EFRAG
European Financial Reporting Advisory Group

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DRAFT

EQUITY INSTRUMENTS – IMPAIRMENT AND RECYCLING

EFRAG

DISCUSSION PAPER

[MONTH 2018]

EFRAG
European Financial Reporting Advisory Group

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The paper invites comment on its proposals via the 'Questions for Respondents'. Such comments should be submitted by using the 'Express your views' page on EFRAG website by clicking [here-insert hyperlink] or should be sent by post to:

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so as to arrive no later than [Comment Deadline Date]. All comments received will be placed on the public record unless confidentiality is requested.

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European Financial Reporting Advisory Group

Our Research Activities in Europe

This paper is part of EFRAG's research activities. 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. EFRAG carries out this research work in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- influencing the development of global financial reporting 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.

Detailed information about our research activities and current projects is available on the EFRAG website.

Table of Contents

OUR RESEARCH ACTIVITIES IN EUROPE 3
TABLE OF CONTENTS 4
EXECUTIVE SUMMARY 6
QUESTIONS TO CONSTITUENTS 8
CHAPTER 1: BACKGROUND 10
- The accounting requirements in IAS 39 and IFRS 9 for equity instruments 10
- What are we looking at? 11
- Scope and objective of the DP 12
- Structure of the DP 12

CHAPTER 2: IMPORTANCE OF RECYCLING AND IMPAIRMENT 14
- Long-term business model and measuring performance 14
- Interrelation between recycling and impairment 15

CHAPTER 3: ALTERNATIVE IMPAIRMENT MODELS 18
- Identifying sub-sets of investments 18
- Two 'bright-line' choices 19
  - *A less subjective AFS impairment model* 19
    - Advantages and disadvantages 21
  - *Dual measurement model* 21
    - Advantages and disadvantages 22

CHAPTER 4: OTHER CHARACTERISTICS 23
- Reversal of impairment losses 23
- Rebuttable presumption to a bright line approach 24
- Unit of account – individual investment or portfolio 25
- Unit of account – cost formula 26

APPENDIX 1 – NOTION OF IMPAIRMENT UNDER ACCOUNTING STANDARDS 27
- How is 'impairment' defined in IFRS Standards? 27
  - *Goodwill and other intangible assets* 27
  - *Tangible assets* 27
  - *Debt instruments* 27
  - *Other assets* 27
- Impairment approaches in European jurisdictions 28
- Impairment approaches in other jurisdictions 28
  - *US GAAP* 28
  - *Japanese GAAP* 28

APPENDIX 2 – ANALYSIS OF EXISTING DISCLOSURE REQUIREMENTS 30

First scenario - current IFRS 9 ... 31
Second scenario – FVOCI with recycling but no impairment ... 32
Third scenario – all equity instruments at FVPL ... 33
APPENDIX 3 – OTHER APPLICATION ISSUES ... 35
INTERRELATION WITH HEDGING REQUIREMENTS ... 35
TIMING OF IMPAIRMENT TESTS AND INTERACTION WITH INTERIM REPORTING ... 36
INTERRELATION WITH FOREIGN CURRENCY EXCHANGE RATES ... 36
APPENDIX 4 – SUMMARY OF EVIDENCE COLLECTED ... 37
CURRENT HOLDINGS OF EQUITY INSTRUMENTS AND ACCOUNTING TREATMENT ... 37
Long-term investing, amount and classification of equity instruments ... 37
OCI balances and changes in the period on equity instruments classified as AFS ... 38
Impairment losses and assessment of impairment losses on equity instruments classified as AFS .. 38
Disposal of equity instruments classified as AFS ... 38
ANTICIPATED BEHAVIOURAL EFFECTS OF THE NEW ACCOUNTING REQUIREMENTS ... 38
KEY MESSAGES FROM THE EVIDENCE ... 39
APPENDIX 5 – BIBLIOGRAPHY ... 40

Executive Summary

ES1 Equity instruments are generally measured at fair value through profit or loss (‘FVPL’) under International Financial Reporting Standard 9 (‘IFRS 9’) *Financial Instruments*, which is effective for most entities for periods beginning on or after 1 January 2018. For equity instruments that are not held for trading or contingent consideration recognised by an acquirer in a business combination, an entity may make an irrevocable election on an instrument-by-instrument basis to present changes in the fair value in other comprehensive income (‘OCI’). Gains or losses on de-recognition of these instruments are not recycled into profit or loss and entities do not assess these instruments for impairment.

