

■ Deciding on fair value

Fair value and write-downs of intangible assets, including goodwill, are expected to be very closely scrutinised this reporting season. And, it's the responsibility of directors to ensure that balance sheet values are supportable and defensible.

The Australian Securities and Investments Commission (ASIC) has indicated it will be contacting companies it believes should have incurred asset write-downs to "better understand their impairment of assets processes". It also expects directors to maintain a strong focus on impairment of intangibles and other assets when finalising the half year or full year results at 31 December 2008.

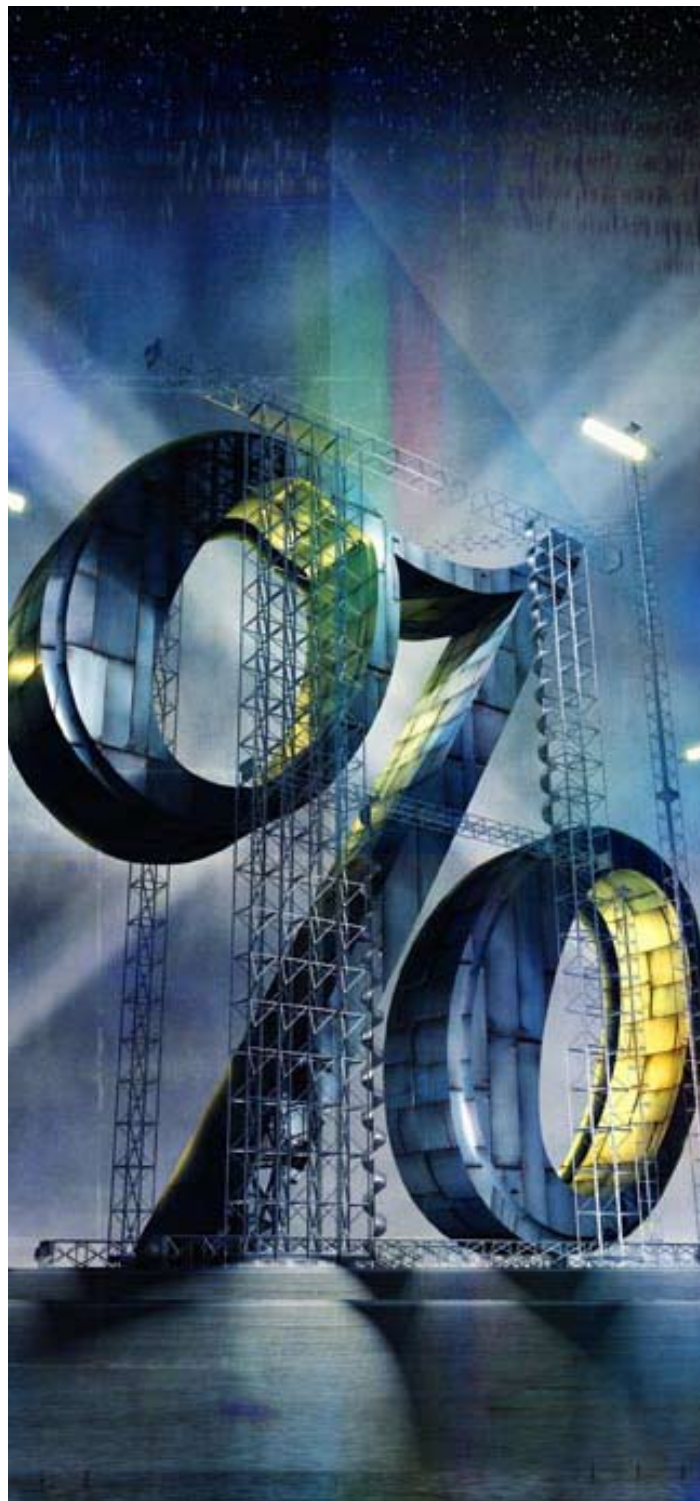
Andrew Beeson, senior corporate adviser of Value Adviser Associates, says the onus will be on directors to fully satisfy themselves that there are robust discounted cash flow valuations in place to either support the current carrying values, or to demonstrate the need for impairment.

A clear indicator of the need for revaluation is that Australian stock market values have fallen by around 30 per cent since June 2008 and over 40 per cent in the last calendar year. "This implies a fall in asset values and the need to carefully scrutinise carry values," he notes.

Beeson says the fact that market capitalisations are below net asset values for many companies doesn't indicate that directors should be placing "fire sale" values on all their assets. "It simply means that directors need to fully understand the forecasts and valuations being presented to them and be satisfied that the asset values remain sustainable, defensible and supportable. If they are not able to do this, they then have to determine the extent of the write-down required."

