

EQUITY INSTRUMENTS - IMPAIRMENT AND RECYCLING

EFRAG DISCUSSION PAPER
MARCH 2018



 **EFRAG**

European Financial Reporting Advisory Group

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European Financial Reporting Advisory Group ('EFRAG') issued this Discussion Paper.

Copies of the Discussion Paper are available from EFRAG's website.

EFRAG welcomes comments on proposals explored in this paper via the 'Questions to Constituents' section. Such comments should be submitted through the EFRAG website by clicking [here](#) or should be sent by post to:

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Comments should arrive by no later than 25 May 2018. All comments received will be placed on the public record unless confidentiality is requested.

EFRAG RESEARCH ACTIVITIES IN EUROPE

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin our research work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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EXECUTIVE SUMMARY

- ES1 International Financial Reporting Standard 9 ('IFRS 9') *Financial Instruments* is effective for annual periods beginning on or after 1 January 2018. Entities undertaking insurance activities are permitted to apply IFRS 9 on or after 1 January 2021. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may however make an irrevocable election to present changes in the fair value in other comprehensive income ('OCI') on an instrument-by-instrument basis (the 'FVOCI election'). This FVOCI election is not available for equity instruments that are held for trading or contingent consideration recognised by an acquirer in a business combination. If an entity applies the FVOCI election, it does not assess these instruments for impairment and cannot reclassify in profit and loss gains or losses previously recognised in OCI on disposal of these instruments – also referred to as 'recycling'.
- ES2 In its endorsement advice on IFRS 9, EFRAG expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling might not properly reflect their performance. The International Accounting Standards Board ('IASB') explained that gains and losses on instruments subject to the FVOCI election should be recognised only once in comprehensive income. Furthermore, the IASB noted that allowing recycling would create the need to assess these equity instruments for impairment and noted that the impairment requirements for available-for-sale ('AFS') equity instruments in IAS 39 *Financial Instruments: Classification and Measurement* had created application problems.
- ES3 The European Commission ('the EC') requested EFRAG to investigate the potential effects on long-term investment of IFRS 9's requirements on accounting for equity instruments. The full EC request is provided in Appendix 1 and is summarised below.
- ES4 In the first phase of the project ('the assessment phase'), the EC asked EFRAG to collect quantitative data on the current holdings of equity instruments in Europe and their accounting treatment and investigate whether entities expect that the new accounting requirements will affect their decisions in relation to investment in equity instruments. EFRAG reported its findings from this phase to the EC in January 2018 and presents a summary of the main findings in Appendix 2. The assessment phase indicated that some entities that consider themselves long-term investors expect to modify their asset allocation decisions as a result of IFRS 9's requirements (although most did not specify to what extent), while others do not.
- ES5 In the second phase of the project, the EC asked EFRAG to provide advice on whether and how IFRS 9's requirements on accounting for holdings of equity instruments could be improved. As part of its due process, EFRAG is now publishing this Discussion Paper ('DP') to gather constituents' views on recycling and impairment of equity instruments designated at FVOCI. EFRAG has not included a preliminary view on the issues explored in this DP but will consider the feedback from constituents in developing its technical advice to the EC.
- ES6 In this DP, EFRAG analyses the relevance of recycling in the context of a long-term investment business model. It also presents arguments on the conceptual relationship between recycling gains and losses on derecognition and recognising impairment losses (which would create the need to develop an impairment model for this category of financial instruments).

- ES7 The issues explored in this DP relate to the specific questions in the EC's request for advice. Other aspects of the requirements of IFRS 9 on accounting for holdings of equity instruments have not been explored.
- ES8 The DP illustrates two models for equity instruments carried at FVOCI:
- a) a revaluation model, in which all declines in fair value below the acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI and recycled on disposal; and
 - b) an impairment model similar to the model of IAS 39 for equity instruments classified as available-for-sale ('AFS'), but with additional guidance to reduce subjectivity.
- ES9 The DP does not express a preliminary view as to which, if either, of these two models is preferable. The DP does however explain the implications of each model. Both models were developed with the aim of being less subjective than IAS 39's impairment model for equity instruments classified as AFS.
- ES10 This DP also considers other aspects relevant to the two models, including:
- a) subsequent recoveries in fair value;
 - b) the use of rebuttable presumptions for recognising impairment losses instead of quantitative triggers;
 - c) the unit of account in applying the models;
 - d) interaction with hedging requirements and the effects of changes in foreign exchange rates; and
 - e) timing of impairment tests and interaction with interim reporting.

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this DP, particularly in relation to the questions set out below. Comments are more helpful if they:

- a) address the question as stated;
- b) indicate the specific paragraph reference to which the comments relate; and/or
- c) describe any alternative approaches EFRAG should consider.

EFRAG should receive all comments **by 25 May 2018**.

EFRAG has not expressed a preliminary view on the issues explored in this DP. The objective of the DP is to obtain feedback from constituents that EFRAG will consider in developing its technical advice to the EC.

QUESTION 1 - RECYCLING GAINS OR LOSSES ON DISPOSAL

The Basis for Conclusions to IFRS 9 (paragraph BC5.25(b)) explains why IASB decided not to allow recycling when equity instruments are carried at FVOCI. EFRAG has previously argued that recycling enhances the relevance of the financial information provided to users of financial statements.

The DP (paragraphs 2.3 – 2.10) presents arguments as to why the recycling of cumulative gains or losses into profit or loss on disposal of equity instruments carried at FVOCI might improve the depiction of the financial performance of long-term investors.

Q1.1 What are your views on the arguments presented in paragraphs 2.3 – 2.10? Do you consider that the reintroduction of recycling would improve the depiction of the financial performance of long-term investors? Alternatively, do you consider that the existing requirements of IFRS 9 provide an adequate depiction? Please explain.

QUESTION 2 - CONCEPTUAL RELATIONSHIP BETWEEN RECYCLING AND IMPAIRMENT

The DP (paragraphs 2.11 – 2.17) discusses the relevance of an impairment model for equity instruments carried at FVOCI.

Q2.1 What are your views on the arguments presented in paragraphs 2.11 – 2.17? Do you consider that, from a conceptual standpoint, recycling should be accompanied by some form of impairment model? Please explain.

QUESTION 3 - ENHANCING PRESENTATION AND DISCLOSURE REQUIREMENTS

The DP (Chapter 3) discusses whether and how presentation and disclosure requirements could provide better information on performance from a long-term investing perspective, including potential impairments of equity instruments. The DP presents arguments as to why enhanced presentation and disclosure requirements might not be an adequate substitute for improving the depiction of performance in profit or loss.

Q3.1 What are your views on the arguments and analysis presented in Chapter 3 of the DP?

Q3.2 Are there other improvements in presentation and disclosure that you would support?

QUESTION 4 - TWO MODELS

The DP (paragraphs 4.4 – 4.22) describes two models for equity instruments carried at FVOCI:

- a revaluation model in which all declines in fair value below the acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI and recycled on disposal; and
- an impairment model similar to the model of IAS 39 for equity instruments classified as AFS, but with additional guidance to reduce subjectivity.

Q4.1 What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?

Q4.2 Which, if either, of the two models do you prefer? Please explain.

Q4.3 Do you have suggestions for a model other than those presented in the DP? If so, please describe it and explain why it would meet characteristics such as relevance, reliability and comparability.

QUESTION 5 - QUANTITATIVE IMPAIRMENT TRIGGERS

The DP (paragraphs 4.12 – 4.22) discusses the inclusion of quantitative impairment triggers in its impairment model. Triggers reduce the extent of judgement in assessing whether a decline in fair value below cost represents objective evidence of an impairment, especially if set within the IFRS Standard. This enhances comparability (across entities and over time) but may reduce relevance.

Q5.1 Do you support the inclusion of quantitative impairment triggers in an impairment model? If so, should an IFRS Standard specify the triggers, or should management determine them?

Q5.2 If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

QUESTION 6 - SUBSEQUENT RECOVERY IN FAIR VALUES

The DP (paragraphs 5.2 – 5.10) considers whether subsequent recoveries of fair value should be recognised through profit or loss and illustrates some different reversal mechanisms.

Q6.1 How should subsequent recoveries in fair values be accounted for? Please explain.

Q6.2 If subsequent recoveries in fair values are recognised in profit or loss, which of the approaches in paragraphs 5.2 – 5.10 do you support and why?

QUESTION 7 - OTHER CONSIDERATIONS

The DP discusses a number of other relevant considerations, including:

- whether an IFRS Standard should introduce specific requirements for particular sub-sets of equity instruments and, if so, how these sub-sets should be defined (paragraphs 4.23 – 4.29). EFRAG has not developed this approach further;
- the use of rebuttable presumptions for recognising impairment losses instead of automatic triggers (paragraphs 5.11 – 5.13);
- the unit of account in applying the models (paragraphs 5.14 – 5.24); and
- other application issues (paragraphs 5.25 – 5.40).

Q7.1 Do you consider that the same model should apply to all equity instruments carried under the FVOCI election? If not, why not and how would you objectively identify different portfolios?

Q7.2 Do you have comments on these other considerations?

Q7.3 Are there other aspects that EFRAG should consider?

QUESTION 8 - OTHER ASPECTS OF IFRS 9'S REQUIREMENTS ON HOLDINGS OF EQUITY INSTRUMENTS

The DP (paragraphs 1.15 – 1.16) explains that the scope of EFRAG's project is based on the specific questions in the EC's request for advice and that other aspects of IFRS 9's requirements on accounting for holdings of equity instruments have not been explored.

