

Insight

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New Asset Impairment Standard to Improve Financial Transparency

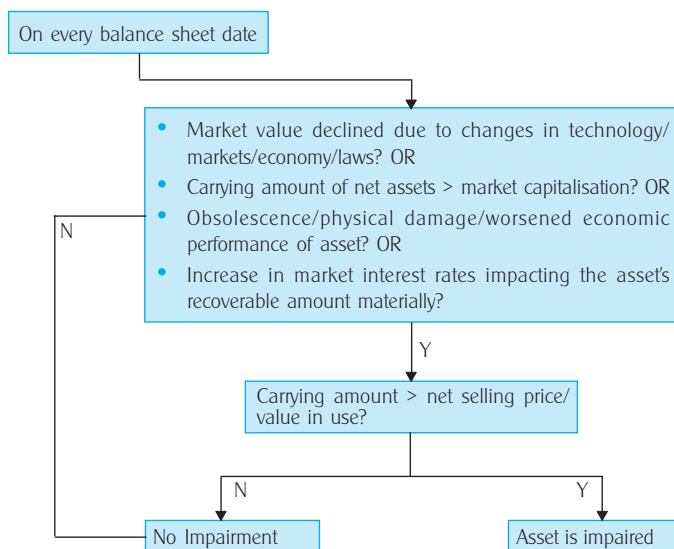
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By March 2005, it will be mandatory for all companies to comply with Accounting Standard 28 (AS28) on asset impairment issued by the Institute of Chartered Accountants of India. While the companies' reported capital structure would be adversely impacted to the extent of the impairment loss, CRISIL believes that the implementation of the standard will result in companies reporting revenue yielding assets. This will take them one step closer to their international peers besides enabling investors to take informed decisions. CRISIL's rating analysis encompasses an assessment of the cash flow generation of an entity. Hence, CRISIL's ratings may not necessarily be affected to the same extent as the one-time impact of the new standard since CRISIL takes a holistic view while rating an instrument, going beyond aberrations in a particular year.

This article explains CRISIL's methodology for treating asset impairment and its impact on the companies' credit profiles.

What is impairment?

When the carrying amount of an asset exceeds its recoverable amount, the asset is said to have been impaired. The adjoining chart depicts the steps that each company needs to follow in assessing impairment. AS28 requires companies to take stock of their fixed assets annually and to assess whether or not any assets need to be recognised as impaired.



The standard stipulates that in the first year when any asset is impaired till fiscal 2005, a company has an option to charge the impairment loss through the general reserves on its balance sheet and not to the profit and loss account for that year. The rationale for this is that the impairment in the first year could pertain to prior periods. In subsequent years, however, the impairment loss is to be charged to the profit and loss account of the respective year.

Similarly, if at a latter date, the fixed asset can be put to productive use, the company can write back the impairment loss. The write-back will depend on the procedure followed while writing off, that is, if the impairment loss was written off through the reserves, the write-back will also be done through the reserves. In the same fashion, if the impairment loss was written off through the profit and loss account, the write-back will be through the profit and loss account.

How does CRISIL treat impairment?

In its credit risk analysis, CRISIL seeks to determine the actual profitability of a company's operations. Therefore, CRISIL factors in any loss due to the diminution in the value of the fixed assets in the period for which the profitability is determined. CRISIL believes that an impairment loss represents the extent to which the fixed assets have been overstated in the annual accounts in the previous years, which could have been corrected through adequate depreciation or write-off of the assets. In CRISIL's opinion, the impairment loss in any year should be treated as an expense in the profit and loss account so as to reflect the company's true profitability. CRISIL charges all yearly impairments through the profit and loss account.

Moreover, CRISIL goes a step further than AS28 in treating first-time impairments. CRISIL observes that often, the first-time impairment incorporates impairments related to the previous years, which were not routed through the profit and loss account, that is, the company had understated depreciation in earlier years when the asset was put to use. In other words, the profit shown in the past would have been over-stated. Hence, CRISIL routes the initial impairment loss through the profit and loss account. Similarly, CRISIL will route an impairment write-back through the profit and loss account.

CRISIL recognises that this treatment may understate (overstate) the profit (loss) in the year in which it is done. But CRISIL's credit analysis takes a holistic view of a company's financial performance by determining its profitability over a suitable period to reflect its true performance and thereby ironing out single-point aberrations.

Let us understand CRISIL's treatment of asset impairment with the help of an example.

In the adjoining table, the base scenario depicts the balance sheet and other profitability indicators of Company X when there is no impairment. Company X's gearing is 0.55 times (x), its profitability is 10 per cent and the return on capital employed (RoCE) is 9 per cent.

On taking stock of its fixed assets, the company decides to impair Rs. 75 million of assets. Within the gamut of AS 28, the company routes the impairment loss through its general reserves. As a result, the adverse impact on its gearing, which deteriorates to 0.75x, is partly offset by the improvement in its RoCE to 11 per cent. The profitability indicators remain undisturbed. CRISIL, however, treats the

Company X '		Rs. in million	
Particulars	Base scenario	As per As 28	Crisil's treatment
Equity	75	75	75
General Reserves	100	25	100
Profit for the yr.	100	100	25
Debt	150	150	150
Total capital employed	425	350	350
Net fixed assets	225	150	150
Other assets	200	200	200
Total funds applied	425	350	350
Other information:			
Impairment loss	-	750	750
Operating Income (Rs. billion)	100	100	100
Ratios:			
Gearing	0.55	0.75	0.75
RoCE	9%	11%	11%
PAT	10%	10%	3%

impairment loss as an expense in the year of impairment. Hence, Company X's profit after tax (PAT) to operating margin ratio for the year deteriorates to 3 per cent. However, if the company has been making the same returns (10 per cent) over the last few years, CRISIL would factor this into its analysis. Accordingly, the company's actual

profitability would be taken as 7.67 per cent on a 3-year period of assessment. Similarly, CRISIL takes a holistic view of the RoCE and other relevant credit risk indicators.

How does impairment affect a company's credit profile?

CRISIL's pool of rated companies shows that impairment alone does not necessarily impact a company's credit profile. The level of deterioration depends on factors such as:

- Level of asset impairment, and
- Level of financial leverage at which the company operates

It is pertinent to note that CRISIL's rating analysis also looks at a company's cash flow generation. If the concerned asset has stopped yielding returns in the past, this will have been suitably factored into CRISIL's current rating on the company. Hence, impairment alone will not impact CRISIL's rating analysis, which remains unperturbed by one-time write-offs on account of impairment.

To sum up, CRISIL's ratings encompass a company's performance over a period of time and any aberrations in a particular year may not necessarily impact its credit profile. CRISIL views a company's sustainable profit levels over a few years and its sustainable cash flow generation to determine its credit quality. Moreover, its credit rating takes into account numerous other factors such as business, management and financial risks. Hence, impairment is not viewed in isolation; rather, CRISIL takes a pragmatic view of its impact on a company's credit profile.