Grant Thornton

Technical Accounting Alert

Impairment of available-for-sale equity investments

Issue

This alert provides guidance on the application of IAS 39's impairment rules to investments in equity instruments that are classified as available-for-sale (AFS equity investments).

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial instruments: Recognition and Measurement	AASB 139 Financial instruments: Recognition and Measurement
IAS 1 Presentation of Financial Instruments	AASB 101 Presentation of Financial Statements
IFRIC 10 Interim Financial Reporting and Impairment	Interpretation 10 Interim Financial Reporting and Impairment

Guidance

Overview of accounting for AFS equity investments
Investments in equity instruments within the scope of IAS 39 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 (IAS 39.43).
- subsequently investments are measured at reporting date fair value* (without deduction for transaction costs) (IAS 39.46).
- fair value gains and losses are reported in other comprehensive income (or directly in equity prior to adoption of the 2007 amendments to IAS 1), except for impairment losses which are reported in profit or loss (IAS 39.55(b)). See IAS 39.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 (IAS 39.55(b)).
- dividends are reported in profit or loss when the right to payment is established (IAS 39.55(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 (IAS 39.46(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 assessments (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 balance sheet date (IAS 39.58). The types of objective evidence that may indicate impairment of equity investments are discussed further below.

IAS 39.60 and IAS 39.IG.E.4.10 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 15.3.20X0 Entity A acquires equity instruments in a quoted company whose shares are actively traded. Cost is $800. The investment is classified as available-for-sale. On 31.03.20X0 (a quarterly reporting date) the quoted price indicates that the fair value has declined to $750. 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 $50 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 IAS 39.59 - 61. IAS 39.59 sets out the main list of indicators. Although these apply to all financial assets within the scope of IAS 39's impairment rules, in practice most of IAS 39.59 is more relevant to debt-type assets than to equity investments. The most relevant guidance for equity investments is in IAS 39.61 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. IAS 39 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.

IAS 39.59(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 (eg 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. IAS 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 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 31.08.X1 Entity B acquires equity instruments at a cost of $1,000 and classifies them as available-for-sale. At 30.09.X1 (its next reporting date) the fair value has declined to $600. 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 Grant Thornton view. As noted above, we believe that application of IAS 39'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 (IAS 39.67 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 (IAS 39.69). In other words IAS 39 treats gains and losses arising on impaired AFS equity investments differently.

Subsequent declines 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 IAS 39 (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 IAS 39 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 IAS 39 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 IAS 39 is clear on these points when all of the evidence in the requirements and the implementation guidance of IAS 39 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) (IAS 39.68). 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; and
- 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 1.10.20X0 Entity X acquires an equity investment at cost and fair value of $500. 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 30.09.X1 the fair value has declined to $300 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.

	Cost/fair	**Quarterly**	**Reported in**		**AFS**	
Date	**value**	**change**	**OCI**	**P&L**	**reserve**	
	$	***$***	***$***	***$***	***$***	
01.10.20X0	500	-	-	-	-	
31.12.20X0	550	50	50	-	50	
31.03.20X1	510	(40)	(40)	-	10	
30.06.20X1	480	(30)	(30)	-	(20)	
30.09.20X1	300	(180)	20	(200)	-	Note 1
31.12.20X1	350	50	50	-	50	Note 2
31.03.20X2	320	(30)	(30)	-	20	Note 3
31.06.20X2	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 IAS 39.69 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 IAS 39'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. IAS 39.58 is clear that the assessment of impairment is required at each balance sheet 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 31.12 annual reporting date and holds an AFS equity investment that originally cost $5,000. At 31.12.X1 the fair value has declined to $3,000 and an impairment loss of $2,000 is recognised in profit and loss. At 31.03.X2 the value has declined further to $2,500. At 30.06.X2 the value is $2,700. At 30.09.X2 and 31.12.X2 the value has recovered to $3,000.

If Entity D reports (or assesses impairment) every quarter, it would record additional impairment losses in Q1 20X2 of $500, 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 $300. 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 (IAS 39.46(c)). However, these investments are strictly in the AFS category and IAS 39'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 (IAS 39.66)
- impairment losses are not reversed (either through profit and loss or though other comprehensive income) (IAS 39.66).

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au