Q8.1 Are there other aspects of IFRS 9's requirements on accounting for holdings of equity instruments, in addition to those considered in the DP, which in your view are relevant to the depiction of the financial performance of long-term investors? Please explain.

CHAPTER 1: OBJECTIVE AND BACKGROUND

THE OBJECTIVE OF THE DISCUSSION PAPER

- 1.1 The main objective of this Discussion Paper ('the DP') is to gather constituents' views on the treatment of equity instruments designated at FVOCI in accordance with IFRS 9 – specifically the treatment of gains/losses on derecognition and negative changes in fair value below the original acquisition cost ('holding losses').
- 1.2 The DP refers to 'impairment'. In the context of this DP, 'impairment' is generally used to describe an event or set of circumstances in which a negative change in fair value is presented in profit or loss prior to the instrument's derecognition; and 'impairment loss' refers to the recognition of the negative change in profit or loss.

THE ACCOUNTING REQUIREMENTS IN IAS 39 AND IFRS 9 FOR EQUITY INSTRUMENTS

- 1.3 The IASB issued IFRS 9 in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. Entities undertaking insurance activities are permitted to apply IFRS 9 or on after 1 January 2021. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI election'). This FVOCI election is not available for equity instruments that are held for trading or contingent consideration recognised by an acquirer in a business combination. The entity may apply the FVOCI election on an instrument-by-instrument basis.
- 1.4 If the entity applies the FVOCI election, changes in fair value are presented in other comprehensive income ('OCI'). These changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess these instruments for impairment. However, dividends that are a return on investment from the instruments are recognised directly in profit or loss.
- 1.5 Under IAS 39, equity instruments, other than those held-for-trading, were classified as Available-for-Sale ('AFS'). These instruments were measured at fair value (subject to an exemption to use cost for equity securities that do not have a quoted market price in an active market and for which fair value cannot be reliably measured) and changes in fair value were presented in OCI. However, AFS accounting under IAS 39 differs from the accounting under IFRS 9's FVOCI election in the following ways:
 - a) under IAS 39, an entity was required to assess at the end of each reporting period whether there was any objective evidence that an equity instrument classified as AFS was impaired. When an entity assessed that an instrument was impaired, the decrease in value below the original historical cost was reclassified to profit or loss as an impairment loss. Impairment losses should not be subsequently reversed;
 - b) under IAS 39, the cumulative gain or loss in OCI was recycled to profit or loss on disposal; and
 - c) IFRS 9 does not provide an exemption from fair value for equity securities that do not have a quoted market price in an active market and for which fair value cannot be reliably measured.
- 1.6 Accordingly, the impact of the change in requirements for equity instruments previously classified as AFS is the following:
 - a) if these instruments are carried at FVPL under IFRS 9, all changes in fair value in each period are recognised in profit or loss of that period; or
 - b) if these instruments are designated in accordance with IFRS 9's FVOCI election, changes in fair value are never recognised in profit or loss.

- 1.7 In the Basis for Conclusions to IFRS 9, the IASB concluded that gains and losses on instruments subject to the FVOCI election should be recognised only once in comprehensive income, and noted that recycling would create the need to assess these equity instruments for impairment. The IASB explained that the impairment requirements for equity instruments classified as AFS under IAS 39 were very subjective and had created application problems.

WHAT ARE WE LOOKING AT, AND WHY?

- 1.8 In its Endorsement Advice to the European Commission ('the EC') on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance. EFRAG had previously stressed the importance of profit or loss as a main indicator of financial performance.
- 1.9 If neither option in IFRS 9 is attractive to some long-term investors, there may be a disincentive for those investors to hold equity instruments on a long-term basis. In its endorsement advice, based on the limited evidence available at that time, EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of IFRS 9. EFRAG noted that broader economic considerations, such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders, are likely to outweigh any accounting concerns.
- 1.10 The EC completed the endorsement process of IFRS 9 with the adoption of Commission Regulation No 2016/2067 on 22 November 2016. During the endorsement process, the European Parliament and some Member States called for close monitoring of the impact of IFRS 9 to ensure that it serves the European Union's long-term investment strategy.
- 1.11 After the completion of its 2015 Agenda consultation, EFRAG added a project on equity instruments to its work plan, specifically related to recycling and impairment of investments in equity instruments with an objective to consider alternative models for the impairment of equity instruments.
- 1.12 In May 2017, EFRAG received a request from the EC for technical advice. The EC request is provided in Appendix 1. The request has two distinct phases:
- a) in the first phase ('the assessment phase'), the EC requests EFRAG to investigate the significance of the equity portfolio for long-term investors under IAS 39 and whether the new requirements in IFRS 9 are expected to affect asset allocation decisions; and
 - b) in the second phase, the EC requests EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is an important element in order to re-introduce recycling, then EFRAG should consider how the impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches. The EC also requests EFRAG to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could enable users to form a view about the performance of the equity investments.
- 1.13 EFRAG reported its findings from the assessment phase to the EC in January 2018 and presents a summary of the main findings in Appendix 2. The assessment phase has indicated that for some entities that consider themselves long-term investors, the aggregate amount/value of equity instruments classified as AFS under IAS 39 is substantial. On the other hand, some other entities that also consider themselves as long-term investors make little or no use of the AFS classification and as a result, they will not be affected by IFRS 9's requirements.

- 1.14 In terms of the impact of IFRS 9 on respondents' decisions to invest and hold equity instruments or other class of assets, most respondents indicated that a variety of factors, including business, economic and regulatory factors, affect such decisions. However, almost half of the respondents (mainly insurance entities) reported that they expect to modify their asset allocation decisions as a result of IFRS 9's requirements, although most did not specify to what extent.
- 1.15 In order to respond to second phase of the EC request, and as part of its due process, EFRAG is now publishing this DP to obtain input from constituents on the topic. EFRAG has not included a preliminary view on the issues explored in this DP. EFRAG will consider feedback from constituents in developing its technical advice to the EC.
- 1.16 EFRAG is addressing the research questions specifically raised in the request for technical advice. Other aspects of IFRS 9, including its requirements on accounting for holdings of equity instruments beyond recycling and impairment when the FVOCI election applies, are outside of the scope of this project. Accordingly, the DP does not discuss the following aspects of IFRS 9:
- a) the use of fair value as the measurement basis for all equity instruments in the statement of financial position;
 - b) the existence of the FVOCI election for equity instruments and its availability for all equity instruments apart from held-for-trading and contingent consideration; or
 - c) the definition of 'equity instrument' or the IASB's decision to limit the availability of IFRS 9's FVOCI election to instruments meeting that definition.
- 1.17 EFRAG's deliberations leading to this DP took place before the publication of the final report of the High-Level Expert Group on Sustainable Finance to the EC on 31 January 2018. The final report recommends, among other things, to investigate alternative accounting approaches to fair value/mark-to-market valuation for long-term investment portfolios of equity and equity-type instruments.

STRUCTURE OF THE DP

- 1.18 In **Chapter 2** EFRAG discusses the relevance of recycling and impairment.
- 1.19 In **Chapter 3** EFRAG considers whether there could be alternative ways to improve IFRS 9's reporting of financial performance via enhanced presentation and disclosure. EFRAG provides examples of how presentation and disclosure could be used to provide information in relation to performance, including impairment losses.
- 1.20 **Chapter 4** presents EFRAG's considerations in developing an impairment model for equity instruments and explains that EFRAG has focused on two accounting models under which some holding losses are recognised in profit or loss. The chapter illustrates how these models work and their implications.
- 1.21 In **Chapter 5**, EFRAG discusses the following other considerations and application issues related to the models proposed in Chapter 4:
- a) how subsequent recoveries in fair value ('reversals') are accounted for;
 - b) the use of rebuttable presumptions for the recognition of impairment losses, instead of quantitative triggers;
 - c) the unit of account in applying the models;
 - d) interaction with hedging requirements and the effects of changes in foreign exchange rates; and
 - e) timing of impairment tests and interaction with interim reporting.
- 1.22 **Appendix 1** provides the EC request for technical advice.
- 1.23 In **Appendix 2**, EFRAG has summarised the key findings from the assessment phase of the EC request and its main takeaways.
- 1.24 In its discussions over an impairment model for equity instruments, EFRAG considered the notion of impairment in other IFRS Standards as well as accounting guidance in other jurisdictions and presents this in **Appendix 3**.

CHAPTER 2: RELEVANCE OF RECYCLING AND IMPAIRMENT

- 2.1 The *revised Conceptual Framework for Financial Reporting* is expected to state that¹:
- a) profit or loss is the primary source of information about an entity's financial performance for the period;
 - b) income and expenses should be included in profit or loss unless the relevance or faithful representation of the information in profit or loss for the period would be enhanced by including a change in the current value of an asset or a liability in OCI;
 - c) income and expense included in OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur; and
 - d) in principle, income and expenses included in OCI should be recycled when doing so would enhance the relevance or faithful representation of the information in profit or loss for that period.
- 2.2 In this chapter, EFRAG presents arguments as to why recycling might enhance the relevance and faithful representation of profit or loss and why the period of disposal might provide a clear basis for identifying the period in which recycling could occur. In addition, in this chapter EFRAG discusses whether recycling without some form of impairment model would be appropriate from a conceptual standpoint.

