Newsletter
Professional, Technical, Risk & Quality Group

PRICEWATERHOUSECOOPERS

January 12, 2010

Available for Sale Equity Investments – Impairment Reminders

While stock markets have increased from their lows in March 2009, many entities still are reporting losses in accumulated other comprehensive income for individual investments in available-for-sale equity securities, i.e. the fair value of these investments still is less than their cost basis. For these investments, management should be assessing whether an impairment loss exists that should be recognized in net income. In this memorandum, we provide reminders of the key questions that management should be considering in making such assessments.

1. When should an entity recognize an impairment loss in net income?

When all of the following criteria are met:

(a) A decline in the fair value of an investment has been recognized in accumulated other comprehensive income at the balance sheet date.[1]
(b) Objective evidence of impairment exists at that date.
(c) The impairment is other than temporary.

Criterion (b) above was taken from International Financial Reporting Standards ("IFRS"). Criterion (c) was taken from US GAAP.

2. What is "objective evidence of impairment"?

Essentially, objective data that comes to the attention of the investor indicating that events have occurred that can be reasonably expected to adversely affect the future cash flows of the security. CICA 3855.A67- A69 provides examples of objective evidence of impairment, including in the case of equity investments, a significant or prolonged decline in fair value. Determining whether such declines have occurred is an important consideration in impairment assessments of available-or-sale equity investments.

3. What does the phrase a "significant or prolonged decline in fair value" mean?

Section 3855 does not provide any guidance on how this phrase should be interpreted or applied. The International Financial Reporting Interpretations Committees of the IASB ("IFRIC") has made the following observations about the equivalent requirement in IAS 39, Financial *Instruments – Recognition and Measurement*, which we believe are relevant in making assessments under Canadian GAAP.

[1] Criterion (a) applies to those AFS investments that are carried at fair value on the balance sheet. For AFS investments carried at cost (because they are non-quoted) criteria), (b) and (c) would be applied.

2005 observations –

- Whether a decline in fair value is significant should be evaluated against the original cost of the investment at initial recognition; whether a decline is prolonged should be evaluated against the period in which the fair value has been below that original cost.

2009 observations –

- IAS 39 cannot be read to mean that a decline must be both significant and prolonged to justify the recognition of an impairment. Recognition is necessary when either of these conditions exist.
- The fact that the decline in the value of an investment is in line with the overall level of decline in the relevant market does not mean that an entity can conclude that the investment is not impaired.
- If an investment is listed in a foreign market, it is not appropriate to assess whether a decline is "significant or prolonged" in the currency of that market. Rather, the assessment must be made in the functional currency of the entity holding the investment because that is how any impairment loss is determined.
- The determination of what constitutes a significant or prolonged decline is a matter of fact that requires the application of judgment.

4. Are there any bright line tests for determining whether a decline is significant or prolonged?

No.

5. What does the phrase "other than temporary decline in fair value" mean?

Section 3855 does not provide any guidance on how this term should be interpreted or applied. The *Basis for Conclusions* to Section 3855 states that the AcSB would have preferred not to include the notion of "other than temporary" in the impairment tests, but concluded that it was necessary to do so in the interest of harmonization with US standards.

In March 2009, staff of the SEC issued amended Staff Accounting Bulletin 111, *Other than Temporary Impairment of Certain Investments in Equity Securities*. SAB 111 states:

> The value of investments in equity securities classified as available-for-sale may decline for various reasons. The market price may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting on the premise that a write down may be required, management should consider all available evidence to evaluate the realizable value of its investment in equity securities classified as available for sale.
>
> There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline in value of an equity security classified as available-for-sale is other than temporary and that a write down of the carrying value is required:
>
> (a) The length of time and the extent to which the market value has been less than cost;
>
> (b) The financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earning potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential;
>
> (c) The intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.
>
> Unless evidence exists to support a realizable value equal to or greater than the carrying amount of the investment in equity securities classified as available-for-sale, a write down to fair value accounted for as a realized loss should be recorded.

We believe that the factors identified in the SEC discussion are also relevant in making other than temporary impairment assessments under Section 3855.

6. Are there any bright line tests in the authoritative accounting literature that can be used to determine whether a duration or extent of a decline in the fair value of an investment is so significant that the decline should be presumed to be other than temporary?

No.

7. How should an entity recognize an impairment loss that is required to be recognized in net income?

For investments carried at fair value on the balance sheet, by transferring the decline in fair value of the investment that has been accumulated in other comprehensive income on the balance sheet date to net income.

For investments carried at cost on the balance sheet, in the absence of evidence that an alternative fair value estimate is possible, the impairment could be based on the difference between the present value of expected cash flows discounted at the current market rate of interest for a similar financial asset and the carrying amount of the investment.

8. Are there specific disclosure requirements relating to impairments in Section 3862, *Financial Instruments – Disclosure*?

Yes. Paragraph 3862.37(b1) states:

> When objective evidence of impairment exists for certain financial assets but an impairment loss has not been recognized in net income because the decline in recoverable amount (in the case of financial assets measured at cost) or fair value (in the case of all other financial assets) is not other than temporary, that fact, the information (both positive and negative) the entity considered in reaching the conclusion that the decline is not other than temporary, and
>
> (i) For financial assets measured at cost or amortized cost, the carrying amount and fair value of either the individual assets or appropriate groupings of those individual assets; and
>
> (ii) For available-for-sale financial assets measured at fair value, the amount of the cumulative loss related to the asset in accumulated other comprehensive income.