernard Lamusse
T: +64 7 839 2106

TAURANGA
Fraser Lellman
T: +64 7 571-6280

ROTORUA
Stephen Graham
T: +64 7 347 9087

GISBORNE
Chris Torrie
Daryl Keast
T: +64 6 869 1400

TARANAKI
Steve Waite
T: +64 6 759 9034

CENTRAL NORTH ISLAND
Glenn Fan-Robertson
T: +64 6 835 3364
Matt Coulter
T: +64 6 872 9817

WELLINGTON
Henry McClintock
Mark Bewley
Geoff Potter
T: +64 4 472 5850

CHRISTCHURCH
Michael Rondel
Warren Johnstone
T: +64 3 379 5155

INVERCARGILL
Greg Thomas
T: +64 3 218 2959