



creating, capturing
and communicating value

Evaluating the Balance Sheet for the effect of the global financial crisis
It is time to **Calculate, Communicate and Comply**

*How has the deterioration in global financial markets affected the balance sheet?
Will it now require an impairment adjustment to comply with accounting standards?*

While companies have a continuous obligation to assess "fair values" of assets and impair where necessary, traditionally, assessments are carried out every six months in line with the ASX reporting timetable. Will receivables remain fully collectable? Will trademarks and brand-names values be sustainable? Will the outlook for cash flows from purchased assets or acquisitions be sufficient to justify carrying forward goodwill at its current level?

CFOs will need to be able to answer these questions over the coming months, leading up to the ASX reporting season which will take place in February 2009. Impairment tests of all assets, particularly intangibles and goodwill, will really come to the fore in the final quarter of this calendar year because the global financial crisis is having a substantive impact on business values, and therefore on the carrying values of these assets on the balance sheet.

It can be reasonably assumed that there was much debate both internally and with your Auditors last June about the potential for impairment. In many cases this debate may have led Board's and Auditors putting many balance sheet values "on watch" for 31 December 2008 reporting, pending achievements of short term forecasts and an improvement in market conditions.

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Even if not formally “on watch” from June, it is highly likely that many Auditors and Audit Committees will place far greater scrutiny on the drivers of asset values. The assumptions that may have avoided impairment in June will now require careful review with a healthy degree of realism and scepticism. Put simply, the essence of the debate now becomes to “Prove why there should not be impairment.” So, there is a heightened task for the CFO at the end of this quarter is to review the current balance sheet values and carry out the process of “Calculate, Communicate and Comply” for this next reporting cycle.

There is a need to revisit the fundamental drivers of value.

Calculate: Value is a function of future cash flows (not the past) and the cost of capital. You need to think about the long term prospects of the business rather than just the short term concerns at the moment. What is the long term landscape, and therefore what are the assumptions that will define your fundamental value? How does this translate into profits and cash flow and therefore value? What is your cost of capital now?

Communicate: The value story needs to be simple and easy to communicate to the CEO, to the Audit Committee, to the Board and to the Auditors in addition to analysts and shareholders. However it is essential that it be based upon the calculated value derived from robust valuation principles and realistic assumptions;

Comply: Accounting standards require continuous assessment of whether impairment is required – traditionally compliance crystallises with half year and end of year reporting. If calculations of fair values are below previous expectations and below carrying values then the company needs to comply.

Let’s backtrack for a moment – why has the financial crisis heightened concern? – essentially because the crisis affects most of the inputs and assumptions behind the assessment of fair value.

Recall that there was uncertainty at 30 June 2008 due to the impact of the tightness of credit which was just beginning to be seen as longer term than first thought. There were several other signals of a changing economic outlook:

- » The All Ordinaries index had just fallen by 14.7% over the quarter to June 2008 – an almost unprecedented fall in recent history – however, it had risen 4% for the full YTD which may have mitigated concerns a little;
- » Debt premiums were high (the BBB spread over Commonwealth bonds was 267bp) and debt markets were drying up;
- » Banks exposed to subprime lending appeared under threat;
- » The exchange rate was rising (it was 0.96¢ US at the end of June 2008);
- » There was uncertainty around inflation and interest rate movements.

It was not clear whether a return to positive territory was just over the horizon or whether there would continue to be a downward trend in economic conditions.

Fast-track to the present day and it is now evident that these value drivers have deteriorated since June and will affect term values:

- » The US exchange rate has fallen from 0.96¢ at the end of June to 0.80¢ at the end of September and to 0.66¢ in mid-October, leading to increased input costs for overseas materials, increased competitive pricing for import competing products;
- » The All Ordinaries Index has fallen 12% to mid-October since 30 June 2008 reflecting the nervousness about capital availability and the cost of capital as well as the increasing likelihood of reduced sales from declining demand;
- » BBB spreads had risen even further to 365bp;
- » There have been unprecedented actions around the globe to support the financial systems reflecting concern for future nation-wide cash flows.

As CFO, there are many questions you are no doubt asking yourself as a result of these changes and these will require discussion and answers for December reporting. Some are:

- » What is the long term outlook for your business? No doubt the outlook is pessimistic in the short to medium term given concerns about a potential recession;
- » For listed companies, how do you explain the possible widening gap between share price based value and your fundamental value and between the book value of your assets and both of the above?
- » How do you comply with accounting standards if the value of your assets that gave rise to the value of intangibles and goodwill appear to be at fire-sale levels? These values may well be below the acquisition value acquired;
- » Can you raise capital? Will long term gearing ratio targets need to be adjusted?
- » What is the relevant weighted average cost of capital?

With the expected stronger emphasis on “defend” or “impair”, now is a good time to prepare for this and avoid key decisions being made on the run. How do you prepare if you haven’t done so already?

We would encourage you to undertake a valuation of your business (build or refine the financial models of the CGUs), prepare the assumptions and therefore the story around the valuations, prepare the CEO, the audit committee and the Board. You will then be ready to talk with your Auditor. We encourage you to “Calculate, Communicate and Comply.”

The determinants of the value equation have deteriorated further.

It is time to reassess your business valuation models.

Value Adviser Associates is a specialist valuation business that can assist in the ‘Calculating, Communicating and Complying’ process.

This should not be viewed as a “compliance cost” but rather as an investment. Why? - because the valuations and associated models have many other valuable uses. At a minimum they are a great basis for ongoing communication between the CFO and CEO and between the executive management and the Board – then subsequently with analysts and shareholders. At the other end of the scale they can become an essential tool in strategy development and analysis.

Value Adviser Associates specialises in helping businesses create, capture and communicate value. We would like to help.

But how? We can help by:

- » building financial models and populating them;
- » providing guidance to your team in valuing the CGUs;
- » reviewing your valuations as the independent adjudicator and assisting you to be ‘answer ready’;
- » authenticating / providing credibility of the valuations as an independent party, including discussions of valuation and impairment with your Auditor;
- » preparing easy to understand communications – we are accustomed to putting valuation constructs into simple language; and / or
- » being a sounding board – giving you confidence or guidance as needed.

The team at Value Adviser Associates has been on all sides of this challenge – as Auditor, as CFO and as independent valuer. Andrew Beeson, recently the CFO of an ASX listed company, heads the Impairment testing team.

Andrew’s email address is a.beeson@vaassociates.com.au or telephone him on 0418 995 160.

Don’t hesitate to call Andrew, Dr Steve Bishop or Michael Churchill if you would like to talk through your potential impairment challenges. Value Adviser Associates specialises in business valuations. Our credentials can be viewed on our website www.vaassociates.com.au and our contact numbers are listed below.



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