ES2 EFRAG noted in its endorsement advice to the European Commission (‘EC’) on IFRS 9 that the fair value through other comprehensive income (‘FVOCI’) election was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses might not properly reflect their performance. The International Accounting Standards Board (‘IASB’) indicated that one of the main reasons for not allowing recycling is that it would create the need to assess these equity instruments for impairment and that the application of impairment requirements of available-for-sale (‘AFS’) in IAS 39 *Financial Instruments: Classification and Measurement* was very subjective.

ES3 The EC requested EFRAG to investigate the potential effects on long-term investment of the IFRS 9’s requirements on accounting for equity instruments. In the first phase of the project (‘assessment phase’), EFRAG was asked to collect quantitative data on the current holdings of equity instruments 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. A summary of the key findings of the assessment phase is presented in Appendix 4.

ES4 The main objective of this Discussion Paper (‘DP’), as noted in Chapter 1, is to gather constituents’ views on possible alternative models for the impairment of equity instruments designated at FVOCI, with the intent to allow recycling of gains and losses on disposal.

ES5 In this DP, EFRAG explains the importance of recycling, particularly to reporting the performance of entities with long-term investing business models, and the interrelationship with impairment. EFRAG also argues that a robust impairment model should be a precondition to the reintroduction of recycling of gains or losses from OCI into profit or loss.

ES6 EFRAG developed two alternative impairment models. These models include:

a) a model similar to IAS 39’s but with additional guidance to reduce subjectivity; and

b) a dual measurement model, where all declines in fair value below the purchase cost would be immediately recognised in profit or loss and changes in fair value above the purchase cost would be recognised in OCI and recycled on disposal.

ES7 Each of the two alternative impairment models aims to be less subjective than the requirements of IAS 39, by introducing ‘bright lines’ to the impairment assessment.

ES8 This DP also considers other aspects of an impairment model for equity instruments including:

a) impairment reversal choices;

b) whether the proposed models could be improved with the introduction of a rebuttable presumption; and

c) the unit of account in measurement.

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.

All comments should be received by [Submission date].

Question 1 – Reintroduction of recycling of disposal gains or losses

The DP (paragraphs 2.3 – 2.11) argues that recycling disposal gains or losses on equity instruments carried at FVOCI allows for a better depiction of the performance of long-term investors.

Q1.1 Do you support the reintroduction of recycling? Why or why not?

Question 2 – Conditions to the reintroduction of recycling

The DP (paragraphs 2.12 – 2.20) argues that a robust impairment model should be regarded a precondition to the reintroduction of recycling.

Q2.1 Do you agree that developing a robust impairment model should be a precondition to the reintroduction of recycling?

Q2.2 Do you have other concerns around the reintroduction of recycling, and/or other suggested preconditions to its reintroduction? Please explain.

Question 3 – Alternative models

In paragraphs 3.10 – 3.28, the DP describes two main models (a) a model similar to IAS 39's but with additional guidance to reduce subjectivity and b) a dual measurement model, where all declines in fair value below the purchase cost would be immediately recognised in profit or loss and changes in fair value above the purchase cost would be recognised in OCI and recycled on disposal) for the subsequent accounting of equity instruments carried at FVOCI.

Q3.1 What should be, in your view, the objective of a robust impairment model for equity instruments?

Q3.2 What are, in your view, the main features of a robust impairment model (relevance, reliability, comparability…)?

Q3.3 In general terms, do you prefer a) a less subjective AFS model, b) the dual measurement model, or c) another model? Please explain.

Question 4 – A less subjective AFS model

In paragraphs 3.11 – 3.22, the DP discusses the introduction of quantitative impairment triggers. Triggers reduce the extent of judgment 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.

Q4.1 Do you support the inclusion of quantitative impairment triggers? If so, who should set them?

Q4.2 If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

Question 5 – Reversals of impairment losses

The DP proposes that impairment losses should be reversed in particular circumstances and illustrates some different possible reversal mechanisms.

Q5.1 Which of the approaches in paragraphs 4.4 to 4.9 do you support and why?

Question 6 – Other characteristics

The DP discusses a number of other characteristics, including:

- the identification of specific sub-sets of equity instruments, which was rejected (paragraphs 3.3 – 3.9);
- whether the proposed models could be improved with the introduction of a rebuttable presumption to a bright line approach (paragraphs 4.10 –4.12); and
- issues related to the unit of account (paragraphs 4.13 – 4.23).

