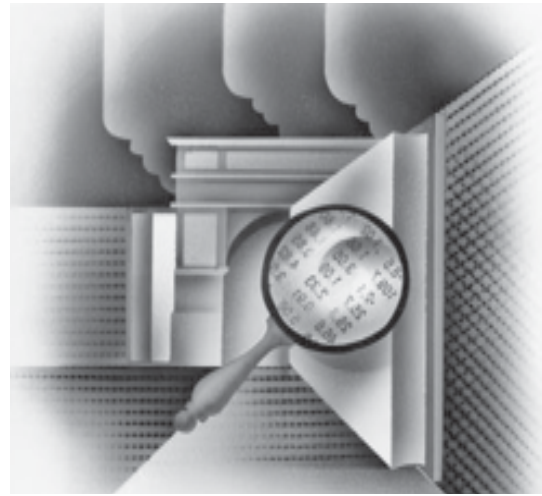


insight



CRISIL's credit analysis unaffected by asset impairment norms

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A CRISIL Ratings study of results published by over 550 companies over three years reveals that, although there have been significant one-time effects of asset impairment on reported capital structures of some companies, the overall rating impact has been negligible. This is because CRISIL's analysis directly factored in the expected impact on cash flow generation by these entities even before the asset impairment accounting standard became mandatory. CRISIL's analysis thus recognised and incorporated the diminished earnings potential of such assets well before impairment was formally recognised.

AS 28 and its implications

In 2002, The Institute of Chartered Accountants of India introduced Accounting Standard 28 (AS28) on impairment of assets, to be compulsorily used in financial statements for all accounting periods

beyond April 1, 2004. Since then, a large number of Indian companies have cleaned up their balance sheets and written off assets with diminished earning potential. This has made the stated asset values on their balance sheets a better indicator of their true future earnings potential. Following up on CRISIL's February 2005 opinion piece, 'New Asset Impairment Standard to Improve Financial Transparency', CRISIL has carried out an analysis of the impact of asset impairments in the last three years on its credit opinions.

Impact analysis

The CRISIL study, across over 550 companies, shows a sharp increase in the number of companies reporting impairment, up at 77 in 2004-05 (refers to financial year, April 1 to March 31) from 24 in 2002-03. The recognition of impairment signals the non-performance or obsolescence of an asset, and leads to a reduction in profits in the year of impairment. However, a depressed return on operating capital employed (RoCE) and a lower asset turnover ratio are leading indicators of an asset facing impairment; CRISIL factors these in early, and therefore captures likely impairment in its analysis well before the financial charge is created by the company in the year of impairment. Consequently, CRISIL's credit views on most of the companies reporting impaired assets have remained stable.

The most significant effect of the initial reporting of impairment was that it led to an erosion of net worth in the year of adoption of the standard, since the impairment was directly routed through reserves. This by itself did not impact CRISIL's analysis, since CRISIL routinely recasts P&L accounts and balance sheets of companies it analyses; the diminished cash flow generating ability of these assets had already been factored in when the diminution started to become apparent. No impact was therefore warranted when the accounting recognition of impairment took place.

Table 1 shows the number of companies analysed in this study and the impact of asset impairment on their tangible net worth.

	2004-05	2003-04	2002-03
No. of companies	77	45	24
Of which			
< 5% erosion to tangible networth	70	38	22
> 5% erosion to tangible networth	7	7	2

Most of these companies routed the impairment directly through the reserves in the first year they adopted the standard, as allowed under AS28. The deferred tax asset that was created on account of the impairment loss was however routed through the profit and loss account in many cases, resulting in an increase in reported profits! This has not affected CRISIL's analysis, since CRISIL routes both impairment losses and the resultant deferred tax asset through the profit and loss account.

The above sample of companies that have impaired assets throws up some interesting observations. To better understand how CRISIL has evaluated these companies, we examine the following three cases:

A telecommunications service provider had been facing obsolescence and competition in its mainstay business, which was reflected in CRISIL's business risk assessment; this eventually constrained its overall credit profile. The company's presence in an increasingly competitive industry, and its inability to revive its existing technological infrastructure, necessitated fresh investments which were yet to generate any substantial returns for the company. This resulted in a sharp drop in the company's operating RoCE from 35 per cent to 9 per cent, and a reduction in the asset turnover from 4 times to 1.4 times; CRISIL took note of these measures in its analysis. Therefore, when the company actually impaired these assets, CRISIL did not revise its view because CRISIL's earlier view already factored the non-performance of the impaired asset.

In another instance, an information technology (IT) services company recognised large impairment of assets, leading to a 12 per cent erosion in its tangible net worth. The signs of an under-performance were already visible in a reduction of one-third in the asset turnover, and a deteriorating RoCE at 7 per cent from an earlier level of 21 per cent. Once again, CRISIL's credit opinion remained stable, as CRISIL had already factored in the declining revenue potential of the company.

Similarly, a leading cement manufacturer acquired a cement plant which did not perform to an extent justifying the valuation. This acquisition depressed the company's operating ROCE from 8 per cent to 5 per cent. CRISIL had, in its analysis, always considered the investment a drain on the company's financial profile, and the impairment, when it came, did not affect CRISIL's credit view.

Conclusion:

The introduction of the accounting standard on asset impairment brings Indian corporates a step closer to their international counterparts

in terms of disclosure. Besides, continuous application of the standard will now ensure that corporate balance sheets will depict the true value of their operating assets and net worth, and better indicate future profitability. The standard thus results in reported asset values

that are more closely aligned with CRISIL's assessment of the cash flow generating ability of these assets; consequently, the introduction of the standard has not materially affected CRISIL's views on the credits it covers.

How does CRISIL treat asset impairment?

CRISIL routes all asset impairment losses, whether one-time or recurring, through the profit and loss account. CRISIL observes that the first reporting of impairment often incorporates impairments related to the previous years. Such impairments were not routed through the profit and loss account when they occurred; in other words, the company has understated depreciation (and therefore over-stated profits) in earlier years when the asset was put to use. Hence, CRISIL routes the initial impairment loss through the profit and loss account, even though the company reporting it is allowed to set it off directly against reserves in the balance sheet. Similarly, CRISIL will route an impairment write-back through the profit and loss account.

Which companies face the risk of impairment?

Companies in sectors which face the risk of technology obsolescence or impairment are information technology and telecom services. Companies operating in areas where investment risks are high due to large outlays and low success probability such as mining, oil exploration and production are also prone to asset impairment than others.