Getting audit ready checklist

Impairment testing is a continuing area of focus of regulators, Audit Committees and other external parties. It is an area which involves a significant amount of judgement and many sources of information which need to be documented and explained. Below are a few of the current areas of focus which management will need to consider in Getting Audit Ready:

What needs to be done?	Practical tips
Check impairment testing is done at the lowest possible cash generating unit (CGU)	CGUs are the smallest group of assets that independently generate **cash** flow and whose **cash** flows are largely independent of the **cash** flows generated by other assets. With the greater focus by businesses on cash flow and changes to operations, make sure current cash flow monitoring aligns to the CGUs identified. In particular, make sure you are not using CGUs at too high a level, e.g. don't default to segments. A full analysis should be performed of the cash flows.
Incorporate reasonable cash flow models	This will likely be the most challenging aspect. It is recommended that a probability weighted scenario approach is used to forecast cash flows. Under this approach, at least 3 or 4 broad market recovery scenarios possible are identified. For example, (i) full market recovery within 6 months (ii) slow recovery or (iii) market does not recover. Each scenario is assigned a probability weighting and combined into the forecast cash flows. This is an efficient way of being able to prepare the impairment assessment and update it closer to signing – the cash flow forecasts do not need to change, just the probability assigned. So management doesn't need to wait until forecasts are more definite to start the impairment assessment. For those using a fair value model, remember the forecasts should be what a market participant would forecast, not what management thinks will happen. The cash flow forecasts need to give greater weight to external evidence, be adjusted for any historical inaccuracy and be supportable. Check the consistency of assumptions across various financial models such as short term cash flow model, going concern model, asset valuation model and DTA/Tax losses model.

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<table>
<tr><th>What needs to be done?</th><th>Practical tips</th></tr>
<tr><td>Capture the basis of preparation</td><td>Given the rapidly changing environment, it will be crucial that the basis of the impairment assessment is documented by management during year-end. This helps protect the company against regulators or external parties (e.g. class actions) using the benefit of hindsight in future periods, especially if actuals vary from the forecasts.

It is recommended that management prepare a paper addressing each key element of the estimate (e.g. revenue, margin, operating expenses, working capital, probabilities assigned to scenarios). Using a table format, for each key element, management should document:
1. How the element has been estimated
2. Why this basis was used
3. The historical actuals for this element and how it compares to the estimate
4. The external or internal information available around this element and how it compares to the estimate
5. Who has reviewed and challenged the estimate within the organisation (showing due process)

If there is data in the assessment (i.e. factual, non-judgemental aspects), management should document where the data is sourced from and why it is accurate.

Management should proactively look for information that may be inconsistent with their assumptions – the assessment is complex and it is likely that management will need to weigh up conflicting information. Capture this process in the accounting paper.</td></tr>
<tr><td>Update discount rate assumptions</td><td>While the risk free rate has declined in Australia, this will most likely be offset by increases in the equity risk premium and cost of debt.</td></tr>
<tr><td>Incorporate grants into assessment</td><td>Jobseeker and other government relief is a new aspect in the impairment assessment so be sure to considering the appropriate treatment of these in the impairment test. Identify early any other new cash flows.</td></tr>
<tr><td>Cross-check the estimate with other valuations</td><td>This is an existing requirement of the accounting standards but of greater importance this year because of greater judgement involved in cash flows. Cross checks are necessary to evaluate the output of the discounted cash flow model. Recommended cross checks by management include:
1. Assess reasonableness of CGU multiples to comparable listed company multiples
2. Assess reasonableness of CGU multiples to guideline precedent transaction multiples
3. Reconcile CGU values to market capitalisation (listed companies only)
4. Research and review of broker reports.

The reliability and comparability of the cross checks should be evaluated.</td></tr>
<tr><td>Consider completeness of assessment</td><td>Ensure that all non-current assets within the scope of AASB 136 have been considered for indicators of impairment and tested where there is an indicator. Reconcile the assets included in the identified CGUs to the balance sheet for completeness ensuring all assets have been considered.
It is highly likely there will be impairment indicators.</td></tr>
<tr><td>Stand back from the detail</td><td>Management focus should not be on justifying judgemental positions. In the absence of clear evidence supporting assumptions, management should reconsider judgemental positions.</td></tr>
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What needs to be done?	Practical tips
Draft disclosure early	Extensive disclosure should be made of the underlying assumptions; scenarios, probability assigned etc This will allow comparability in the marketplace.
Follow on implications	Additional implications to consider as a result on the recognition of an impairment charge. These follow on implications can include: 1. **Thin capitalisation** – If the company has debt, it may be subject to the tax thin capitalisation rules for income tax purposes. These rules are applied based on the balance sheet of a company, therefore when an impairment arises it will likely have a flow on impact to the thin capitalisation position and may cause a denial of interest deductions. 2. **Dividend traps** – If an impairment is expected, it is important for management to consider and plan for any potential impact to the dividend strategy of the company. Often dividend traps can arise if the company no longer has positive retained earnings (due to impairment) and therefore cannot pay out the desired dividends to shareholders. 3. **Breaches of covenants** – which may cause potential reclassification of debt to current and going concern implications. 4. Forecasts used should be consistent with those used to assess recoverability of any deferred tax assets. 5. Deferred tax accounting for differences between the tax and accounting bases resulting from the recognition of impairments. It's important to remember that impairment testing is also required in the entity accounts. Companies with investments in subsidiaries will need to perform an assessment of the indicators of impairment. This includes consideration of the net assets of the subsidiary. Impairments in the consolidated accounts will likely indicate a need to test the investment for impairment