LONG-TERM BUSINESS MODEL AND MEASURING PERFORMANCE

- 2.3 In July 2015, EFRAG issued a Bulletin *Profit or loss versus OCI*, which identified four groups of business models, one of which was the long-term investment business model. The business models used, for example, by banks and insurance entities would generally belong to this group, although banks may also undertake short-term trading activities.
- 2.4 In a long-term investment business model, entities acquire assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar 'condition' as when it was bought. Cash flows are generated by holding the asset (e.g. in the form of dividends, or income from letting others use the asset) and from sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective.
- 2.5 EFRAG notes that both dividend receipts (which are included in profit or loss) and gains on disposal from the sale of equity instruments represent a form of realisation of the fair value the instruments. Therefore, it could be argued that both events should be presented in the same way.
- 2.6 The FVOCI election implicitly acknowledges that, although fair value information is relevant in the statement of financial performance, short-term changes in the value of particular equity instruments may not be relevant to periodic financial performance for some entities. Accumulated OCI represents capital appreciation gains and losses accumulated since the acquisition of the assets.
- 2.7 Based on these premises, EFRAG has previously assessed that the prohibition on recycling of cumulative gains or losses at the time of disposal may limit the relevance of reported profit or loss. Gains and losses reported in profit or loss on disposal are indicative of the performance of the investor and useful for assessing management's stewardship of the entity's resources.

1 Source: Summary of Decisions of Conceptual Framework for Financial Reporting, June 2017.

2.8 EFRAG notes that some constituents do not support recycling. Some argue that reporting in profit or loss the full gain accumulated since an asset was originally acquired does not properly reflect performance in the period of disposal.

They consider that holding decisions are as important as selling decisions, and that the accumulated gain or loss relates to performance over the entire holding period and not the period of disposal. Some also express the concern that recycling of gains under IAS 39 creates opportunity for selective profit-taking at the end of the reporting period (sometimes referred to as 'earnings management').

2.9 EFRAG's Endorsement Advice to the EC on IFRS 9 was consistent with the arguments outlined in paragraphs 2.3 to 2.7 above. EFRAG noted that the current value of the assets provides relevant information to assess the financial position of the entity (as the ultimate cash inflow is through sale). However, the default requirement to measure all equity investments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries.

2.10 As noted in paragraph 2.1c) above, the forthcoming revised Conceptual Framework for Financial Reporting is expected to state that income and expense included in OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur. As discussed above, in a long-term business model, assets are sold to obtain the ultimate cash flow. The period in which that cash flow is obtained is clearly identifiable (i.e. it is not arbitrary), and could also be considered economically significant. Accordingly, for equity instruments accounted at FVOCI, it can be argued that the period of disposal provides a clear basis to identify the period in which recycling should occur.

RELEVANCE OF IMPAIRMENT TO RECYCLING

2.11 Paragraphs 2.12 to 2.16 present arguments as to why, if equity instruments were to be measured as at FVOCI with recycling, some form of impairment (or equivalent) model would be appropriate from a conceptual standpoint.

2.12 One of the arguments in favour of having some form of impairment model is consistency with other IFRS Standards and categories of assets. IFRS Standards generally have some form of impairment (or equivalent) requirement for assets, other than those measured at FVPL. This is the case for both for assets carried at cost, such as inventory, property, plant and equipment, intangible assets and amortised cost debt instruments, and for assets accounted for at FVOCI, including revalued property, plant and equipment and intangible assets and FVOCI-debt instruments.

2.13 It can be argued that an impairment model enhances the relevance of profit or loss for stewardship purposes. The underlying objective of IAS 39 for recognising an impairment loss on an equity instrument was to reflect in profit or loss the effect of objectively identifiable, adverse changes in the issuer's economic condition. For example, IAS 39 stated that objective evidence of impairment for an investment in an equity instrument included 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, which indicates that the cost of the investment in the equity instrument may not be recovered. Accordingly, in principle, an impairment loss on an equity instrument is an incurred loss and is therefore economically similar to a loss on disposal. EFRAG considers that inclusion of incurred losses enhances the relevance of profit or loss as the primary source of information about an entity's financial performance, including from a stewardship perspective.

- 2.14 It can also be argued that an impairment model provides information that is relevant for the assessment of future cash flow prospects. The returns generated in a long-term business model are linked to the ultimate cash flows from the sale of assets. In principle, an impairment model results in declines in fair value being recognised in profit or loss prior to ultimate disposal when those declines relate to identifiable adverse changes in the issuer's economic condition. An impairment model would provide relevant information to users of financial statements if it provides insight into whether a decline in fair value is more or less likely to reverse in the future. It can even be argued that the informational value of impairment with respect to assessing future cash flows would be important enough regardless of whether or not recycling occurs.
- 2.15 A robust and operational impairment model also eliminates or reduces any accounting-related incentive to maintain loss-making equity investments for an indefinite period. Allocation decisions would therefore be less affected by accounting requirements and this would reduce the opportunity costs for shareholders that management does not pursue better investments.
- 2.16 Any impairment model has the effect that the accounting treatment of gains and losses is asymmetric. Gains would be recognised in profit or loss only upon sale if recycled, while some losses would be recognised in profit or loss earlier. If recycling was required without an impairment model then both gains and losses would be recognised in profit or loss only upon sale. When EFRAG commented on the Exposure Draft *Conceptual Framework for Financial Reporting*, it advocated that prudence should be re-introduced in the Framework and should under some circumstances lead in accounting policies that treat income and expenses asymmetrically. Recognising impairment losses in profit or loss seems to be consistent with this notion of prudence.
- 2.17 EFRAG also assessed whether presentation or disclosure approaches could provide an appropriate alternative to an impairment model. Presentation and disclosure approaches are discussed in the next chapter.

CHAPTER 3: ENHANCING PRESENTATION OR DISCLOSURE REQUIREMENTS

INTRODUCTION

- 3.1 Chapter 2 presents arguments as to why some form of impairment (or equivalent) model would be appropriate from a conceptual standpoint if recycling was required. EFRAG acknowledges however that, from a practical standpoint, it is difficult to develop an impairment model that is at the same time relevant and ensures full comparability among entities. It may be argued that, given the range of equity instruments and the differences in features, markets and volatility, no single model is appropriate in all circumstances.
- 3.2 For this reason, the EC asked EFRAG to consider other ways to provide information that would help users form a view about the performance of equity investments. For example, how well presentation and disclosure solutions can effectively replace a solution based on recognition and measurement? How much of this information would already be available under the existing presentation and disclosure requirements?
- 3.3 In relation to the first question, it is generally supported that information recognised is more value-relevant than information disclosed in the notes. Some academic studies – not specific to this topic – found that while the notes to the accounts are important to professional equity investors, information recognised in the financial statements receives more attention than disclosures in the notes. Other literature suggests that recognised information is more reliable than disclosed information, or that investors have difficulty in understanding disclosed information.

INFORMATION PROVIDED BY EXISTING DISCLOSURES

- 3.4 IFRS Standards already specify various general disclosures about financial assets and liabilities as well as disclosures specifically about equity instruments designated at FVOCI. Some of the general disclosures include:
- the carrying amount of each of the categories of financial assets and liabilities be disclosed in either the statement of financial position or in the notes²; and
 - the net gain or loss in the statement of comprehensive income or in the notes³.
- 3.5 IFRS 7 *Financial Instruments: Disclosures* also includes disclosure requirements specifically for investments in equity instruments designated at FVOCI⁴:
- which investments in equity instruments have been designated at FVOCI;
 - the reasons for using this presentation;
 - the fair value of each such investment at the end of the reporting period;
 - dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period;
 - any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers;
 - the reasons for disposing any investment;
 - the fair value of any investment disposed at the date of derecognition; and
 - the cumulative gain or loss on disposal.

2 IFRS 7 *Financial Instruments: Disclosures* paragraph 8.

3 IFRS 7 *Financial Instruments: Disclosures* paragraph 20.

4 IFRS 7 *Financial Instruments: Disclosures* paragraph 11A and 11B.

POSSIBLE DISCLOSURE ENHANCEMENTS

- 3.6 The additional presentation and disclosure requirements necessary to achieve a particular information objective depend on both the 'starting point' (in other words the information provided in the primary financial statements based on the applicable requirements on recognition and measurement) and on the desired objectives. For the purpose of this analysis, EFRAG considered the following three scenarios in terms of starting point:
- a) current IFRS 9 requirements with use of the FVOCI election;
 - b) FVOCI with recycling but no impairment model; and
 - c) all equities carried at FVPL.
- 3.7 For each scenario, EFRAG assessed the information that users would need to adjust profit or loss as reported in order to depict profit or loss on the basis of FVOCI with both recycling and an impairment model. Said differently, EFRAG's assessment takes the perspective of a hypothetical user that holds the view that performance is better reflected with current changes in fair value recognised in OCI and later recycled when the instruments are either impaired or derecognised. EFRAG does not claim that all users share this view of performance.
- 3.8 EFRAG's assessment is illustrated by the following simplified example. For each of the three scenarios, the example describes the extent to which the information to make the adjustments is met by the existing disclosures (summarised above). The example then considers whether and how the 'missing' information could be met by adding new disclosure requirements.

