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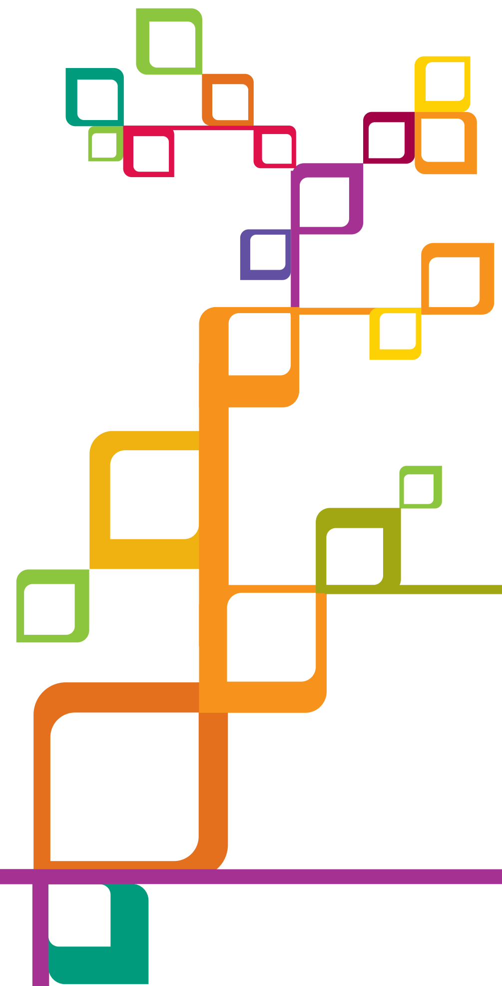
MFRS Hot Topics

The effect of events after the reporting period on valuation, impairment and existence of financial assets

APRIL 2014

Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue provides guidance on the effect of events after the reporting period on valuation, impairment and existence of financial assets.



After the reporting date, but before the date of authorisation of its financial statements, a reporting entity may receive information on the value, recoverability or existence of financial assets (investments) that it holds. This Hot Topic addresses the considerations for the recognition and measurement of the financial assets at the reporting date. Specifically:

- when do fair value measurements need to be adjusted?
- how is the recognition and measurement of impairment losses affected?
- where fraud is involved are there any special considerations for the recognition and measurement of the assets?
- when should financial statements of earlier periods be restated?

References are made to MFRS 110 Events after the Reporting Period.

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Introduction

In the current general economic downturn many companies have announced unfavourable news in respect of the current financial condition or performance of their business or lower expectations of future performance. A number of high profile and significant frauds and alleged frauds have also been reported. This type of information normally results in significant falls in the value of the issuer's equity and debt securities. We consider below the practical implications for investors with respect to the recognition and measurement of financial assets at the reporting date when such information subsequently comes to light before the financial statements are authorised for issue.

General guidance
An entity adjusts amounts recognised in its financial statements to reflect adjusting events after the reporting period (MFRS 110.8). Adjusting events are those that provide evidence of conditions that existed at the end of the reporting period (MFRS 110.3(a)). Events that are indicative of conditions that arose after the reporting period are not adjusted for at the reporting date but should be disclosed where they are material (MFRS 110.3(b), 10, 21). Professional judgement may be required to make this determination in some cases.

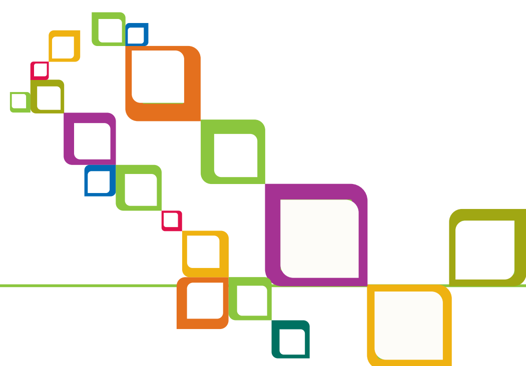
When events after the reporting period are non-adjusting events, the reporting entity makes the disclosures in MFRS 110.21 and 22.

Impact of events after the reporting period

1) Impact of events after the reporting period on period end fair value

Fair value measurement using quoted market prices

The best evidence of fair value at the reporting date is the quoted price in an active market. When such a quoted price is available it must be used without adjustment to measure the financial asset except in limited circumstances such as when a quoted price in an active market does not represent fair value at the measurement date (IFRS 13 Fair Value Measurement paragraph 79(b)). A decline in the quoted price of investments between the reporting date and the date when the financial statements are authorised for issue is a non-adjusting event after the reporting date (MFRS 110.11). An abnormally large change in value after the reporting date should be disclosed in the notes (MFRS 110.22(g)).



