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# MFRS Hot Topics

Impairment of available-for-sale equity investments

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Audit | Tax | Advisory

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# Issue

This Hot Topic provides guidance on the application of MFRS 139's impairment rules to investments in equity instruments that are classified as available-for-sale (AFS equity investments).

Relevant MFRS
MFRS 139 Financial Instruments: Recognition and Measurement

# Guidance

### Overview of accounting for AFS equity investments

Investments in equity instruments within the scope of MFRS 139 do not meet the definition of held-to-maturity investments or of loans and receivables. They are therefore classified either as at fair value through profit or loss or as available-for-sale (AFS) financial assets. Under the AFS classification:

- investments are measured initially at fair value plus any directly attributable transaction costs (MFRS 139.43)
- subsequently investments are measured at reporting date fair value* (without deduction for transaction costs) (MFRS 139.46)
- fair value gains and losses are reported in other comprehensive income, except for impairment losses which are reported in profit or loss (MFRS 139.55(b)). See MFRS 139.AG83 regarding the treatment of any foreign exchange component
- gains or losses reported in other comprehensive income are reclassified to profit or loss on de-recognition (MFRS 139.55(b))
- dividends are reported in profit or loss when the right to payment is established (MFRS 139.55(b)).

* except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Such investments are measured at cost less impairment losses (MFRS 139.46(c)).

### When is an AFS equity investment impaired?

An AFS equity investment is impaired when:

- its fair value has declined to below cost **and**
- there is objective evidence of impairment (sometimes referred to as an impairment indicator or trigger)

Entities holding AFS equity investments (or any other financial assets that are not measured at fair value through profit or loss) are required to assess whether there is objective evidence of impairment at each statement of financial position date (MFRS 139.58). The types of objective evidence that may indicate impairment of equity investments are discussed further below.

MFRS 139.60 and MFRS 139.IG.E4.10 make clear that a decline in fair value to less than cost is not necessarily an impairment. The key issue (which will often require the use of professional judgement) is to determine whether a decline in value below cost is accompanied by objective evidence of impairment.

### Example 1 - decline in fair value but not impaired

On 15 March 20X0 Entity A acquires equity instruments in a quoted company whose shares are actively traded. Cost is CU800. The investment is classified as available-for-sale. On 31 March 20X0 (a quarterly reporting date) the quoted price indicates that the fair value has declined to CU750. Entity A's management considers whether there is any objective evidence of impairment and determines that there is not. The decline in value is believed to result from short-term profit-taking and portfolio balancing by large institutional investors.

Based on the facts and circumstances described, these equity investments are not impaired. The decline in fair value of CU50 is reported in other comprehensive income and a debit balance of the same amount is included in the available-for-sale reserve component of equity.

### Objective evidence of impairment for AFS equity investments

Guidance on the events and circumstances that give rise to objective evidence of impairment is set out in MFRS 139.59-61. MFRS 139.59 sets out the main list of indicators. Although these apply to all financial assets within the scope of MFRS 139's impairment rules, in practice most of MFRS 139.59 is more relevant to debt-type assets than to equity investments. The most relevant guidance for equity investments is in MFRS 139.61 which states:

> 'In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.'

In summary, therefore, AFS equity investments whose fair value is less than cost are impaired if:

- adverse developments affecting the investee or operating environment have occurred since acquisition that, individually or collectively, amount to objective evidence of impairment **or**
- the decline in fair value is significant or prolonged (whether or not there is other objective evidence that accompanies or explains the decline).

The reference to a 'significant or prolonged decline' is particularly important. MFRS 139 effectively assumes that such a decline is attributable to events or circumstances that constitute an impairment event. It restricts the ability of the reporting entity to 'second-guess' the market's assessment of value and the prospects for recovery. This requirement can however be difficult to interpret or apply and is discussed further below.

MFRS 139.59(e) and 60 both refer to the disappearance of an active market. Disappearance of an active market as a result of financial difficulties is objective evidence of impairment (eg an issuer may have its shares suspended under local stock exchange rules on announcing an adverse development in its business). Disappearance of an active market because the investments are no longer actively traded is not objective evidence of impairment (e.g. a decision by the issuer to de-list its shares from a stock market).

### Meaning of 'significant or prolonged' decline in fair value

As noted above, a significant or prolonged decline in fair value is objective evidence of impairment. MFRS 139 does not provide any further guidance or quantitative thresholds for 'significant' or 'prolonged'. In the absence of further authoritative guidance, applying these criteria is a matter for professional judgement and we do not have any formal view on how to quantify them. In assessing what is significant or prolonged, entities should consider, among other things, the normal volatility of the equity investment in question. It is also important to note that the reference is to 'significant or prolonged' (emphasis added). We believe that the term 'prolonged' should be assessed based on the period for which fair value has been less than acquisition cost, not (for example) the elapsed time since the value of the investment was at its peak.