ILLUSTRATIVE EXAMPLE

- 3.9 Assume a reporting entity holds three investments in equity instruments designated at FVOCI. The three investments were acquired before the start of the current period. The table below summarises the relevant data:

	ACQUISITION COST	FV AT THE BEGINNING OF THE PERIOD	FV AT THE END OF THE PERIOD
Investment X	50	60	75
Investment Y (disposed during the period)	50	80	-
Investment Z	50	50	32
Total	150	190	107

- 3.10 At the beginning of the reporting period, the entity would have a cumulative gain in OCI of EUR 40 for these three investments. During the current reporting period the entity sold investment Y for EUR 85, so the cumulative gain on the disposal is EUR 35 and the fair value change of the period for this investment is EUR 5. At the end of the reporting period the entity continued to hold equity instruments with a fair value of EUR 107 and a cumulative gain in OCI of EUR 7 (10+15-18).

FIRST SCENARIO - CURRENT IFRS 9 REQUIREMENTS WITH THE USE OF FVOCI ELECTION

- 3.11 Under this scenario the hypothetical user referred to above would need to make the following adjustments:
- transfer the cumulative gain previously recognised in OCI for the equity instruments sold during the reporting period (Investment Y) of EUR 35 to profit or loss; and
 - assess whether the fall in value of Investment Z of EUR 18 should be treated as an impairment loss and, if so, deduct EUR 18 reported profit or loss.
- 3.12 The information for the first adjustment is provided by existing disclosures (IFRS 7.11B(c)), but information for the second adjustment (i.e. impairment) is not. One way to help a user make this assessment would be to require entities to disaggregate the net OCI balance between the total debit balance and the total credit balance, with the first amount providing an indication of the maximum loss exposure. If however the entity holds more one investment with a loss in OCI, the hypothetical user would be unable to make an impairment assessment because the cumulative losses are reported in the aggregate rather than by investment. Information on the cumulative loss would then need to be provided for all equity instruments that have a debit OCI balance and are still held at the reporting date. In addition, the user might need information comparing the fair value to the original cost and information on how long the fair value has been below cost. IFRS 7 requires disclosure of fair value, but not the comparison to original cost nor the length of time over which any shortfall has prevailed.
- 3.13 Accordingly, when an entity applies IFRS 9's FVOCI election as it is today, the presentation and disclosure requirements in existing IFRS Standards provide some, but not all, of the information users would need to make these adjustments. In particular, new disclosures would need to be added to enable users to assess potential impairment losses.

SECOND SCENARIO - FVOCI WITH RECYCLING BUT NO IMPAIRMENT

ASSUMPTIONS

This alternative assumes that the requirements of IFRS 9's FVOCI category were to be amended by requiring recycling on disposal but with no impairment requirement.

- 3.14 Some of the IFRS 7 disclosure requirements described above would not be applicable under the assumption that recycling is required. For example, transfers of cumulative gain or loss within equity would not occur.
- 3.15 Under this scenario, the hypothetical user referred to above would need to make only one adjustment, i.e. assessing if an impairment loss should be added in relation to Investment Z.
- 3.16 As mentioned in the previous scenario, the hypothetical user would need additional information to make an impairment assessment when there is more than one investment. The information needed, as the associated challenges, are the same as for the first scenario.

THIRD SCENARIO - ALL EQUITY INSTRUMENTS AT FVPL

ASSUMPTIONS

This scenario assumes that entities carry all their equity instruments at fair value with the changes recognised in profit or loss.

Nothing is recognised in OCI and there is no need to determine an impairment loss.

- 3.17 Most of the IFRS 7 disclosure requirements described above would not be applicable under the assumption that all equity instruments are carried at FVPL.
- 3.18 Under this scenario the hypothetical user referred to above would need to make following adjustments:
- adjust by an amount of EUR 30 the gain or loss on Investment Y which was sold in the period. This adjustment would reflect prior period increases in fair value;
 - remove from profit or loss the net negative fair value change on the investments still held at the reporting period for EUR 3 (positive change of 15 EUR and negative change of EUR 18); and
 - assess whether the decline in value of Investment Z of EUR 18 should be treated as an impairment loss and retained in profit or loss or removed.
- 3.19 New disclosures would be needed for all the adjustments. For the first and second adjustment, the entity would be required to present as separate line items gains and losses on instruments still held at the reporting period ('unrealised gains or losses') and gains or losses on instruments derecognised in the period ('realised gains or losses').
- 3.20 While there is no specific requirement to provide such an analysis, reporting entities have the ability to include supplemental information. IAS 1 *Presentation of Financial Statements* requires that for a fair presentation an entity 'provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'
- 3.21 An analysis could either be presented in the statement of comprehensive income or disclosed in the notes. IAS1 addresses the information included in OCI and paragraph 85 states: 'An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.'

3.22 Using the example above, the information could be provided as follows:

Net fair value change for the period (this amount would be in profit or loss in the assumptions)	2
Unrealised portion (related to Investments X and Z)	(3)
'Realised' portion (related to Investment Y)	5

3.23 After this adjustment, the hypothetical user would need a comparison of the current fair value to the original acquisition prices (for each instrument that has suffered a decline in value) and information on how long the fair value has been below cost as a basis to assess impairment losses.

SUMMARY

3.24 The analysis above illustrates that, under all three scenarios, existing disclosures would not be sufficient to provide the information users would need to adjust profit or loss on the basis of FVOCI with both recycling and an impairment model. It could be contemplated that the missing information is provided by introducing new disclosure requirements. However, such disclosures could be voluminous given the size of equity portfolios held by some long-term investors. In addition, any such disclosures would only help the user to make its own quantitative assessment of impairment based on the information disclosed. In practice, the user would not realistically have access to all the information (both qualitative and quantitative) that is available to the entity's management.

CHAPTER 4: TWO PROPOSED MODELS

- 4.1 This chapter describes two models that could accompany measurement at FVOCI with recycling. The models were developed based on the scenario that the FVOCI category is adapted only to require recycling on disposal. All other aspects are assumed to stay the same. One model is referred to as a revaluation model and the other as an impairment model similar to the impairment model in IAS 39 for financial instruments classified as AFS, but with additional guidance to reduce subjectivity.
- 4.2 Both models require the recognition in profit or loss of some holding losses. Both the models also aim at reducing the subjectivity that created application problems with the IAS 39 impairment model. In substance, the models use quantitative triggers that some may view as bright-lines.
- 4.3 This chapter also briefly describes another approach that EFRAG considered but did not develop in detail at this stage. This is referred to as a 'strategic investment' approach. Contrary to the other two models, this model would not be applicable to all equity instruments carried at FVOCI, and therefore would have required to develop specific qualifying criteria.

THE TWO MODELS

- 4.4 EFRAG has identified two main models:
- a 'revaluation model'; and
 - an impairment model similar to IAS 39 with less subjectivity.

REVALUATION MODEL

- 4.5 Under this model, the equity instrument is carried at fair value in the statement of financial position and:
- changes in fair value below the original acquisition cost (both declines in value and subsequent recoveries) are recognised in profit or loss; and
 - changes in fair value above the original acquisition cost are recognised in OCI.
- 4.6 In developing IAS 39, the IASB considered a model along those lines. The IASB noted at the time that this would 'significantly change the notion of 'available for sale' in practice' and believed such a change was not appropriate at that time. However, the AFS notion is no longer an issue, as it is not contained in IFRS 9.

IMPLICATIONS

- 4.7 Under this model, the amount recognised in profit or loss in a period is simply the difference between:
- the (negative) difference between the fair value at reporting date and the original cost; and
 - the cumulative difference recognised in profit or loss in prior periods.
- 4.8 In some cases, the amount recognised in profit or loss would not represent the change in value over the period. For example, consider an instrument acquired at EUR 100; its fair value at the end of the prior period was EUR 105 and its fair value at the reporting date is EUR 98. Under this scenario, the entity would recognise the decrease from EUR 105 to EUR 100 as a loss in OCI and the additional decrease from EUR 100 to EUR 98 (the portion of the change below the initial acquisition cost) as a loss in profit or loss.

- 4.9 This model effectively removes all judgement (putting aside any judgement involved in measuring the instrument's fair value), and would seem to overcome any concerns about the possible lack of objectivity and comparability. In this sense, the model provides a practical solution to the identification of criteria to assess impairment.
- 4.10 However, the model does not attempt to determine if negative changes in fair value are the effect of objectively identifiable, adverse changes in the issuer's economic condition. In this sense, some may not view it as an impairment model. In addition, some of the conceptual arguments in Chapter 2 are based on the usefulness of distinguishing those declines in fair value that are adverse changes in the issuer's economic condition from other declines in fair value. These arguments do not apply to the revaluation model.
- 4.11 Finally, the FVOCI election was designed to eliminate volatility in profit or loss during the holding period, which some entities believe does not reflect their business model. The revaluation model does not fully achieve that objective, because volatility is reported in profit or loss when, and for as long as, the current fair value is lower than the original cost.