Fair value measurement using a valuation technique

The objective of using a valuation technique is to establish what the transaction price would have been at the measurement date in an arm's length exchange involving knowledgeable and willing parties and motivated by normal business considerations. The valuation should incorporate all factors that market participants would consider in setting a price (IFRS 13.3). It is implicit in a fair value measurement that information is incorporated in a valuation only if it would be available to market participants in establishing the transaction price.

The estimates and assumptions used in the valuation technique should reflect market conditions at the reporting date. Judgement may be required in some cases to determine whether a knowledgeable buyer would have been aware of the relevant information at the reporting date. This will involve consideration of the nature of 'typical' market participants and the normal buying process they would undertake in acquiring the financial asset in concern (including the extent of due diligence that is customary in the circumstances). For example, a venture capitalist contemplating the purchase of a substantial investment in a private entity would typically carry out extensive due diligence. By contrast a bank which routinely buys and sells loans might rely primarily on publicly available credit ratings and undertake only limited further investigation.

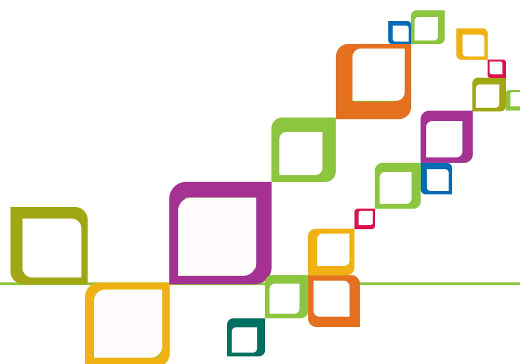
If a knowledgeable buyer would reasonably have been expected to obtain and consider the relevant information at the reporting date, it should be reflected in the inputs to the valuation technique (for example, by adjusting the discount rate used or estimates of future cash flows).

Example
Fair value using a valuation technique

Entity A holds a loan note issued by Entity B. This is classified as an available for sale financial asset. The loan note is not quoted in an active market. Entity A therefore uses a valuation technique. Entity A prepares its financial statements to 31 March each year. On 15 May 20X1, prior to the authorisation for issue of Entity A's financial statements for 31 March 20X1, Entity B announces that it plans to withdraw from one of its key markets. The deterioration in the economy of country X has resulted in a loss of customers and future sales orders for a major product. Entity B expects to make a significant loss as a result of asset write downs, restructuring costs and the reduction in future revenues.

Should Entity A adjust the fair value of the loan at the reporting date?

Entity A determines that the announcement provides evidence of conditions that existed at the reporting date as the poor performance of the economy in country X had been evident for some time. Information about Entity B's exposure to changes in economic conditions in country X was disclosed in publicly available information including Entity B's latest annual and interim financial statements. Entity A therefore concludes that a knowledgeable buyer would have taken this information into account in setting a price for the loan at the reporting date. Entity A revises the discount rate (to reflect the increased credit risk of the borrower) or the estimates of future cash flows (to reflect expected recoveries) used to determine the fair value of the loan.



2) Impact on recognition and measurement of impairment losses

Impairment of available for sale financial assets

If a decline in the fair value of an available for sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (MFRS 139 Financial Instruments: Recognition and Measurement, paragraph 67)).

The receipt of information after the reporting date indicating that an asset was impaired at the reporting date is an adjusting event after the reporting date (MFRS 110.9(b)). An announcement by the investee may therefore provide qualitative evidence that an available for sale financial asset carried at fair value was impaired at the reporting date. For example, it may indicate that adverse changes had taken place at the reporting date in the technological, market, economic or legal environment in which the issuer of an equity security operates (MFRS 139.61) or that the issuer of a debt security was in significant financial difficulty at the reporting date (MFRS 139.59(a)).

Although the information received after the reporting date may indicate the existence of impairment, it may not affect the measurement of the impairment loss. This is because the information may not affect the period end fair value (see guidance above). For an available for sale financial asset, the impairment loss that is reclassified to profit or loss is the difference between the fair value of the financial asset at the reporting date and the acquisition cost (net of any principal repayment and amortisation) less any impairment previously recognised in profit and loss (MFRS 139.68).

