

Is Impairment a Compliance Based or a Judgment Based?

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Introduction

X Holdings Limited is one of the investing company which is majorly focusing on investing in subsidiaries, investing in Associates (Quoted and non-quoted investments), investing in joint ventures and other investments (Quoted and non-quoted).

Issue relates with

The issue relates with the investment made by the X Holdings (Investor) in

	Balance as at 31.03.2015
	A
1.1 Investments in Subsidiaries	1,851,674,904
1.2 Investments in Associates	771,484,621
1.3 Investments in Joint Venture	5,020,000
1.4 Other Investments	222,432,128
	2,850,611,653

ordinary shares of D (Pvt) Ltd (Investee) which is a *Non-Quoted company* in Tea exporting industry and while analyzing, It came to light the objective evidence for impairment indications. Since an “impairment test” was carried out with the view to identify whether it is needed to provide or not. **The issue is, even though there were indications for impairment, Client disagreed to allow Auditors to provide against the impairment.**

Discussion of the Issue

- ✓ *Recognition of “other investment “in F/S of X Holdings Limited*
 As per LKAS 39 Financial instrument recognition and measurement,
Other Investment → Financial Asset → Available for sale → NCA
- ✓ *Measurement*
 Typically, Initially at **FV+TC**
 Since no active market for unquoted investment and no reliable measurement, initially has been measured at cost.
- ✓ *Identification of indications for impairment*
 1. By comparing the Proportionate net assets with the Carrying value of the investment as follow

Company	Holding % by X Holdings Ltd	Net assets of D (Pvt) Ltd as at 31.03.2015	Net Assets for the X Holdings	C/V of investment of X Holdings as at 31.03.2015	Net assets over carrying value	Impairment indicator
	A	B	C=A*B	D	E=C-D	
D (pvt) Ltd	7.20%	1,748,579,798	125,897,745	222,432,128	(96,534,383)	√

- Since the C/V of the investment is more than the Net assets of the company, there is an implication for the impairment.
- 2. Investee getting continuous losses for past three years.
- 3. Current Tea industry depression.
- 4. Current liabilities more than current Assets
- 5. Serious loss of capital

Indications for impairment are available as per above.

✓ *Client argument for disagreement to provide for impairment*

Investee planned to issue "Cumulative redeemable preference shares" in near future. As a result of that the Net asset of the investee will be impacted to be increased and will cause to vanish the impairment indications.

✓ *Auditors argument against client*

LKAS 32 Financial instrument: "Presentation 32 (a) page number 793, Cumulative redeemable preference shares are not an equity component but a liability component. (Will be settled by cash in future)

✓ *Is there any impairment Loss really?*

So X Holdings (Investor) limited was asked to do an assessment for impairment. X Holding came up with the Business plan of the D (Pvt) Ltd which is going to expand green Tea market in Sri Lanka by importing a tea bag producing machine out of the funds raised from issuance of Preference shares.

✓ *Will the business plan be a viable in future as per our professional judgment?*

- Auditors analyzed past sales trends and independently forecast by confirming the reasonability of the assumptions they applied. There is a huge variance between auditors' forecasting and the client forecasting.
- In Sri Lankan culture there is no much more demand for Green tea. Client much more incurred cost on marketing expenses. Effectiveness of the marketing of this product is less as per our professional judgment. Because it is difficult to change the thinking pattern and their habits of people in Sri Lankan culture.
- For the Green tea there is a specific targeted group which will not be changed as per recent market analysis.
- There is a Tea market depression these days due to low oil prices. There is a going concern issue in the industry (As per article of BBC and Sri Lanka Tea Development Board)

Implication of the Issue

Then, as per the professional knowledge and the judgment, it was concluded that the business plan will not be a viable in future as far as their aspiration. Since based on Auditors independent analysis of the cash flows of the business plan, it

was arrived to the Fair value of the business of D (Pvt) Ltd (Investee) by using Net Present Value (NPV) of the forecasted cash flows as follow.

* Total value of the firm at 9.57%	1,428,001,206	A
Total No of shares	100,093,693	B
Value per share in LKR	14.27	C=(A/B)
X Holdings share holding %	7.20%	D
X Holdings share holding	7,206,746	E=(B*D)
Fair value of investment	102,816,087	F=(E*C)
Carrying value of investment	222,432,128	

Book value of the Investment 

*Total Value of the firm = PV of the future Cash Flows

<p>Impairment Loss/ (Gain) = Carrying value of the Investment - PV of future Cash flows</p> <p style="text-align: center;">= 222,432,128 - 102,816,087</p> <p style="text-align: center;">= 119,616,041</p>
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As per LKAS 39 Financial instrument recognition & measurement paragraph 66,

Conclusion and Recommendation

Based on the professional judgment and knowledge, it was concluded that the X Holdings should identify the impairment loss on their financial statement as follows.

P & L	Dr	119,616,041
Investment	Cr	119,616,041

While Auditors making decisions on such provision for impairment for Available for Sale (AFS) assets, essential to be smart enough to use the professional Knowledge and judgment accurately. Because, once if impairment loss is charged to the P&L can't be reversed again (Since the Fair Value increment is adjustable to equity) and will be highly impacted to the financial statement of the client.

Since it would be concluded that the impairment loss was identified based on the professional knowledge & the judgment of Auditors. Hence,

“Impairment is not a compliance based but it is a judgment based”