AN IMPAIRMENT MODEL SIMILAR TO IAS 39 WITH LESS SUBJECTIVITY

- 4.12 IAS 39 included a general principle to recognise impairment losses on a financial asset when there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition (a 'loss event'). IAS 39 also included a non-exhaustive list of examples of types of objective evidence of a loss event.
- 4.13 For equity instruments, IAS 39 provided some additional examples of objective evidence of impairment. Objective evidence included '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'.
- 4.14 IAS 39 also stated 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'. EFRAG understands that this 'significant or prolonged' trigger has been the most determinative part of IAS 39's impairment guidance in the context of equity instruments classified as AFS in practice. EFRAG's findings in the assessment phase of this project confirmed that most entities in the samples used a criterion of 'significant or prolonged' decline in fair value to assess impairment of equity instruments (see Appendix 2 of the DP).
- 4.15 This model proposed in the DP is conceptually consistent to IAS 39 but attempts to reduce the subjectivity around the use of 'significant or prolonged'. Initially EFRAG considered to replace 'significant or prolonged' with other terms, but other terms also included some element of subjectivity.
- 4.16 To reduce the subjectivity of the assessment, the IFRS Standard should be more prescriptive and leave less room for judgement. One of the challenges in applying judgement is that IAS 39 does not define the impairment of equity instruments based on a specific likelihood that the original acquisition cost will not be recovered. Further, the relationship between the general guidance on objective evidence and the 'significant or prolonged' trigger is not explained. While EFRAG supports the use of reasoned judgement in a principle-based system, these challenges lead to a risk that the judgement on 'significant or prolonged' becomes arbitrary.
- 4.17 EFRAG's findings in the assessment phase of this project confirmed that entities in the samples use different thresholds for 'significant or prolonged' and therefore add weight to this concern (see Appendix 2 of the DP). The ESMA report *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe* on the 2012 financial statements of 39 major European financial institutions also had similar findings.

- 4.18 The model could be made less subjective if the thresholds for 'significant or prolonged' were defined or described in terms that are more specific. A 'significant' decline could be defined as a specific percentage decline from the acquisition cost and 'prolonged' as a specific time period where the fair value has been below the acquisition cost. This could be done in one of three ways:
- a) the IFRS Standard would specifically define quantitative thresholds;
 - b) the IFRS Standard would require reporting entities to define quantitative thresholds for both 'significant' and 'prolonged' as part of their accounting policy, explain and disclose them; or
 - c) a combined approach, under which the IFRS Standard sets an upper limit for both terms, and reporting entities select a threshold within the limit.

IMPLICATIONS

- 4.19 This model removes much of the subjectivity that the IASB referred to in its arguments for prohibiting recycling in IFRS 9. It would substantially eliminate judgement when applying the 'significant or prolonged' part of the impairment guidance for equity investments (putting aside any judgement involved in measuring the instrument's fair value). In terms of mechanics, it is similar to the revaluation model discussed earlier except that the quantitative thresholds for both significant and prolonged would be other than zero. Unlike the revaluation model, this model makes a distinction between 'impairments' and other declines in fair value and can therefore be considered to reflect the notion that an impairment arises from an adverse change in the issuer's economic circumstances. EFRAG also notes that this model would generally lead to lower reported volatility in profit or loss than the revaluation model.
- 4.20 There is an unavoidable trade-off in a threshold-based approach of this kind. A single quantitative threshold set by an IFRS Standard enhances comparability and reduces the risk of bias, but moves away from a principles-based approach and may limit relevance. For example, an IFRS Standard that defined a period for prolonged would not differentiate an investor with a 10-year average holding period from an investor with a 3-year average holding period.
- 4.21 The second option permits the reporting entity to make a judgement as to the appropriate threshold. Allowing entities to define thresholds, even within a pre-determined range, may improve relevance. Thresholds established by the reporting entity for 'prolonged' may better reflect the average holding period of the investor, and for 'significant' may better reflect the types of equity instruments held by the reporting entity.
- 4.22 However, allowing entities to define their own thresholds will lead to less comparability. The obligation to disclose the thresholds and apply them consistently would mitigate but not eliminate the fact.

A 'STRATEGIC INVESTMENT' APPROACH

- 4.23 EFRAG initially discussed whether different approaches should be used for different classes of equity instruments under the FVOCI election. This would have required the identification of different categories of investments.
- 4.24 EFRAG considered various criteria for defining categories, including the purpose of the investment. It may be argued that entities acquire equity instruments of other entities for a variety of reasons: sometimes it is solely or primarily to collect a stream of expected cash flows in the form of dividends and disposal gains (i.e. the purpose is to realise an investment return), sometimes for other reasons, including the following:
- a) gain influence over the investee, this could be a competitor, supplier, customer, or part of a distribution chain;
 - b) make an initial investment with a view that it may lead to a business combination (step-acquisition); and
 - c) facilitate the formation of a strategic alliance.

- 4.25 In developing IFRS 9, the IASB discussed restricting the use of the FVOCI election to strategic investments but eventually abandoned the idea. EFRAG understands that the main reason was that the IASB could not find a clear definition. More recently, in the context of the IASB's *Primary Financial Statements* project, the IASB staff has suggested the introduction of an 'investing' category within the statement of profit or loss and OCI. Gains and losses would be included in this category when they arise from assets that generate a return individually and largely independently from other resources held by the entity.
- 4.26 EFRAG debated whether 'strategic investments' could be assessed for impairment using a model similar to the one in IAS 36 *Impairment of Assets*, with these instruments being allocated to a cash generating unit ('CGU'). The argument would be that they contribute to the return on other assets of the holder. Accordingly their recoverable amount should not be assessed on a standalone basis (i.e. considering only standalone dividends and disposal gains), but in combination the assets whose cash flows are affected by the related synergies.
- 4.27 In general terms the model would comprise the following steps:
- a) include the original cost of the strategic equity instrument in the carrying amount of the CGU;
 - b) compare the carrying amount of the CGU to its recoverable amount;
 - c) if there is a negative difference, reclassify the change in fair value of the strategic equity instrument from OCI to profit or loss until the OCI balance is nil; and
 - d) if there is a residual negative difference, allocate it pro-rata to the other assets in the CGU.
- 4.28 There could be additional complexities in determining the allocation of the impairment loss when for instance the CGU includes goodwill.
- 4.29 EFRAG has not developed this approach further, mainly a result of concerns that defining a category of strategic investments would introduce too much judgement and complexity. Entities can hold an investment in an equity instrument for many reasons and consider the investment strategic. In addition, the reason an entity holds an investment can change over time and, accordingly, a continuous reassessment would be needed potentially leading to differences in where gains or losses are presented.

CHAPTER 5: OTHER CONSIDERATIONS

5.1 Chapter 4 described the main features of the two proposed models. In both cases, there are other relevant considerations to address, some with a potentially significant impact. We discuss them below.

HOW TO TREAT SUBSEQUENT RECOVERIES IN FAIR VALUE

5.2 Under IAS 39, impairment losses resulted in a new cost basis and reversals of impairment losses for AFS equity instruments were not allowed. The Basis for Conclusions of IAS 39 explained the prohibition on reversals on the basis of difficulties in distinguishing a reversal of an impairment from other increases in value.

5.3 The conceptual arguments against reversals merit re-examination. In Chapter 2, EFRAG argued that the objective of an impairment model could be to reflect significant changes with an adverse effect on the issuer's perspectives, which may result in the cost of the investment not being recoverable. If these changes reverse and the conditions no longer apply, then recognising subsequent recoveries in profit or loss would provide equally relevant information. EFRAG notes that, with the exception of goodwill, reversals of impairments are allowed in IFRS Standards.

5.4 Under the revaluation model, the basic principle is that changes below the original acquisition cost are recognised in profit or loss. Fair value changes do not create a new cost basis, so recoveries in fair value are credited to profit or loss up to the original cost basis. Therefore, reversals are not relevant under the revaluation model, because if the fair value recovers after a decline, the positive change is automatically recognised in profit or loss up to the acquisition cost.

5.5 Recognition of recoveries of fair value in profit or loss could be implemented in different ways that we illustrate below.

5.6 A limited reversal approach would allow recognition of a reversal only from the moment when the fair value recovers over the initial cost or the impairment threshold. In an impairment model with a 'significant' threshold this would introduce a degree of symmetry – moving across the threshold would trigger both the recognition of downward changes and recoveries in profit or loss.

5.7 Similar to the outcome under the revaluation model, an ongoing reversal approach would allow recognition of reversals as soon as the fair value starts recovering, with no consideration for whether the recovery is significant or prolonged.

5.8 To illustrate these approaches, assume that on 1 January 2015, an entity acquires shares in Entity A, for their fair value of EUR 100. On 31 December 2015, the fair value of the shares had fallen to EUR 82. Since the entity uses a quantitative threshold of 10% decline, it recognises an impairment of EUR 18. On 31 December 2016, the fair value of the shares recovers to EUR 88, on 31 December 2017 to EUR 95 and on 31 December 2018 to EUR 100:

	NO REVERSAL	LIMITED REVERSAL	LIMITED REVERSAL WITH THRESHOLD	ONGOING REVERSAL
Cumulative impairment at the end of 2015	(18)	(18)	(18)	(18)
Profit or loss 2016	0	0	0	6
Cumulative impairment at the end of 2016	(18)	(18)	(18)	(12)
Profit or loss 2017	0	0	13	7
Cumulative impairment at the end of 2017	(18)	(18)	(5)	(5)
Profit or loss 2018	0	18	5	5
Cumulative impairment at the end of 2018	(18)	0	0	0

- 5.9 There is an additional issue related to the limited reversal with the threshold approach. Under the example, at the end of 2017, the fair value has recovered over the impairment threshold of EUR 90 but the accumulated profit or loss still includes an impairment of EUR 5. The question arises if a recovery over the threshold should result in fully reversing the initial impairment loss. This could be especially an issue if the fair value declined below the threshold in interim periods (thus triggering an impairment loss) and recovered above the threshold but below the acquisition cost by year-end.
- 5.10 EFRAG also acknowledges that any reversal approach could give rise to other operational issues. For example, an impairment in one period might be followed by a recovery in value in another period that is accounted for as a reversal (in profit or loss). If this is followed by a new decline in value in another period, the question then arises as to whether that should automatically be considered an impairment, or should be subject to a new assessment. EFRAG has not attempted to address this and other detailed issues at this research stage but notes that further development might be required in due course.