Example
Impairment of AFS financial asset

Entity C holds quoted debt securities in Entity D which are classified as available for sale financial assets. Entity C prepares its financial statements to 31 December each year. At the reporting date, the fair value of the debt securities had declined below their cost. Entity C initially determines the decline is neither significant nor prolonged based on its normal assessment criteria. On 15 February 20X2, prior to the authorisation for issue of Entity C's financial statements for 31 December 20X1, Entity D announces a significant loss and that it has breached some of its banking covenants at 31 December 20X1.

Should Entity C recycle the loss recognised in other comprehensive income to profit or loss?

The announcement provides objective evidence that the investee (Entity D) was in financial difficulty at 31 December 20X1. This is likely to be objective evidence of an impairment at the reporting date (see MFRS 139.59(a)). Entity C reclassifies the loss from equity to profit or loss as a reclassification adjustment. It does not revisit the period end fair value, which is determined as quoted price in an active market. Accordingly the amount of the loss reported is not affected.

Impairment of financial assets carried at cost or amortised cost

If there is objective evidence that an impairment loss on loans and receivables or held to maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (MFRS 139.63). For a financial asset quoted at cost (for example, unquoted equity instruments where fair value cannot be reliably measured) the impairment loss is calculated on a similar basis except the discount rate used should equate to the current market rate of return on a similar financial asset (MFRS 139.66).

As noted earlier, the receipt of information after the reporting date indicating that an asset was impaired at the reporting date is an adjusting event (MFRS 110.9(b)). Judgement will be required to determine whether the information obtained provides objective evidence of impairment at the reporting date depending on the specific facts and circumstances. For example, the financial difficulties of a debtor resulting in a potential default often build up over time and significant deterioration may have occurred by the reporting date. However, in some cases the financial difficulty of the debtor may be linked to one event that occurred after the reporting date.

If there is objective evidence of impairment at the reporting date, the reporting entity is required to measure the impairment loss (MFRS 139.63 and 66). For this purpose the reporting entity's estimates of future cash flows should take account of the most up to date information available (which would include the information obtained after the reporting date) in measuring the amount of the impairment.

Example

Impairment of loan receivable

Entity E holds a loan note in Entity F which is classified as a loan and receivable in accordance with IAS 39. Entity E prepares its financial statements to 31 December each year. On 25 March 20X3, prior to the authorisation for issue of Entity E's financial statements for 31 December 20X2, Entity F announces a significant loss for the preceding financial year, which brings into doubt Entity F's ability to repay its borrowings. Entity F's major customers are in the construction sector in country Y which has experienced a significant decline in activity over the past twelve months and this has resulted in a fall in demand for Entity F's products.

Should Entity E provide for an impairment loss at the reporting date?

The announcement provides objective evidence that the loan and receivable was impaired at the reporting date. Entity F is in significant financial difficulty and this condition has built up over a period of time. Entity E calculates the impairment loss in accordance with MFRS 139.63. Its estimates of future cash flows expected in relation to the loan note take account of the new information on Entity F's financial condition.

3) Additional considerations when fraud is involved

Valuation and impairment

We believe the views expressed above on valuation and impairment remain applicable if the information received after the reporting date involves a fraud at the investee which was ongoing but undiscovered at the reporting date. Accordingly, if the investee entity announces a fraud event after the reporting entity's reporting date:

- a period end fair value determined as the quoted price in an active market is not adjusted for the effects of the fraud announcement
- a fair value determined using a valuation technique takes account of the fraud announcement if
  - the information provides evidence of circumstances existing at the reporting date
  - it is reasonable to conclude that the information would have been obtained by market participants transacting at the reporting date (this is probably a reasonable assumption only if the normal buying process would involve a due diligence process that would have a reasonable expectation of discovering the fraud)
- the fraud event may provide objective evidence of impairment at the reporting date and, if so, would be taken into account in measuring impairment losses for assets carried at cost or amortised cost.

Some confusion is caused by the example provided in MFRS 110.9(e) of an adjusting event after the reporting date stating that an entity is required „…to adjust the amounts recognised in its financial statements…when the discovery of fraud or errors show that the financial statements are incorrect' (MFRS 110.9(e)). Some may interpret this statement to require a reporting entity to make adjustments if the investee's financial statements have been misstated as result of fraud or error. In our view, however, MFRS 110.9(e) refers to the financial statements of the reporting entity (investor). The financial statements of the investor are not 'incorrect' if they correctly report the financial assets measured in accordance with the requirements of MFRS 139.