**Example 2 - significant but not prolonged decline in fair value**

On 31 August X1 Entity B acquires equity instruments at a cost of CU1,000 and classifies them as available-for-sale. At 30 September X1 (its next reporting date) the fair value has declined to CU600. Entity B's management believes that this is explained by a change in market sentiment towards the investee's sector as a whole. Management is not aware of any other adverse factors affecting the investee or its economic environment that constitute objective evidence of impairment. Management, having regard to the normal volatility of equities in the sector and jurisdiction concerned, generally regard fair value declines as being 'significant' when they exceed 20% and 'prolonged' when they are over 6 months.

Although the fair value decline is not prolonged based on Entity B's normal criteria, it is significant. Accordingly this investment is impaired.

Some companies (although only a minority) have disclosed their own criteria for applying these terms within their accounting policies (or key judgments and estimates disclosures). In the relatively few cases identified where specific criteria have been disclosed, these criteria have fallen within the following ranges:

- 'significant' between 20% and 30%
- 'prolonged' between 9 and 12 months.

This information is included to serve as a potentially useful starting point for discussion, not to set out 'bright lines' or a formal GTI view. As noted above, we believe that application of MFRS 139's criteria is a matter for professional judgement. This requires a careful analysis of the specific facts and circumstances of each case.

## Accounting for impaired AFS equity investments carried at fair value

### Initial impairment

When an AFS equity investment is determined to be impaired, the cumulative loss recorded in other comprehensive income is recognised in profit or loss as a reclassification adjustment. The amount of the impairment loss is the difference between the acquisition cost and the current fair value less any previous impairment losses (MFRS 139.67 and 68). It follows that:

- losses (and gains) are always recognised first in other comprehensive income, and then reclassified to profit or loss when necessary, even when it is clear that the investment is impaired
- the cumulative impairment loss reclassified to profit or loss cannot exceed the decline in fair value below acquisition costs - in other words losses are not 'double-counted'
- the impairment loss is the entire decline in fair value - once the equity investment is impaired there is no basis to split that amount into an impairment loss portion and a non-reclassified portion (eg on the grounds that management believes that some of the decline will be recovered).

### Subsequent increases in fair value

If the fair value of an impaired AFS equity investment subsequently increases (to an amount higher than the carrying value at the date of the original impairment) the carrying value of the asset is increased to its reporting date fair value in the normal way. The gain is reported in other comprehensive income. There is no reversal through profit or loss (MFRS 139.69). In other words MFRS 139 treats gains and losses arising on impaired AFS equity investments differently.

### Subsequent increases in fair value

Once an AFS equity investment is impaired, any further decline in fair value below acquisition cost is also an impairment loss. This is on the grounds that, if the original impairment loss arose because a decline in fair value was viewed as significant or prolonged, any further decline in fair value is even more significant and/or more prolonged. This view is consistent with an IFRIC rejection note of June 2005 that explains:

> 'The IFRIC considered whether to develop guidance on how to determine whether under paragraph 61 of MFRS 139 (as revised in March 2004) there has been a 'significant or prolonged decline' in the fair value of an equity instrument below its cost in the situation when an impairment loss has previously been recognised for an investment classified as available for sale.
>
> 'The IFRIC decided not to develop any guidance on this issue. The IFRIC noted that MFRS 139 referred to original cost on initial recognition and did not regard a prior impairment as having established a new cost basis. The IFRIC also noted that MFRS 139 Implementation Guidance E.4.9 states that further declines in value after an impairment loss is recognised in profit or loss are also recognised in profit or loss. Therefore, for an equity instrument for which a prior impairment loss has been recognised, 'significant' should be evaluated against the original cost at initial recognition and 'prolonged' should be evaluated against the period in which the fair value of the investment has been below original cost at initial recognition. The IFRIC was of the view that MFRS 139 is clear on these points when all of the evidence in the requirements and the implementation guidance of MFRS 139 are viewed together.'

As noted above the total impairment loss recognised in profit or loss does not exceed the cumulative decline in fair value (ie the reporting date fair value less acquisition cost) (MFRS 139.68). Accordingly, when there is a subsequent increase in value followed by a further decrease, the decrease is recorded:

- in other comprehensive income to the extent that it offsets the post-impairment increase recorded in other comprehensive income
- in profit or loss to the extent that the fair value has fallen further below acquisition cost.

The accounting for initial impairment losses and subsequent value changes is illustrated in Example 3 below.