He provides the following guidelines to directors to ensure their responsibilities are met:

1. Fully understand the requirements of the Australian accounting standards. Various accounting standards, AASB 136 and 138 in particular, deal with the impairment and the definitions of goodwill and intangible assets.
2. Ensure there are internal and external fair value indicators in place to monitor the need for a more detailed appraisal. A formal valuation is only required if there is some change in the operating environment that could lead to a fall in asset values below that recorded on the balance sheet. There is, however, a



- need to monitor a set of indicators which signal when a more detailed examination is required.
3. Appraise management's forecasts used in the valuation models. Be comfortable that the assumptions and forecasts are robust and in line with the company's operating strategies. This particularly applies to short and long-term revenue growth rates, pricing strategies, operating margins, wage inflation, capital expenditure and the potential impact of the carbon pollution reduction scheme.
 4. Understand the basis of the weighted average cost of capital used as the discount factor in the valuations. Relatively small movements in the cost of capital can have a significant impact on a valuation, and inputs into the calculation are frequently under-researched and poorly understood.
 5. Reconcile fair values to market capitalisation. Boards may not necessarily be writing down asset values to levels where the book values are in line with market capitalisations. However, what is important is that directors are aware of any differences and can substantiate them.
 6. Have a communications strategy prepared to inform investors of the reasons for impairment. This should minimise negative investor sentiment and unfavourable press comments, often aimed at directors who are accused of "paying too much for assets in the past".
 7. Comply with continuous disclosure obligations. Directors need to disclose a significant impairment immediately, which may be in advance of the official release of the December 2008 results. Alternatively, non-impairment also presents a disclosure issue as it may mean bringing forward the release of information regarding the company's future operating plans and strategic initiatives to explain to investors why the directors still believe the asset values are defensible.

■ Avoiding insolvency

Directors have been urged by the accounting profession to pay close attention to their organisations' finances to avoid slipping into insolvent trading.

"Figures released by the Australian Securities and Investments Commission (ASIC) and the Insolvency and Trustee Service Australia show that insolvency and bankruptcy continue to rise and it is important that board members have a thorough understanding of the company's financial figures," says Roger Cotton, CEO of the National Institute of Accountants (NIA).

"To be a responsible board member, I would suggest seeking advice on the company's financial health more regularly and I believe that this is a good time to ensure there is a close working relationship with the business's accountant.

"If insolvency does become a concern for a board of directors, there are options that can be undertaken depending on the company's specific circumstances and they should seek the counsel of a qualified accountant."

Cotton says businesses can determine whether they are solvent by applying two tests; one is the cash flow or commercial test, and the second is the balance sheet or absolute insolvency test.

According to Cotton, under the cash flow test, a company is insolvent if it is generally unable to pay debts as and when they become due. Under the balance sheet test, a company is insolvent if its total liabilities exceed the value of its total assets.

"Often small businesses are so busy running the business that they do not realise that they are trading while insolvent and will quickly find themselves in a very difficult financial position," warns Cotton.

"This is particularly important as financial institutions tighten their access to finance, leaving some businesses with few options. Your accountant is able to monitor key indicators and interpret financial information relating to a business's working capital. This includes managing receivables, monitoring inventory levels and ensuring financial information is timely and accurate."

For more information about insolvency, watch out for the February edition of *Company Director*. Also, click [here](#) to access the information published on AICD's website.

■ Mitigating your OH&S liabilities

Navigating the complex and highly regulated maze of state-run occupational health and safety (OH&S) jurisdictions in Australia can be onerous for directors.

“To decrease the risk of directors’ liability, directors need to first recognise the importance of OH&S regulations, to protect not only themselves but also their employees. From there they can take simple remedial steps to eliminate the risk and avoid unnecessary accidents,” says Nicole Albert, national manager at workplace health solutions provider, Konekt Containment.

“Given that all OH&S legislation in Australia has moved towards a risk management model, having a system in place to identify hazards and assess and control risks is now a fundamental aspect of running a business operation.”

Here are some tips from Albert on how to mitigate your OH&S liabilities:

Focus, measure and evaluate

When developing an OHS Management System, ensure you have key OH&S objectives and targets in place. Develop effective methods of capturing critical data and measuring and evaluating your safety system.

OH&S plan

Ensure that OH&S risk management systems are established, including proper risk assessment, control mechanisms and training. Specific duties should be delegated at all times to ensure all OH&S laws are complied with. The system should be regularly reviewed and tested. OH&S matters and the review of incidents should be a standing agenda item for all senior management and board meetings. Put in place a system of internal and external audits for your OH&S management system to ensure it meets Australian standards and has been effectively implemented.

Proactive risk management

Always be proactive in identifying OH&S hazards and issues. Make sure workplace inspections are continuously carried out by experienced staff, and that you regularly receive and respond to reports on OH&S issues from all business units and operating regions. Maintain systems for the reporting of hazards from all employees and contractors. It is vital that ongoing enquiries are carried out to ensure that management is capable of meeting the corporation’s statutory obligations. Take action if you become aware of any system failure.

