



Snapshot

by Capital Markets & Accounting Advisory Services (CMAAS)

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Impact of the current interest rate hike on WACC used for MFRS 136 impairment assessment

Discount rate used to derive VIU of non-financial assets



MFRS 136 "Impairment of Assets" requires annual impairment tests for certain assets and for any non-financial asset where there is an indicator of impairment. A non-financial asset is impaired if its carrying amount exceeds its recoverable amount, which is the higher of value in use ("VIU") and fair value less costs of disposal.

Estimating the VIU 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; and
- (b) Applying the appropriate discount rate to those future cash flows.

In a situation where an asset-specific discount rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. As a starting point in making such an estimate, the entity might take into account the entity's weighted average cost of capital ("WACC"), using techniques such as the Capital Asset Pricing Model. However, the rate should 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.

WACC, the discount rates used to discount cash flows should not reflect risks for which the estimated cash flows have been adjusted (e.g. expectations about possible variations in the timing and amount of those cash flows). Otherwise, the effect of some assumptions will be double-counted.

In addition, consistency between discount rates and cash flow forecasts is fundamental to the MFRS 136 impairment calculation. Therefore, they should either both be estimated on nominal terms, or both estimated on real terms. If the VIU calculation is done in nominal terms, it is important that the market expectations of inflation as at the reporting date are fully taken into account within both the cash flow forecast and the discount rate. WACCs are usually nominal (i.e. they include the impact of inflation).



What is the issue?

The WACC of many entities are publicly available, although it is worth noting that they are reliant on certain judgemental assumptions - in particular, the equity risk market premium. The WACC of an entity will be reliant on some publicly available inputs, such as the risk-free rate.

A WACC relies on the market's current expectation of future long-term assumptions, for example the long-term rate of inflation and risk-free rates. These long-term assumptions in WACCs are affected by many different economic factors and both the impact and the extent will differ between countries and even industries.



What is the issue? (continued)

In the current climate of global economic uncertainty, with many countries experiencing rising inflation and interest rates, this raises the question whether these increases represent a change in the market's current expectations of future long-term assumptions, or whether they represent an anomaly resulting from short term volatility in the markets.

Paragraph 16 of MFRS 136 states that "short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life". It is therefore necessary to understand whether an observable rise in short-term interest rates is limited to the short-term, or whether there is a simultaneous change in the market's current expectation of long-term interest rates (cost of debt) and also the risk-free rate.



What is driving the increase in inputs to observable WACCs?

We have observed a notable increase in the market's current expectation of long-term risk-free rates in a number of countries, including Malaysia. While the risk-free rate is by no means the only variable that has changed or is changing, it is arguably the variable in the WACC calculation showing the largest relative change over the last year in many instances. Below is an extract of the yield on 20-year government bonds of some countries (which the bond yield often assumed to represent the long-term risk-free rate):

Country	Yield on 20-year government bonds		
	28 Dec 2020	27 Dec 2021	26 Dec 2022
Malaysia	3.42%	4.13%	4.41%
Singapore	1.20%	2.03%	2.69%
Australia	1.60%	2.24%	4.36%
United states	1.45%	1.95%	4.11%
United kingdom	0.71%	1.20%	4.03%

Source: www.worldgovernmentbonds.com

The above figures indicate that, for these countries, there has been a change in the market's current expectation of long-term risk-free rates. This increase in long-term risk-free rates will increase WACCs, although this increase is not necessarily on a one-for-one basis (i.e. a 1% increase in the risk-free rate will not necessarily result in a 1% increase in the WACC).

There are other components of a WACC which might have been impacted by the current economic climate, such as the target level of gearing and equity risk premium. It is therefore important to consider all components of the WACC.



What is the impact?

Given the market movements outlined in the table above, whether preparing or reviewing MFRS 136 impairment test for December 2022 year ends, careful consideration of the inputs into WACC-reliant discount rates will be of particular importance. Current economic trends should not be readily dismissed from WACC calculations on the basis of being short term.

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