REBUTTABLE PRESUMPTION TO A BRIGHT LINE APPROACH

- 5.11 Some might argue that a single threshold does not take into account that some equity instruments are more volatile than others. Applying a single threshold to all equity instruments makes the model quite rigid and may result in an impairment loss for a decline in value that, for more volatile equity instruments, may be expected to reverse in the future.

- 5.12 If this is perceived to be an issue, the model could be further modified in different ways to better reflect the specificities of individual instruments. One way is by introducing a rebuttable presumption. For example, the impairment presumption could be rebutted when the share price of an equity instrument is below the threshold at the reporting date, but the original cost of the investment remains within a trading range over prior 90 days just preceding the reporting date. Assume an entity acquires shares of a start-up biotech entity on 25 September for EUR 95. At 31 December of the same year, the fair value of the shares was EUR 75. During the last three months of the year, the share price ranged between EUR 68 and EUR 112. In that case, an impairment would not be necessary because during the previous three months the investee's trading range included the initial acquisition cost of EUR 95.
- 5.13 This rebuttable presumption would not result in subjective judgement because it is still based on observable evidence. However, it includes an operational and conceptual disadvantage that it could only be applied in practice to equity securities that are listed. Further, EFRAG notes that this approach is not consistent with a 'significant or prolonged' approach. This is because no impairment is recognised even though the decline in value is 'significant'.

UNIT OF ACCOUNT - INDIVIDUAL INVESTMENT OR PORTFOLIO

- 5.14 The unit of account for the measurement of financial instruments is the individual instrument. Under IFRS 9, equity instruments are measured at fair value in the statement of financial position. The introduction of an impairment approach would not change the measurement basis in the statement of financial position, but only the presentation of a loss.
- 5.15 EFRAG has considered the level of aggregation at which the models would be applied. Both could be applied at different levels, for example: the level of the individual tranche (i.e., the holding in equity instruments of an individual issuer acquired on a particular date), the individual investment (i.e., the total holding in equity instruments of an individual issuer), particular portfolios of equity instruments carried at FVOCI, or the entire portfolio.
- 5.16 Applying the two models at the level of a portfolio of equity instruments carried at FVOCI would limit the recognition in profit or loss to when the portfolio itself had a cumulative (significant) decline in fair value. It could be argued that if an entity has a large portfolio of equity instruments, there is no information value in presenting separately the gains and losses on an individual instrument level. On the other hand, a portfolio level approach in an impairment model weakens the link between an adverse change to the economic circumstances of an individual issuer and the recognition in profit or loss.
- 5.17 For example, consider an entity that acquires three equity instruments as part of a portfolio and the fair value of these instruments changes by the end of the reporting period as follows:

<i>Amounts are in EUR</i>	ACQUISITION COST	FAIR VALUE
Equity instrument A	60	75
Equity instrument B	25	40
Equity instrument C	50	45
Total	135	160

- 5.18 If the model was applied on an individual instrument level, the entity would or might recognise in profit or loss the holding loss of EUR 5 for equity instrument C. No amount would be taken to profit or loss if the model were applied on a portfolio basis since the aggregate fair value of the portfolio exceeds its aggregate acquisition cost.

- 5.19 One issue with using a portfolio level approach is that it would need to be determined whether all equity instruments at FVOCI are treated as a single unit of account, even if those instruments are managed in separate portfolios. If the separate portfolios used for management purposes were the unit of account for the impairment calculation, the question would arise on whether transfers between portfolios would be acceptable.

UNIT OF ACCOUNT – COST FORMULA

- 5.20 EFRAG also considered whether the model should specify a cost formula for an individual investment when it has been acquired in multiple tranches – such as a weighted average cost basis or a first-in-first-out ('FIFO') basis.
- 5.21 The cost formula has an impact on both recognition and measurement of the profit or loss charge. For example, assume an entity acquires 200 shares in another entity over time:
- a) initially 100 shares at EUR 60; and
 - b) later another 100 shares at EUR 80.
- 5.22 If the fair value at year-end is EUR 75, this would be higher than the average cost of EUR 70, and under the revaluation model there would be no loss in value. If the fair value was compared to the original cost of each tranche, the entity would charge to profit or loss the decline of EUR 500 on the second tranche.
- 5.23 IAS 39 does not provide guidance on this issue, which affects both the assessment of impairment and the gain or loss recognised on partial disposals. Entities have presumably developed an accounting policy and use a consistent method for both. Either the weighted average cost method or the individual tranche method could be prescribed or left to the reporting entity to decide.
- 5.24 If the reporting entity determines which cost formula to use it would enable the entity to align its financial reporting and tax treatments.

OTHER APPLICATION ISSUES

INTERACTION WITH HEDGING REQUIREMENTS

- 5.25 The interaction between the measurement of equity instruments and the hedging requirements of IFRS 9/IAS 39 is a complex issue because of the different accounting options available to entities reporting under IFRS Standards:
- a) the option to carry equity instruments either at FVPL or FVOCI; and
 - b) the option to continue applying the hedge accounting requirements in IAS 39 or apply those in IFRS 9.
- 5.26 In general terms, when a fair value hedge meets the qualifying criteria, the hedging relationship is applied as follows:
- a) the changes in the fair value of the hedging instrument are charged to profit or loss; and
 - b) the changes in fair value attributable to the hedged risk adjusts the carrying amount of the hedged item, and is recognised in profit or loss.
- 5.27 However, this general model is fit for hedged items that are otherwise carried at cost. If the hedged item is carried at FVOCI, the change in fair value attributable to the hedged risk is already incorporated in the carrying amount.

- 5.28 For this reason, IFRS 9 has a specific provision for equity instruments designated at FVOCI. Paragraph 6.5.8 of IFRS 9 indicates that in this case, the changes in fair value of the hedging instrument are recognised in OCI. The following paragraphs assess the implications of recognising impairment losses in profit or loss.
- 5.29 In this case, the recognition of an impairment loss in profit or loss would conflict with the application of the fair value hedge. Assume the following example:
- a) the entity acquires an equity instrument for EUR 100;
 - b) the entity has a derivative that hedges the changes in fair value of the equity instrument; and
 - c) an impairment loss is automatically triggered when the fair value decreases by more than 10% of the original price.
- 5.30 At the end of Year 1, the fair value of the equity instrument has decreased from EUR 100 to EUR 80 and the fair value of the derivative has increased from EUR 0 to EUR 15.
- 5.31 If the entity was applying the fair value hedge requirements in IFRS 9 with no impairment, both changes in fair value would be recognised in OCI. If an impairment model were to be introduced, then the decrease of EUR 20 would be recognised in profit or loss, while the requirement in paragraph 6.5.8 of IFRS 9 would result in recognising the increase of EUR 15 in OCI.
- 5.32 To avoid this outcome, consequential amendments would be needed to paragraph 6.5.8 of IFRS 9. One possible approach would be to set the automatic trigger net of the effect of the hedging. With this change, in the scenario above, the entity would assess that the decline in fair value is equal to $(EUR\ 20 - EUR\ 15) = EUR\ 5$, which represents 5% of the original acquisition price. Accordingly, when considered net of the hedging effect, the quantitative impairment threshold has not been reached.
- 5.33 Under such an approach the entity would recognise an impairment in profit or loss only when the net change exceeded the quantitative impairment threshold.

INTERACTION WITH CHANGES IN FOREIGN EXCHANGE RATES

- 5.34 Under IAS 39, the reporting of changes in the carrying amount of a financial instrument in profit or loss or in OCI depended on various factors. These factors included whether it is an exchange difference or other difference in the carrying amount, whether the instrument is a monetary or non-monetary item and whether it is designated as part of a foreign currency cash flow hedge.
- 5.35 Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Exchange differences formed part of the change in the fair value of the instrument, which was recognised in OCI. Any foreign exchange component of that gain or loss on disposal of AFS equity instruments was recognised in profit or loss.
- 5.36 Paragraph B5.7.3 of IFRS 9 states that the gain or loss that is presented in OCI for equity instruments includes any related foreign exchange component. Paragraph B5.7.4 of IFRS 9 states that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss.

TIMING OF IMPAIRMENT TESTS AND INTERACTION WITH INTERIM REPORTING

- 5.37 IAS 39 required an AFS equity instrument to be assessed for impairment at the end of each reporting period. This requirement suggested that an entity should perform the impairment review at the end of both the interim and annual periods. IAS 34 *Interim Financial Reporting* states that the frequency of an entity's financial reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results. This might suggest that an impairment loss recognised at an interim period could be reversed at the year-end.

- 5.38 Consider, for example, an entity that acquires an equity share for EUR 100 at the beginning of the reporting period. If the fair value of the share had decreased to EUR 70 at the end of the half-year, it is very likely to conclude that the share had become impaired. Consequently, a loss of EUR 30 would be recognised in profit or loss. However, if the share price had recovered to EUR 100 by the end of the full financial year, the question arose, as to whether this loss should be reversed as there was a perceived conflict between IAS 39 and IAS 34.
- 5.39 The IFRS Interpretations Committee resolved this conflict when it published in 2006 the Interpretation IFRIC 10 *Interim Financial Reporting and Impairment*. IFRIC 10 required that impairments of AFS equity instruments recognised in an interim period should not be reversed.
- 5.40 EFRAG considers that IFRIC 10 would still apply if impairment of equity instruments were to be reintroduced without impairment reversal. If impairment of equity instruments were reintroduced with reversal, a revised IFRS 9 would likely supersede the IFRIC guidance.