The following are typical questions which management should consider when pulling together their impairment assessment. This list is not an exhaustive list but some further key considerations over and above the current reporting period focus areas:

Typical questions asked	What management should do
How have you assessed your CGU or Asset against the indicators of impairment?	Management should prepare and document supporting memos which includes: • The assessment of external indicators of impairment. • For listed companies, management should calculate the surplus/deficiency between the company's market capitalisation and net assets. Where a deficiency exists, management should document their consideration of whether this indicates that an impairment may exist. • The assessment of internal indicators of impairment, disclosing the budgeted results vs actual results by CGU.
What should you include in your impairment position paper/Memo?	Once you have determined that and Indicators exists, management should prepare a memo which includes: • The basis for key cash flow projection assumptions, with external evidence where available • Explanation of any differences between cash flow projections in the impairment model and the most recent financial budgets/forecasts approved by management (e.g. estimated cash inflows/outflows expected to arise from future restructings). Where there are no differences, the memo should state this fact. • Causes of differences between past cash flow projections and actual cash flows over the last 3 years at a minimum, and how accuracy of historical forecasting has been considered in the current cash flow projections Management should explain how historic accuracy of forecasting has been factored into current forecasts. • Justification for the terminal growth rate and discount rate used • Consideration of new competitors entering the market and economic conditions on cash flow forecasts • Basis for allocating future overheads necessary for the use of the asset/CGU (e.g. corporate costs)

Typical questions asked	What management should do
How many years worth of cash flows have you incorporated into your model?	Where relevant, management's memo should also include: • Explanation of how cash flow projections have been extrapolated beyond the period covered by the the most recent financial budgets/forecasts (e.g. how cash flows have been extrapolated for years 2-5 if most recent financial budgets/forecasts only cover the next 12 months). This explanation should include justification if an increasing growth rate has been used in such extrapolation. • Justification for the forecast period if greater than five years (which is not recommended best practise), including: - how management is confident that cash flows can be reliably forecast for a period greater than five years, and - management's ability to accurately forecast over that longer period based on past experience • The basis for estimating net cash flows to be received or paid for the disposal of the asset at the end of its useful life
How does your carrying value of the assets in your CGU reconcile to your financial statements	Management should prepare a schedule listing all asset and liability GL accounts and next to each account note whether the account is included or excluded from the net operating assets of the CGU for impairment testing purposes. Management to provide details on how the new accounting standards such as AASB 16 have impacted on the forecast cashflows in the model and related carrying value of assets in the CGU. Explanations should be provided where necessary, particularly where judgement is required.
How have you allocated corporate costs in your model?	Management should prepare a reconciliation showing total corporate costs (which agrees to segments disclosures if applicable), corporate costs allocated to CGUs, and unallocated corporate costs. Provide a detailed explanation for any unallocated corporate costs.
How has your headroom in your impairment model changed year on year?	Management should prepare a reconciliation between headroom per prior year impairment model to headroom per current year impairment model. Explanations should be provided for any significant changes in headroom (both increases and decreases).
Have you considered an alternative recoverable amount?	Management should include commentary in their memo regarding the calculation of recoverable amount under both models and why their model equates to the higher of VIU or FVLCTS
What sensitivity analysis have you performed over your impairment model? What is the basis for these sensitivities?	Management is required to perform sensitivity calculations to determine whether a reasonably possible change in key assumptions (this should not be limited to growth and discount rate) would result in an impairment, regardless of the level of headroom or "conservatism" of the key assumptions within the impairment models. The sensitivity calculations should include explanations of the key assumptions which have been sensitised and the outcome of the sensitivity (i.e. whether headroom remains or an impairment exists). Management should include considerations for weighted scenario analysis under the current market conditions, including documentation on how the scenarios were derived and the potential impact on disclosures.

Typical questions asked	What clients should do

What are the key areas of judgements involved in the cash flow analysis? What are the basis of these judgements and what benchmarking has been done?	Management should prepare a paper for their Audit Committee and/or Board outlining:
	• The basis for key assumptions in the impairment model such as
	  - revenue and EBITDA estimates
	  - operating and capital expenditure
	  - working capital changes
	  - allocation of corporate costs and elimination of costs
	  - free cash flow (see below)
	  - other significant assumptions used.
	• Whether key assumptions reflect past experience or are consistent with internal or external sources of information
	• Differences between key assumptions in the impairment model and past experience/external sources of information e.g. why revenue growth of 5% has been forecast if historical growth has been only 3%

How have you considered the use of hindsight in your impairment model?	Impairment models are often prepared prior to year-end e.g. an impairment model for a 30 June 2020 year-end client may be prepared in May 2020. In this case, the FY20 results used as the baseline for the future cash flows in the impairment model will be based on latest budgets or forecasts. Management will need to reconsider if the model performed prior to 30 June accurately reflects the results to 30 June.

Documentation to be retained	What management should retain
What documentation should be retained?	• All documents provided to the Board and sub-committees (e.g. the Audit Committee) should be retained in a separate folder on a shared server (use shortcuts where relevant). • All documents provided to the audit team should be retained in a separate folder on a shared server (use shortcuts where relevant). Any Board or Audit Committee reports discussing the results of audit work performed over impairment testing as well as the external audit report should also be retained within this folder. • Retain a copy of the final impairment testing model, explanatory memo (including the considerations discussed above) and any other supporting documents on a shared server. • Retain a copy of the final discount rate calculation and all relevant supporting documentation (e.g. source documents for inputs to the discount rate calculation). • If external experts or consultants have been used in impairment testing (e.g. to calculate discount rates used in impairment models), retain copies of all communication (including attachments) in a separate folder on a share server. • Management should retain a copy of the sensitivity calculations on a shared server.