Existence

In rare circumstances the discovery of a fraud at the investee may bring into question the existence and accuracy of the description of a reporting entity's investments. It may be determined that the investment contract is fraudulent or that the underlying investments to which the reporting entity believed it has rights do not actually exist. For example, an investor may engage a custodian to acquire and hold investments (such as equity shares) on its behalf. It may then discover that the custodian has not in fact acquired the shares and has misappropriated the monies advanced by the investor. Accordingly some or all of the investments that the investor believed that it owned do not actually exist.
In such circumstances, the issue is one of existence or rights to the assets rather than valuation of those assets. Where it is determined that the assets did not exist at the reporting date, or that the entity's rights under the investment contract are unenforceable, then the investments do not meet the definition of an asset (MFRS 132 Financial Instruments: Presentation, paragraph 11) and should not be recognised in the financial statements.

Example
Fraud at asset custodian

Entity G prepares its financial statements to 31 March each year. Entity G has engaged a broker (Entity H) to acquire and hold certain investments on its behalf during the year ended 31 March 20X0. On 20 April 20X1, prior to the authorisation for issue of Entity G's financial statements for the year ended 31 March 20X1, Entity H is charged with an alleged securities fraud perpetrated over a number of years. It is alleged that H has misappropriated some of the funds provided to it by investors and has not acquired all the assets it was engaged to hold in trust. Entity G had valued its investments at 31 March 20X1 based on information provided by Entity H and without any knowledge of the existence of the alleged fraud.

Should Entity G adjust the carrying amount of the investments in funds at the reporting date?

Entity G reviews its internal procedures and determines that it carried out appropriate due diligence in relation to its investments in H and had access to the same publicly available information as other market participants. Entity G therefore concludes that it would not reasonably have been expected to have knowledge of the fraud at the reporting date. However, Entity G also determines that the majority of the underlying investments it believed were held on its behalf did not actually exist at 31 March 20X1. Accordingly, Entity G adjusts the carrying amount of its investments to write off the non-existent rights.

4) When should prior periods be restated?

The entity may determine that the information received provides evidence that amounts included in prior period financial statements may have been misstated. For example, the information provides evidence that the recorded investments did not exist or that investments carried at amortised cost were impaired or that fair values (estimated using a valuation technique) were overstated in the prior period.

Prior period financial statements should only be restated for prior period errors (MFRS 108 Accounting Policies, Changes in Accounting Estimates and Errors). A prior period error is defined as an omission from or misstatements in prior period financial statements arising from a failure to use or misuse of reliable information that (a) was available when financial statement for those periods were authorised for issue and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements (MFRS 108.5). The effect of any changes in accounting estimates should be reflected in the current period financial statements (MFRS 108.36).

Judgement will be required in determining whether the entity failed to obtain available information which it should reasonably have taken into account in preparing the prior period financial statements.

In the context of investments, this determination will include consideration of the nature of the investments, the reasonableness of the information obtained by the entity in relation to other available market information and the level of due diligence that would normally be expected of an investor in the circumstances. For example, an investor that holds unquoted debt securities in a listed entity, whose shares are trading freely at expected levels with normal volatility, would not be expected to obtain information that was not publicly available. In contrast, an investor that holds a material loan receivable from a private entity may be expected to obtain regular and up to date information from the borrower (for example, the borrower's recent management accounts).

Example

Restatement of prior periods

The facts are the same as in the previous example above. The fraud at Entity H (the broker) has been ongoing for several years. If information as to the fraud been available and properly considered, then it would have been reasonable for Entity G to conclude that the investments purportedly held on its behalf by Entity H did not exist either at 31 March 20X0 or at 31 March 20X1.

Should entity G also restate its 31 March 20X0 financial statements?

Information about the fraud was not publicly available when the 31 March 20X0 financial statements were authorised for issue. Entity G has also concluded that it performed appropriate due diligence in relation to its investments and in accordance with its own internal procedures. Accordingly, Entity G concludes that, in preparing its 31 March 20X0 financial statements, it obtained the information that it could reasonably have been expected to obtain. The new information about the fraud received in April 20X1 is not therefore considered to indicate an error in the 31 March 20X0 financial statements. Accordingly, these statements are not restated. The write-off of the non-existent assets is recorded as an expense in the year ended 31 March 20X1.

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