APPENDIX 1 – THE EC REQUEST

Ref. Ares(2017)2680228 - 29/05/2017



EUROPEAN COMMISSION

Directorate General Financial Stability, Financial Services and Capital Market Union

INVESTMENT AND COMPANY REPORTING

Accounting and financial reporting

Head of Unit

Brussels,
FISMA B3/DR/dd/Ares(2017)2825410

Jean-Paul Gauzes
President
EFRAG
Square de Meeûs 35
B-1000 Brussels

Subject: Request for technical advice on the accounting treatment of equity instruments under IFRS 9 from a long term investment perspective

Dear Mr Gauzes,

The Commission completed the endorsement process of IFRS 9 with the adoption of Commission Regulation (EU) No 2016/2067 on 22 November 2016.

The effect of IFRS 9 on long-term investors was widely debated during the endorsement process. In particular, the Commission asked EFRAG to consider long-term investment in developing its endorsement advice to the Commission on the standard. EFRAG concluded that it is unlikely that long-term investors would change their investment strategy because of the accounting changes brought by IFRS 9. The Commission subsequently conducted its own fact-finding exercise and came to the same conclusion. These assessments were qualitative rather than quantitative because they were largely based on behavioural expectations.

Notwithstanding these findings, the Commission has noted that EFRAG commented in its endorsement advice that the accounting treatment of equity instruments under IFRS 9 may not reflect the business model of long-term investors. Accordingly, the Commission considers it important to closely monitor the impact of IFRS 9 on long-term investors in order to avoid any unintended effects. Furthermore, during the standard's endorsement process, the EP¹ and some Member States have also called for close monitoring of the impact of IFRS 9 to ensure that it serves the EU long-term investment strategy.

As part of this monitoring exercise, the Commission would like to:

- obtain quantitative information about long-term equity investments and evaluate the possible impact of IFRS 9 on long-term investments ("phase 1") by the end of 2017 and;
- identify whether and how IFRS 9 could be improved with respect to the accounting treatment of equity instruments held for long-term investments ("phase 2") by mid-2018.

¹ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0381+0+DOC+PDF+V0//EN>

Equity instruments are by default measured at fair value through Profit or Loss. To avoid fluctuations from unrealised gains and losses from changes in fair values being recognised in Profit or Loss, long-term investors can choose to recognise fair value changes in Other Comprehensive Income. However, EFRAG believes that long-term investors are unlikely to use this option because of the prohibition on presenting realised gains on sales of equity as profits (the so-called "ban on recycling")².

Against this background, the Commission would like to request EFRAG to conduct some fact-finding and research in this area. This work should address the areas set out below.

Phase 1 problem definition

1. Quantitative information about the significance of the equity portfolios for long-term investors before the entry into application of IFRS 9

This information could include the following for the years 2016 and 2015 (to the extent data is available):

- The size of the equity instruments' portfolios held by insurance companies and other long-term investors and the proportion that is considered to be held for the long term;
 - The criteria used by long-term investors to classify their equity portfolios as long term and what information is disclosed about their long-term business model and the long-term portfolios in the financial statements;
 - The accounting classification under IAS 39 of their equity portfolios and the amount of fair value changes recognised in Other Comprehensive Income in relation to the part of the equity portfolio that is considered long term;
 - The amounts (in gross and net amounts) of realised gains and losses recycled through the profit and loss and the amount of the underlying equity portfolio sold to give rise to these gains and losses; the factors leading long-term investors to realise part of their long term equity portfolios;
 - The magnitude of the fair value changes, and realised gains and losses in terms of annual profit.
- What impairment charges were recognised on the equity portfolios accounted for at fair value through Other Comprehensive Income and what criteria were applied?

2. Assessing the possible effects of the application of IFRS 9 on the equity portfolios of long term investors

As long-term investors will be further ahead in their implementation plans or have had more time to develop their thinking than during the endorsement process for IFRS 9, it would be helpful if EFRAG could provide information on the following points:

- Will long-term investors use the option to measure their long-term equity investments at fair value through other comprehensive income (FVOCI); what factors will influence their

² See EFRAG endorsement advice on IFRS 9, page 75: <http://www.efrag.org/News/Project-1&1/EFRAG-Endorsement-Advice-on-IFRS-9-Financial-Instruments->

choice; what will be the size of the equity portfolio measured at FVOCI compared to the overall equity portfolio?

- Would long-term investors envisage that the application of IFRS 9 would affect their holding of and financial reporting (including investor relations) for their long-term equity portfolios? There should be an explanation of these effects together with, where possible, quantification. Any other information relevant to an assessment of their significance such as any mitigating actions likely to be taken should be included.

Phase 2 possible solutions

3. How to improve the new IFRS 9 accounting framework: How significant is an impairment model to the removal of the ban on recycling from a conceptual perspective?

The IASB initially sought to simplify IFRS 9 by requiring all changes in fair values to be recognised in Profit or Loss. However, the Board accepted that long-term investors preferred to report volatility on their investments in Other Comprehensive Income rather than in Profit or Loss. The IASB introduced the ban on recycling because it wanted to avoid earnings management by companies which could hold onto loss-making investments while realising gains on others. The impairment model for equities reported as available-for-sale under IAS 39 was open to judgement and had led to significant diversity in practice. According to the IASB, a robust impairment model would be needed to prevent companies to manage their earnings. Lacking such a model, IFRS 9 prohibits recycling.

We would invite EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling and also consider possible alternatives. For example, could fair value changes over time in Other Comprehensive Income be analysed between positive and negative changes on equity instruments so that investors could form a view about the performance of the equity investments? Alternatively, could the fair value changes on equity investments measured at Fair Value through Profit and Loss be disclosed with an analysis between realised and unrealised changes?

4. If an impairment model is considered to be an important element of a "recycling" approach, what features would characterise a robust impairment model and could these feasibly be made operational?

In the context of the EFRAG's ongoing research project, we would like to ask EFRAG to identify how the existing impairment model under IAS 39 for equity investments could be improved or if another impairment model could be developed, possibly by looking at other national or third-country GAAPs. The availability of a practicable and robust impairment model could be a significant factor to influence the IASB to reconsider the ban on non-recycling in IFRS 9.

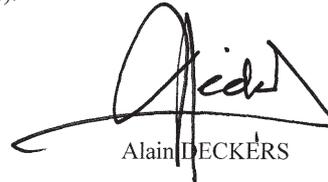
Also in the light of the EP resolution calling on the Commission to report on whether IFRS 9 could be detrimental to long-term investment, we would be grateful if EFRAG could provide us with the preliminary outcome of its work on phase 1 by the end of 2017.

In order to provide appropriate qualitative and quantitative evidence of the need, if relevant, for a change to IFRS 9 or additional further disclosure around this area, we would ask EFRAG to consult publicly to the maximum extent possible within the given timeframe.

We thank you in advance for your cooperation and would be happy to provide any clarification required on this letter to EFRAG representatives.

Should you have any questions, please contact Erik van der Plaats or Dawn Robey (Telephone: +32 2 29 55565 or +32 2 29 52282).

Yours sincerely,



Alain DECKERS

cc.: A. Watchman, (EFRAG TEG Chairman), V. Ledure (FISMA)

APPENDIX 2 – SUMMARY OF EVIDENCE COLLECTED

- 1 The objective of this Appendix is to present EFRAG's findings in relation to the assessment phase of the EC's request. In this phase, EFRAG was asked to collect quantitative data on the current holdings of equity instruments in Europe and their accounting treatment and investigate whether, and to what extent, entities expect that the new accounting requirements will affect their decisions in relation to investment in equity instruments (refer to Appendix 1).
- 2 EFRAG's findings in relation to the assessment phase are mostly based on:
 - a) a public consultation conducted in 2017, which resulted in 26 respondents in total, including respondents from the insurance, the financial services and non-financial sectors, and covered the years 2014-2016; and
 - b) a review of samples of 2016 and 2015 annual financial statements. The samples included 30 and 38 entities respectively.
- 3 When using the data, it should be considered that the samples are not statistically representative, consistent with any other EFRAG public consultation.

CURRENT HOLDINGS OF EQUITY INSTRUMENTS AND ACCOUNTING TREATMENT

LONG-TERM INVESTING, AMOUNT AND CLASSIFICATION OF EQUITY INSTRUMENTS

- 4 Most respondents to the public consultation view themselves as long-term investors in equity instruments. Ten respondents indicated that all their equity instruments classified as AFS under IAS 39 are held for the long term.
- 5 The total amount of equity instruments held on average for years 2014-2016 by respondents is 753 billion EUR. 166 billion EUR are classified as AFS and therefore carried at fair value with the changes recognised in OCI. The rest is carried at FVPL, either because the instruments are held for trading or because the entities used the fair value option under IAS 39. While the overall ratio of 166 billion of equity instruments classified as AFS over the total equity instruments of 753 billion for the sample equals to 22%, at the individual level the ratio for most respondents is 60% or higher. Holdings of equity instruments are highly concentrated in a small number of the respondents.
- 6 The total amount of equity instruments held by the entities in the sample of the review of 2016 financial statements was 315 billion EUR, of which 57 billion EUR was classified as AFS. The rest is carried at FVPL. While the overall ratio of 57 billion EUR of equity instruments classified as AFS over the total equity instruments of 315 billion EUR for the sample equals to 18%, at the individual level the ratio for most respondents is 55% or higher.
- 7 The entities from the non-financials industry (in both the consultation and the sample of financial statements) have higher percentage of equity instruments classified as AFS over total equity instruments.