### Example 3 - impairment loss followed by subsequent changes in fair value

Entity X reports quarterly. On 1 October 20X0 Entity X acquires an equity investment at cost and fair value of CU500. The investment is classified as available-for-sale. At the following seven quarterly reporting dates the fair value of the investment is determined to be the amount in the second column of the table below. At 30 September 20X1 the fair value has declined to CU300 and management determines that the investment is impaired. In subsequent quarters the fair value increases, but then decreases.

The table illustrates how the fair value changes and impairment are reported in other comprehensive income (OCI), profit and loss (P&L) and the AFS reserve within equity.

| Date | Cost/fair value | Quarterly change | OCI | P&L | AFS reserve | |
|---|---|---|---|---|---|---|
| 01 Oct 20X0 | 500 | - | | - | - | |
| 31 Dec 20X0 | 550 | 50 | 50 | - | 50 | |
| 31 Mar 20X1 | 510 | (40) | (40) | - | 10 | |
| 30 Jun 20X1 | 480 | (30) | (30) | - | (20) | |
| 30 Sep 20X1 | 300 | (180) | (20) | 200 | - | Note 1 |
| 31 Dec 20X1 | 350 | 50 | 50 | - | 50 | Note 2 |
| 31 Mar 20X2 | 320 | (30) | (30) | - | 20 | Note 3 |
| 31 Jun 20X2 | 290 | (30) | (20) | (10) | - | Note 4 |

**Notes**

1. The net credit of 20 in OCI comprises a loss in OCI of 180 and a reclassification adjustment of 200. The fair value movement in the quarter is first recorded in OCI (Dr OCI 180; Cr asset 180) and then the cumulative decline in fair value below cost is reclassified to P&L (Dr P&L 200; Cr OCI 200).
2. The increase in fair value in this quarter is recorded in OCI because MFRS 139.69 prohibits reversals of impairment losses on equity investments through profit and loss.
3. The decline in fair value in this quarter is recorded in OCI because the cumulative decline in fair value below cost at the quarter end is less than the impairment loss previously recognised in P&L.
4. An additional impairment loss of 10 is recognised in P&L because the fair value has fallen below cost by a total of 210 and impairment losses recognised in P&L previously are 200.

### Frequency of assessment and impairment recognition

One consequence of MFRS 139's asymmetric approach to dealing with impairments and impairment reversals is that the amount of impairment losses recognised may be affected by the frequency of reporting. MFRS 139.58 is clear that the assessment of impairment is required at each statement of financial position date. In our view it is also therefore appropriate to determine the impairment losses to be reclassified from other comprehensive income to profit and loss (if any) with the same frequency. Entities could choose a more frequent assessment basis although we expect this to be rare in practice. Entities that prepare interim financial statements may therefore report higher impairment losses than those that report only on an annual basis.

IFRIC 10 confirms that impairment losses recognised in interim periods on equity investments cannot be reversed in a subsequent interim or annual period (IFRIC 10.8).

**Example 4 - quarterly, half-yearly and annual assessment**

Entity D has a 31 Dec annual reporting date and holds an AFS equity investment that originally cost CU5,000. At 31 Dec X1 the fair value has declined to CU3,000 and an impairment loss of CU2,000 is recognised in profit and loss. At 31 Mar X2 the value has declined further to CU2,500. At 30 Jun X2 the value is CU2,700. At 30 Sep X2 and 31 Dec X2 the value has recovered to CU3,000.

If Entity D reports (or assesses impairment) every quarter, it would record additional impairment losses in Q1 20X2 of CU500, which cannot be reversed through profit or loss in subsequent quarters. If it reports (or assesses impairment) half-yearly, it recognises an impairment loss in H1 20X2 of CU300. If it reports annually and assesses impairment annually, no additional impairment loss is recognised in 20X2.

### AFS equity investments carried at cost

The previous guidance is written in the context of AFS equity investments carried at fair value. Investments in equity instruments that are not quoted in an active market and whose fair value cannot be measured reliably are carried at cost less any impairment loss (MFRS 139.46(c)). However, these investments are strictly in the AFS category and MFRS 139's general principles on impairment apply to them. However, for equity investments carried at cost:

- the 'significant or prolonged decline in fair value' impairment trigger is less relevant in practice given that fair value is not readily available or reliably measurable. Instead, the investor may need to focus more on qualitative and quantitative factors such as the issuer's financial performance (including dividends), financial condition and operations, and its market and economic environment
- if there is objective evidence of impairment, the impairment loss needs to be quantified as an additional exercise (given that the investment's fair value is not routinely determined). Impairment is measured as the difference between the carrying amount of the investment and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (MFRS 139.66)
- impairment losses are not reversed (either through profit and loss or though other comprehensive income) (MFRS 139.66).

# How Grant Thornton can help

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms. If you have any questions about MFRS, kindly be in touch with our team.

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