

Some companies are taking years to recognise asset impairments, and may be misleading investors who are not privy to the valuation decisions. [Research](#) shows this is because managers of many firms think or hope that assets are not overvalued.

This occurs when companies either don't recognise, or delay the recognition of asset impairments. These asset impairments represent a downward adjustment in the value of assets, to what is called "recoverable amount". This is determined by either the value the asset could be sold for, or its value to the business right now.

One example of this process of recognising asset impairments can be easily seen in Nine Entertainment Corporation Ltd in 2015. Through the first half of 2015 the share market value declined significantly, and by year end its book value (the value of net assets on the balance sheet) would have exceeded the firm's market value.

This was probably occurring as investors revised their estimates of future returns in response to changes in the television industry and increasing competition from pay television, internet-based television and other online media. These factors are indicators of declining asset values, which are explicitly identified in the regulation, and this requires a test for asset impairment by the firm.

Next, Nine would have determined the recoverable amount of the assets. The company would have had to estimate future returns and, while there are extensive guidelines on how this should be done, considerable judgement is still required. The end result in this case was an asset impairment of A\$792 million that resulted in Nine reporting a loss for the year.

The Australian Securities and Investment Commission (ASIC) regularly reviews the financial reports of listed firms. Where necessary, it seeks their explanations for particular accounting treatments. Risk-based criteria are used to select which firms are reviewed and in some instances this leads to material changes in their reports.

The most recent review by the corporate regulator into [end-of-year financial reports](#) for 2015 found the biggest number of the queries (11 out of 24) into accounting related to the valuation of assets.

It is unlikely this is a consequence of poor regulation. The regulation sets out clear criteria, identifying the circumstances when asset impairment should be formally considered (i.e., where indicators of impairment exist) and the basis for calculating the amount of asset impairment.

In some cases determination of asset impairments should be straight forward. For example, where firms are unprofitable and the book value exceeds the market value of equity, the indicators of impairment are readily observable to all because it can be identified using “firm level” information.

However, in other cases it is not so straightforward and determining whether impairments are necessary and calculating the recoverable amount is then much more difficult.

Asset impairments are required to be evaluated at the level of business units, or what the regulation refers to as “cash-generating units”, rather than at the firm level. Accordingly, while asset impairments may be necessary in some business units, the need for or amount of asset impairments may be obscured in firm-level information.

For example, Arrium is clearly experiencing financial problems and has made a number of asset impairments. But it is not all bad; some of its business units are profitable. When the firm level information is considered it may start to mask the very poor performance in other business units. Hence, whether the need for asset impairment is obviously necessary will depend on relative size and number of poorly performing business units.

Significant judgement will be required in these cases. This includes defining business units and attributing assets to them. Only then can future returns be estimated, and this can never be done with certainty. If there are problems with the exercising of this judgement, then maybe the assumptions on which asset impairment decisions are based should be made clear and disclosed.

Unfortunately, the people who use these financial statements, such as investors, are often kept in the dark because firms are only required to disclose the assumptions behind their judgements if an impairment is actually made. However if these disclosures were always made, it would either support the asset values reported, or alternatively confirm that asset impairments are really necessary.

In the absence of these disclosures, investors and other users of financial statements do not get important up-to-date information about future returns that would underpin share prices.

It's time to amend the regulation and reveal the explanations for not recognising asset impairments. Whenever there are indicators that impairment is necessary, companies should be required to disclose their assumptions even if the decision is not to impair.

Doing this will highlight how asset impairments are being (or, more critically, not being) determined and assets valuation will always be more transparent.

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