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MFRS Hot Topics

Equity accounting, fair value adjustments and impairment

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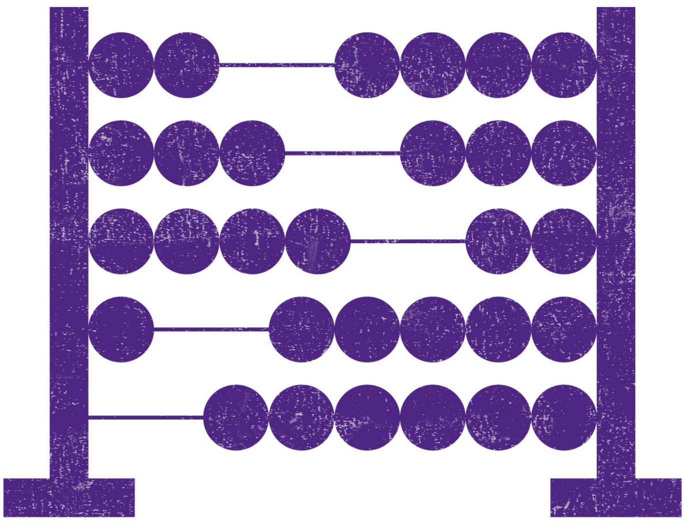
Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication discusses the adjustments required on the initial acquisition of an investment in an associate, and the effect of those adjustments on the investor's share of the associate's profit or loss (including impairment charges).



Contents

Guidance

An investor initially records an interest in an associate at cost (Paragraph 10 of MFRS 128 Investments in Associates and Joint Ventures). On acquisition, the investor should also determine the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities (MFRS 128.32). Consequently, the investor effectively restates the associate's statement of financial position in the same way as an acquiree's statement of financial position is restated in a business combination. The investor:

- revalues to fair value assets and liabilities included in the associate's statement of financial position
- recognises at fair value intangible assets (such as brands and customer relationships) that may not be included in the associate's statement of financial position
- recognises at fair value the associate's contingent liabilities
- records adjustments to give effect to uniform accounting policies

It should be noted that this exercise also includes accounting for deferred taxes - Paragraph 19 of MFRS 112 Income Taxes. The difference between the cost of the investment and the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities is goodwill. Because the investment is recorded as a single item, goodwill and the adjustments referred to above are included within the overall net investment. However, the acquisition-date adjustments affect the investor's share of the associate's profit or loss in future periods.

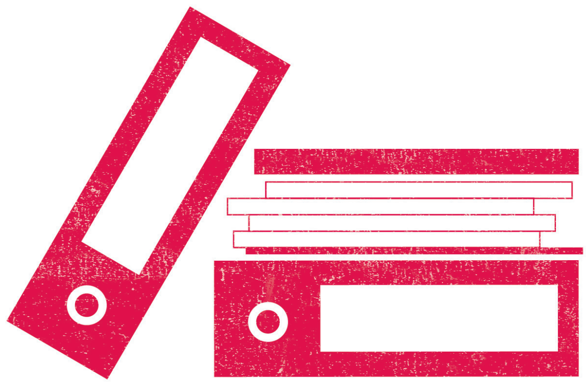
In reporting results from its investments in associates, the investor needs to track the values of the assets and liabilities imputed on acquisition, in order to determine the correct adjustments for depreciation, amortisation and impairment. In some cases an impairment charge may be necessary for an asset that the associate itself has not even recognised in the associate's own financial statements.

For example:

- depreciation charges are based on the fair values of depreciable assets at the acquisition date not on the amounts recorded in the associate's own financial statements (MFRS 128.32)
- intangible assets not recognised by the associate give rise to amortisation charges (unless they have an indefinite useful life). The requirements of MFRS 136 on impairment also need to be applied. Hence the investor may recognise (its share of) an impairment charge even though no charge is included in the associate's financial statements
- if the associate has recognised goodwill in its financial statements, any related impairment charge is excluded from the investor's share of the associate's profit or loss for equity accounting purposes.

These adjustments are necessary in order to ensure that the investor records the correct share of the associate's profit or loss in accordance with MFRS 128.10. After applying the equity method, the investor should also consider whether there is objective evidence of impairment of its overall net investment (MFRS 128.40). Any goodwill identified at acquisition is included in the overall net investment for this purpose. In evaluating the need for any additional impairment charge, the investor:

- applies the requirements of Paragraphs 58-62 of MFRS 139 Financial Instruments: Recognition and Measurement to determine whether or not there is objective evidence of impairment (MFRS 128.40)
- if necessary, applies the requirements of MFRS 136 to quantify any impairment loss (MFRS 128.42).



Discussion

MFRS 128 requires use of the equity accounting method of investments in associates (with some very limited exceptions). In summary, the equity method involves:

- recording the investment at cost on acquisition
- subsequently adjusting the carrying value for the investor's share of profits or losses, less any distributions received (MFRS 128.10).