Instil a culture of safety

As a director, you have the ability to instil a culture of safety from the top down. You can also actively promote safety among managers and employees by championing OH&S issues. Ensure that senior managers and employees are committed to your OH&S system and that achieving OH&S objectives is an important part of their roles and KPIs. Consulting with employees and supervisors is crucial in engaging them on OH&S issues. Harness the collective knowledge of the people who are most affected by OH&S issues through formalised consultation arrangements such as designated workgroups, health and safety representatives and OH&S committees. Ensure that OH&S information is clearly and positively communicated at all times.

Training and knowledge

Firstly, make sure that you have either the required experience or training in dealing with OH&S issues and a thorough understanding of the legal framework. Check that adequate procedures are in place for the induction, supervision and training of employees in regards to OH&S matters. Regularly conduct a gap analysis to determine if training requirements are met, both from a licensing and site-based perspective.

■ Preventing fraud

Two large international swindles – Bernard Madoff’s pyramid scheme in the US and Satyam Computer Services in India – are a reminder to directors to ensure their organisations are being extra vigilant about fraud.

Madoff is said to have lost \$US50 billion in a Ponzi scheme by trading on his impeccable reputation and his links to A-list investors which included banks and high profile individuals. The scheme involved using the money of later investors to pay earlier investors’ returns.

Satyam’s co-founder Ramalinga Raju reportedly tried to cover up one quarter of poor performance by inflating profits, but over time, this escalated into a fraud reported to be worth \$US1 billion. In a letter explaining the fraud, he described it as “riding a tiger, not knowing how to get off without being eaten”.

Lisa Bundesen, a partner in the Forensic Services division of BDO Kendalls, says the methods used to perpetrate these frauds are not complicated, even though they are significant in dollar terms. “Ponzi schemes have been around since the early 1900’s and inflating profits has been seen in previous corporate collapses around the world,” she says.

“The main lesson is that fraud does not need to be complex to have a devastating effect on a company. Considering the current climate, directors need to ensure that their organisations are vigilant of fraud at all levels.”

Bundesen says now may be an appropriate time to consider the use of exception reporting if the company does not already do this. “The development of exception reports which indicate potential red flags is a cost effective method of fraud prevention – as long as those exception reports are acted upon. Of course, other prevention and detection controls need to remain in place and vigilance is vital.”

In the current economic climate, some of the questions Bundesen believes directors could ask to help reduce the risks of fraud in their organisations include:

1. How are controls adapting to the reduction of staff within the company? Gaps in internal controls can appear when staff are not replaced, making it easier for fraud to be committed.
2. Can we adapt exception reports to allow red flags to be recognised? If this is an option, it must also be remembered that these exception reports need to be reviewed and any red flags acted upon.
3. Are we ensuring employees are fully aware of the company’s fraud policy and are we providing them with the ability to report fraud when they suspect it is occurring?

■ Good governance equals better returns

Investors who avoid weakly governed companies as part of a broader investment strategy are likely to perform better.

So argues Julie Hudson, head of SRI and Sustainability, UBS Investment Bank, in a recent paper entitled *Corporate Governance and Capital Markets*.

“When shareholders are disappointed by poor company performance, the reasons for it are soon sought in the area of governance,” says Hudson, pointing to the Japanese real estate bubble of the late 1980s and the technology bubble of the late 1990s as examples. Now a root cause of the current credit crisis is being attributed to weak corporate governance in the finance sector.

Hudson notes that academia has struggled to find a clear relationship between corporate governance and performance. “This is hardly surprising. When governance frameworks fail to function as they should, it can take a long and variable amount of time before the proverbial chickens come home to roost, particularly when market conditions are benign. Furthermore, surprises, being “outliers” or “100-year events”, are not easily incorporated into traditional market models. In the immortal words of Warren Buffett: ‘It’s only when the tide goes out that you learn who’s been swimming naked’.”

Drawing on various studies, she notes: “If the price of risk for countries becomes uncertain when the rule of law is weak, then, analogously, we believe the performance of individual companies is also likely to be more volatile in the context of weak governance.”

While she concedes that determining the effectiveness of governance frameworks is difficult, she details three studies which suggest that company performance, including share price performance, is in some way related to the quality of corporate governance.

“This research, together with the experiences of Japan in the late 1980s, the tech sector a decade later and the financial sector today, indicates that weak corporate governance may be a significant source of risk at the level of country, sector and company,” says Hudson.

“If... weak corporate governance is accompanied by an increased risk of potentially unwelcome surprises in the medium-term, then investors who avoid weakly governed firms as part of a broader investment strategy are likely to pick up performance points, also over the medium-term.

“In the context of the credit crunch and developments underway in financial markets, this conclusion appears to be borne out. History suggests that the seeds of recovery will be laid as firms and market regulators move to control such uncertainty by tightening governance in response to the crisis.”

To view the full report, click [here](#).