- 8 EFRAG received data for a sample of credit institutions by the European Banking Authority, where equity instruments classified as AFS represent on average 19% of total equity instruments in 2014, 2015 and the period ended 30 September 2016.
- 9 Most of the equity instruments of the respondents from the insurance and the financial services industries are direct equity holdings. The non-financials hold the majority of their equity holdings classified as AFS indirectly, i.e. through a collective investment vehicle. Consequently, these instruments may not be eligible for the FVOCI election.

OCI BALANCES AND CHANGES IN THE PERIOD ON EQUITY INSTRUMENTS CLASSIFIED AS AFS

- 10 Respondents reported a net accumulated OCI balance related to equity instruments classified as AFS amounting to 8% of the carrying amount of those instruments. The respective percentage was 11% for the sample of the 2016 annual financial statements. Four respondents and two entities in the sample had a net debit accumulated OCI balance.
- 11 Respondents reported a net change for the period of the accumulated OCI balance related to equity instruments classified as AFS amounting to 7% of earnings before tax (in absolute terms).

IMPAIRMENT LOSSES AND ASSESSMENT OF IMPAIRMENT LOSSES ON EQUITY INSTRUMENTS CLASSIFIED AS AFS

- 12 12 respondents recognised impairment losses on equity instruments classified as AFS during the period amounting to 3 billion EUR, which ranged from 1% to 24% of those respondents' earnings before tax. Insurance entities reported higher impairment losses.
- 13 19 entities in the sample of 2016 financial statements recognised impairment losses amounting to 1,6 billion EUR or 3% of earnings before tax (in absolute terms).
- 14 Most respondents to the public consultation and entities in the sample use a criterion of 'significant' or 'prolonged' decline in fair value (as required by IAS 39) to assess impairment of equity instruments. The range of quantitative thresholds varies across industries.

DISPOSAL OF EQUITY INSTRUMENTS CLASSIFIED AS AFS

- 15 Respondents that provided information on the net gain on disposal on equity instruments classified as AFS during the period, reported a total of 5 billion EUR which represents 19% of earnings before tax (in absolute terms).
- 16 Entities in the 2016 sample of financial statements recognised a total net gain from disposal of equity instruments classified as AFS of 0,6 billion EUR, which represents 3% of earnings before tax.

ANTICIPATED BEHAVIOURAL EFFECTS OF THE NEW ACCOUNTING REQUIREMENTS

- 17 Most respondents indicated that a variety of factors, including business, economic and regulatory factors, affect their decisions to invest and hold equity instruments or other classes of assets.
- 18 Most respondents, across all industries covered, expect to use the election in IFRS 9 to designate investments in equity instruments for measurement at FVOCI to some extent. The choice to use the election depends on different factors, including the business purpose of the investment, the expected volatility of the equity instrument and the economic linkage to other items.
- 19 The majority of respondents do not expect to modify their holding period for equities following the introduction of IFRS 9.
- 20 Respondents reported mixed views about the impact of the requirements on their asset allocation decisions. 12 entities (mainly insurance entities) expect to modify such decisions, although most did not specify to what extent. Some respondents indicated that they might shift some of their investment into different asset classes, including unquoted equities, as possible alternatives to quoted equities. They observed that returns from non-listed investments are mostly collected as dividends - which are recognised in profit or loss - and that unlisted investments are less volatile.
- 21 Some respondents that expect to modify their asset allocation decisions explained that they view disposal gains as part of their performance and that IFRS 9's prohibition to recycle when using the FVOCI election results in accounting mismatches in profit or loss.

KEY MESSAGES FROM THE EVIDENCE

- 22 In its endorsement advice on IFRS 9, based on the limited evidence available at the time EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9. The assessment phase has confirmed that some entities expect to modify their asset allocation decisions, while others do not.
- 23 It should be noted that most insurance entities are still at an early stage of assessment since they will apply IFRS 9 only in 2021.
- 24 In EFRAG's view, these are some of the key messages from the evidence gathered in the assessment phase:
 - a) the aggregate amount/value of equity instruments classified as AFS under IAS 39 by entities that consider themselves long-term investors is substantial. Our findings indicated a high level of concentration of holdings of equity instruments classified as AFS in a relatively small number of entities;
 - b) the importance of AFS accounting varies among entities that consider themselves long-term investors. For some, recycled gains and losses represent a significant proportion of net profits in the years examined. However, others make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9's requirements;
 - c) asset allocation decisions of long-term investors are driven by a plurality of factors;
 - d) entities that are concerned about the IFRS 9's requirements often point out to a form of 'economic linkage' between their holdings of equity investments and some of their liabilities; and
 - e) entities in practice use different criteria to assess impairment of equity instruments.

APPENDIX 3 – IMPAIRMENT UNDER ACCOUNTING STANDARDS

IMPAIRMENT IN IFRS STANDARDS

GOODWILL AND OTHER INTANGIBLE ASSETS

- 1 IAS 36 requires that an impairment test be conducted for goodwill at least annually. Goodwill is associated to a CGU (or group of CGUs not exceeding an operating segment). A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Goodwill is tested at the level of each CGU or group of CGUs that represents the lowest level within an entity at which the goodwill is monitored for internal management purposes, and is not larger than an operating segment. The test compares the CGU's carrying amount, including goodwill, to its recoverable amount.
- 2 The recoverable amount is the higher of fair value less cost to sell and value in use. Fair value less costs to sell is based on a market participants' perspective. Value in use is usually determined with a discounted cash flow model. Any negative difference is firstly allocated to goodwill. Subsequent reversals of the impairment loss allocated to goodwill are prohibited.
- 3 Other intangible assets with indefinite lives shall also be tested at least annually for impairment by comparing their carrying amount to their recoverable amount. Unlike goodwill however, it is allowed to reverse previous impairment losses at a later date.

TANGIBLE ASSETS

- 4 Tangible assets are assessed for impairment in each reporting period. The entity first needs to assess if there is an indication that an asset may be impaired. IAS 36 provides guidance for indicators of impairment, which can be both external and internal factors.
- 5 If any such indication exists, the entity needs to perform an impairment test to compare the carrying amount of the asset to its recoverable amount. The test is performed for the individual assets when possible. Otherwise, assets are grouped into CGUs to determine the recoverable amount for the CGU.

DEBT INSTRUMENTS

- 6 Debt instruments and other non-equity financial assets under IFRS 9 that are not measured at FVPL are assessed for impairment using an expected credit loss model. The expected credit loss model is intended to reflect the pattern of deterioration or improvement in the credit quality of the financial instrument. Expected credit losses are measured through a loss allowance equal to credit losses expected in the upcoming 12-month period plus the expected credit losses for the full lifetime if the credit risk has significantly increased since initial recognition.

OTHER ASSETS

- 7 Inventories, under IAS 2 *Inventories*, are measured at the lower of cost and net realisable value. Net realisable value is determined based on the expected selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

- 8 The carrying amount of deferred tax assets under IAS 12 *Income Taxes* is reviewed at each reporting period and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised.
- 9 An entity shall measure a loss allowance on a contract asset recognised under IFRS 15 *Revenue from Contracts with Customers* in accordance with IFRS 9. IFRS 9 allows a simplified method for trade receivable based on the lifetime expected credit losses.

IMPAIRMENT APPROACHES IN OTHER JURISDICTIONS

US GAAP

- 10 US GAAP requires most equity instruments to be carried at fair value with changes recognised through profit or loss. For equity instruments using level three measurements whose fair value is not readily determinable, an entity may elect to carry the equity instrument at cost subject to impairment. Cost needs to be adjusted for observable price changes in orderly transactions for the identical or a similar investment of the same issuer, and the entity should make a reasonable effort to identify any observable transactions.
- 11 For such instruments, there is a qualitative assessment each reporting period using indicators, such as significant deterioration in the earnings performance, a significant adverse change in the general market condition, factors that raise significant concerns about the investee's ability to continue as a going concern, etc.
- 12 The notion of 'other than temporary' impairment that was previously applied to equity instruments classified as AFS is no longer in use.

JAPANESE GAAP

- 13 Under Japanese GAAP, equity instruments that are not held for trading are carried at FVOCI (similar to the AFS category in IAS 39). If the fair value is extremely difficult to obtain, the instruments are carried at cost.
- 14 For equity instruments carried at FVOCI, an entity uses judgement to recognise an impairment loss when the fair value has declined significantly, unless the fair value is expected to recover. However, the standard indicates that:
 - a) if the fair value has declined more than 30% but less than 50%, the entity shall assess the recoverability; and
 - b) if the fair value has declined more than 50%, the investment is presumed to be impaired, unless the entity can prove otherwise.
- 15 If the entity assesses that the fair value is expected to recover close to the original value within a year, it does not recognise an impairment loss. However, the entity cannot conclude that the value is expected to recover if any of the following has occurred: a) the fair value has declined significantly in the past two years, b) the net assets of the investee are negative, and c) the investee has incurred losses for the past two years and is expecting a loss in the next year.
- 16 For equity instruments carried at cost, an entity shall recognise an impairment loss when the value has declined significantly, unless it can demonstrate that the decline is recoverable.



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