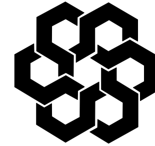

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **21 June 2007, London**

Project: **Annual Improvements**

Subject: **IAS 28 – Impairment of investment in associate (Agenda paper 12D)**

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1. The Board considered a proposed Annual Improvement at the May 2007 Board meeting relating to the impairment of an investment in an associate. The Board decided that an impairment measured against an investment in an associate after equity accounting has been applied, is not allocated to any goodwill included in the investment balance. It also decided that this impairment shall be reversed if the recoverable amount of the investment subsequently increases.

2. The Board asked the staff to consider whether the impairment test of the associate should be performed by applying the guidance in IAS 36 or IAS 39. The IAS 36 impairment test differs from the IAS 39 test by permitting an entity-specific value (value in use) to be considered when determining recoverable amount.

Issue: Should an investment in an associate which is accounted for using equity accounting, be tested for impairment in accordance with IAS 36 or IAS 39?

Staff recommendation

3. The staff recommends that:

- an investment in an associate be tested for impairment in accordance with IAS 36; and
- the Board should amend IAS 28 as proposed in paragraph 21 of this paper.

Background

4. The Board asked the staff to consider whether the impairment test of the associate should be performed by applying the guidance in IAS 36 or IAS 39. The IAS 36 impairment test differs from the IAS 39 test by permitting an entity-specific value (value in use) to be considered when determining recoverable amount.

5. It may be helpful to understand why such an impairment might arise when assessing which standard should be applied.

IAS 28 impairment testing guidance

6. Paragraph 31 of IAS 28 requires that impairment testing of the investor's net investment in the associate is performed only after the equity method has been applied.

7. Applying the equity method requires the investor to 'make appropriate adjustments' to its share of the associate's profits or losses to reflect, for example, additional depreciation based on the fair values of the assets at acquisition date (IAS 28.23). Applying the equity method also requires the investor to make appropriate adjustments to its share of the associate's profits or losses for impairment losses recognised by the associate for items such as goodwill or property, plant and equipment (IAS 28.23).

8. The staff notes that the fair value of an associate's assets at acquisition date will usually exceed the carrying amount of those assets. The staff understands the guidance in IAS 28.23 to mean that the difference between the fair values of the associate's assets at acquisition date and the book values of those assets in the associate's own accounting records will give rise to an increased impairment charge as part of equity accounting if the associate recognises an impairment against those assets. Thus the investor will recognise a lower share of profit or larger share of loss.

9. An equivalent effect arises in respect of the goodwill included in the investment in the associate. An impairment charge recognised by the associate might give rise to an increased impairment charge as part of the investor's equity accounting.

10. Recognising additional depreciation/amortisation and additional impairment charges through applying the equity method will result in the carrying value of the investment in the associate being no greater than the sum of the recoverable amounts of the associate's underlying net assets. However, IAS 28 paragraph 31 contemplates the need for a separate impairment test after the application of equity accounting.

11. The staff understands that this additional impairment test is required in circumstances where the investor is not able to fully realise the carrying amount of its investment because it does not have direct access to the underlying cash flows of the associate. It must therefore rely on the ability to receive dividends and/or sell its interest in the associate to recover its investment. The use of the IAS 39 impairment indicators in identifying the need for an additional impairment test is consistent with this understanding.

12. The guidance on impairment indicators in IAS 39 (paragraphs 58-62) is included in Appendix A to this paper. This guidance includes the following examples of objective evidence:

    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).

Issue

13. The Board decided at the May 2007 Board meeting that any impairment recognised by an investor against an associate when it applies the additional impairment test described above shall not be allocated to goodwill and other underlying assets of the associate and there shall be no restrictions on the reversal of the impairment charge to the extent that the recoverable amount subsequently increases.

14. The question to be considered by the Board is whether this additional impairment test should be performed in accordance with IAS 36 or IAS 39. The distinction between the two tests being that IAS 36 considers an entity-specific recoverable amount (value in use) as well as fair value. It is therefore necessary to consider whether it is possible for an investor to determine an

entity-specific value in use for the associate that would differ from the investment's fair value.

15. Fair value less costs to sell is defined as the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal [IAS36.6]. Value in use is defined as the present value of the future cash flows expected to be derived from an asset or a cash-generating unit [IAS36.6]. Value in use should reflect management's best estimates of future cash flows [IAS36.33-38].

16. The staff believes there are circumstances in which value in use may give a different recoverable amount from fair value. These include:
- the use of internal information regarding the associate's budgets and forecasts that is available to the investor because of its significant influence but not publicly available and therefore not reflected in a market participant's determination of fair value
- the ability to use its significant influence to participate in decisions such as investment policy and dividend policy and thus achieve a greater outcome than might be expected by a market participant that does not have such influence.

Staff recommendation

17. The staff believes that an entity-specific value is determinable for an investment in an associate and accordingly that IAS 36 is the appropriate standard to apply when testing for impairment.

18. **Does the Board agree?**

19. If the Board does agree that IAS 36 should be applied, the staff recommends that the wording of paragraph 33 of IAS 28 be amended as proposed in paragraph 21 of this paper.

20. **Does the Board agree?**

Drafting

21. The staff recommend that IAS 28 should be amended as follows:

Impairment losses

…

33 Because goodwill included in the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36 *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested ~~under~~ in accordance with IAS 36 for impairment as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired. Any additional impairment loss recognised is not allocated to the goodwill and other assets included in the investment in the associate. Accordingly any reversals of the additional impairment loss are recognised to the extent that the recoverable amount of the investment subsequently increases. In determining the value in use of the investment, an entity estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions, both methods give the same result.

Basis for Conclusions on Proposed Amendments to IAS 28 Investments in Associates

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Impairment losses

BC1 The Board has identified unclear guidance in IAS 28 regarding the extent to which impairment reversals shall be recognised as an adjustment to an investment in an associate.

BC2 The Board noted that applying the equity method includes reflecting the impact of acquisition date fair values on the investor's share of impairment losses recognised by the associate against assets such as goodwill or property, plant and equipment. The Board decided that any additional impairment recorded by the investor, after applying the equity method, shall not be allocated against any goodwill included in the investment balance. Such an impairment charge shall therefore be reversed in a subsequent period to the extent that the recoverable amount of the associate increases.

BC3 The Board has decided to address this ambiguity by clarifying that an investment in an associate is treated as a single asset for impairment testing. It also decided to specify that any additional impairment loss is not allocated against any goodwill or other assets included in the investment balance. Accordingly reversals of the additional impairment shall be recognised as an adjustment to the investment in the associate to the extent that the recoverable amount of the associate increases.

Appendix A: IAS 39 guidance on indicators of impairment of financial assets

Impairment and uncollectibility of financial assets

58 An entity shall assess at each balance sheet date 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.

59 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).

60 The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

61 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.

62 In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.