The share of profits or losses of the associate for this purpose will not usually be directly available from the associate's separate financial statements. This is because MFRS 128 requires the investor to perform steps similar to an MFRS 3 Business Combination 'acquisition method' for the recognition and measurement of the associate's assets and liabilities on acquisition of its investment. In effect, equity accounting is therefore similar to accounting for a business combination (even though the investment and the subsequent share of profit or loss are presented as single items in the statement of financial position and income statement).

The acquisition method will often result in fair value adjustments to the assets and liabilities recognised by the associate. Additional identifiable intangible assets might also be recognised, in particular, internally-generated intangibles such as brands. Intangibles are recognised if they are identifiable (if they meet either the separability criterion or the contractual-legal criterion) and their fair value can be measured reliably (MFRS 3.B31). Contingent liabilities of the associate are also included at fair value if these liabilities are present obligations that arise from past events (MFRS 3.23). These assets, liabilities and contingent liabilities are subsumed into the overall carrying value of the investment for presentation purposes, but need to be identified and tracked for measurement purposes.

As explained in the guidance section, the acquisition method adjustments affect the subsequent measurement of the investor's share of the associate's profit or loss. This should be derived from the associate's financial statements, as adjusted:

- to achieve uniform accounting policies
- to reflect the future effect of the acquisition method adjustments referred to above.

One practical consequence of these requirements is that the investor may need to carry out impairment tests on certain intangibles of the associate (because the associate has not recorded them). This will require information from the associate including forward-looking information.

Example

(The following example is intended to illustrate some of the points in the Hot Topic. It is not necessarily realistic or comprehensive. For the purpose of the example, tax effects are ignored).

On 1 Jan 20X1, investor A acquires a 40% interest in entity B, for CU300,000. Entity A determines that B meets the MFRS 128 definition of an associate. Entity B reports in accordance with MFRS and applies accounting policies consistent with A's. At 1 Jan 20X1, Entity B's net assets total CU540,000. Entity A applies the requirements of MFRS 3 to recognise B's identifiable assets, liabilities and contingent liabilities. The book values and adjustments are summarised in the following table:

CU000s	Book value at 1 Jan 20X1	Fair value and other adjustments	Notes	Total
Property, plant & equipment (PP&E)	300	100	(a)	400
Goodwill	40	(40)	(b)	-
Other intangible assets	-	150	(c)	150
Other assets & liabilities	200	-		200
Contingent liability - litigation	-	(150)	(d)	
Total	**540**	**60**		**600**
Entity A's 40% interest				**240**
Cost of 40% interest				**300**
Notional goodwill				**60**

Notes

a) Adjustment to revalue PP&E to fair value of CU400,000. The remaining useful life is assessed as 10 years, with zero residual value

b) Goodwill recognised by entity B is not an identifiable asset so is excluded from the fair value statement of financial position

c) Adjustment to recognise two brands owned by entity B: Brand X is valued at CU130,000. Brand Y is valued at CU20,000. The estimated useful life of both brands is 10 years

d) Adjustment to record at fair value a contingent liability in relation to a lawsuit filed against Entity B.

The accounting entry recorded on 1 Jan 20X1 is as follows:

1 Jan 20X1 (CU000s)	Debit	Credit
Investment in associate	300	
Cash		300

During 20X1, Entity B records a net profit of CU200,000. This figure includes:

- an impairment charge of CU40,000 in relation to the goodwill recorded in Entity B's statement of financial position
- depreciation of CU30,000 in relation to PP&E
- a charge of CU200,000 reflecting a payment to settle the lawsuit referred to in (d) above.

Also, during 20X1 Entity B's management decides to discontinue Brand Y and focus on Brand X. Entity A determines that Brand Y is fully impaired. Entity B does not make any distributions in the year.

Based on these facts, Entity A makes the following adjustments to Entity B's net profit to determine the share profit for equity accounting purposes:

	Notes	CU000s
Net profit as reported by Entity B		200
Adjustments:		
- additional depreciation	(a)	(10)
- reversal of B's goodwill impairment	(b)	40
- amortization of Brand X	(c)	(13)
- impairment of Brand Y	(d)	(20)
- litigation settlement	(e)	150
Net profit for equity accounting purposes		**347**
Entity A's 40% interest		**139**

Notes

a) Adjustment to record additional depreciation based on the fair value of Entity B's PP&E

b) Goodwill recognised by Entity B is excluded from the fair value statement of financial position, so the impairment charge needs to be reversed for equity accounting purposes

c) Amortisation of Brand X - CU130,000/10 years

d) Impairment charge of CU20,000 to write-off Brand Y

Entity B has recorded an expense of CU200,000 for the litigation settlement but the contingent liability was recorded at an amount of CU150,000 in the fair value statement of financial position. This contingent liability is reversed for equity accounting purposes.

31 Dec 20X1 (CU000s)	Debit	Credit
Investment in associate	139	
Income statement (share of profit of associate)		139

Consequently, the carrying value of the investment at 31.12.20X1 becomes CU439,000. If there is any objective evidence of impairment of this net investment amount, an impairment review should be undertaken. The goodwill identified at acquisition (CU60,000) is included in the overall net investment for this purpose.

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