Guideline on Impairment of an Investment in a Listed Equity Instrument

Introduction

The Institute of Chartered Accountants of Sri Lanka believes that there is a necessity to provide the interpretation on the significant or prolonged decline in the fair value of an investment in an equity instrument below its cost stated in the paragraph 61 of LKAS 39 *Financial Instruments Measurement & Recognition*, to the local context considering the facts and circumstances relevant to the local condition.

Purpose

The purpose of this guideline is to provide the interpretation on the significant or prolonged decline in the fair value of an investment in an equity instrument below its cost as stated in paragraph 61 of LKAS 39 *Financial Instruments Measurement & Recognition.*

This **guideline shall be applied only for the paragraph 61 of LKAS 39 *Financial Instruments Measurement & Recognition.***

Background

In light with the recent market behaviors of Colombo Stock Exchange (CSE), most of the investment appear to have triggered the definition of “Significant & Prolonged”. However, Non-of these investments indicate any other objective evidence/s such as decrease in profits, decrease in revenue, decrease in total assets, decrease in earnings per share, decrease in net assets value per share, etc. to support permanent loss of capital as stated in the paragraph 59 of LKAS 39 *Financial Instruments Measurement & Recognition*.

Issue

LKAS 39 requires entities that hold equity securities classified as Available for Sale (AFS) to assess whether these instruments are impaired. The last sentence of paragraph 61 of LKAS 39 states that, “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 this regard, there is no application guidance on the meaning of ‘significant or prolonged’. The issue is how should ‘significant or prolonged’ be interpreted in Sri Lankan context.

References to the of LKAS 39 *Financial Instruments Measurement & Recognition*

Impairment and uncollectibility of financial assets

An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss. *(Paragraph 58 of LKAS 39)*

Paragraph 59 of LKAS 39 stated that;

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

(a) significant financial difficulty of the issuer or obligor;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

   (i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

   (ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

Paragraph 61 of LKAS 39 stated that;

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.**

Recommendation

As noted in paragraph 61 of LKAS 39, a significant or prolonged decline in fair value is objective evidence of impairment. LKAS 39 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.

The term 'prolonged' should be assessed based on the period for which fair value has been less than acquisition cost. **A general stock market decline over the period of 12 months may not be necessarily considered as 'prolonged' in the Sri Lanka stock market context. A decline of 20%-30% of the fair value of an investment in an equity instrument below its acquisition cost may be considered as "significant".**

As noted above, we believe that application of LKAS 39's criteria is a matter for professional judgement. This requires a careful analysis of the specific facts and circumstances of each case.