Q6.1 Do you have comments on the other features?

Q6.2 Are there other aspects that EFRAG should consider?

Chapter 1: Background

The accounting requirements in IAS 39 and IFRS 9 for equity instruments

1.1 The IASB issued IFRS 9 in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. In accordance with IFRS 9, equity instruments are generally measured at FVPL. At initial recognition, an entity may make an irrevocable election to present changes in the fair value in FVOCI. This FVOCI election is not available for equity instruments that are held for trading. The entity may apply the FVOCI election on an instrument-by-instrument basis.

1.2 If the entity applies the FVOCI election, changes in fair value are presented in OCI and are not recycled on disposal and there is no requirement to assess these instruments for impairments. Dividends from the instruments are, however, recognised directly in profit or loss.

1.3 Under IAS 39, equity instruments, other than those held-for-trading, were classified as AFS. These instruments were measured at fair value and changes in fair value are presented in OCI. However AFS accounting under IAS 39 differs from the accounting under IFRS 9's FVOCI election in the following two ways:

a) when an entity assessed that an instrument is impaired, the decrease in value from the original cost was reclassified to profit or loss as an impairment loss. Impairment losses should not be subsequently reversed; and

b) on disposal the cumulative gain or loss in OCI was recycled to profit or loss.

1.4 Accordingly, entities that classified some or all of their equity instruments as AFS under IAS 39 will need to modify their accounting treatment in one of the following ways:

a) if these instruments will be carried at FVPL, under IFRS 9's default accounting requirement, changes in fair value will immediately be recognised in profit or loss; or

b) if the entity will use the FVOCI election, changes in fair value are never recognised in profit or loss.

1.5 In the Basis for Conclusions of IFRS 9, the IASB noted that one of the primary reasons for not allowing recycling is that it would create the need to assess these equity instruments for impairment. The IASB also observed that the impairment requirements for equity instruments classified as AFS under IAS 39 were very subjective.

What are we looking at?

1.6 In its Endorsement Advice to 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.

1.7 If neither of the available accounting options in IFRS 9 is attractive to some long-term investors, this may create an incentive for those investors to reduce their holdings of equity instruments in favour of other asset classes. In its endorsement advice, EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation 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 in deciding whether or not to invest in equity investments. EFRAG acknowledged that its assessment was based on the limited evidence available at that time.

1.8 With respect to recycling, EFRAG had previously stressed the importance of profit or loss as a main indicator of financial performance.

1.9 After the completion of the 2015 EFRAG Proactive Agenda consultation, EFRAG added a project on equity instruments in its work plan, specifically related to recycling and impairment of investments in equity instruments with an objective to consider alternative models to the impairment of equity instruments.

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 In May 2017, EFRAG received a request from the EC for technical advice. The request has two distinct phases:

a) the first phase ('the assessment phase'), which was due by the end of 2017, consisted of information about 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. The key findings from this phase of the project are presented in Appendix 4; 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 a precondition to re-introduce recycling, then EFRAG should consider how the existing impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches, possibly by looking at other national or third-country Generally Accepted Accounting Principles ('GAAPs'). The EC also requests EFRAG to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could be used to provide users with the necessary information to make the adjustments deemed necessary to the reported profit or loss.

Scope and objective of the DP

1.12 The scope and main objective of this DP is to gather constituents' views on possible alternative models for the impairment of equity instruments designated at FVOCI in accordance with IFRS 9, with a view to allowing the recycling of gains and losses on disposal.

1.13 Throughout this DP, EFRAG uses the term 'impairment'. EFRAG acknowledges that some may not consider equity instruments carried at fair value on the statement of financial position to be impaired insofar as the carrying value reflects any change in fair value. The term 'impairment' is used in this DP to describe an event or set of circumstances in which an unrealised decline in the fair value of an equity instrument designated at FVOCI to less than its original cost is recycled from OCI to profit or loss.

1.14 For the purposes of this DP, EFRAG has not challenged or reconsidered the following aspects of IFRS 9's requirements on accounting for investments in equity instruments:

a) equity instruments are measured at fair value in the statement of financial position; and

b) the FVOCI election is neither removed nor made obligatory.

1.15 The DP will not address any changes in the definition of an equity instrument under IFRS Standards.

Structure of the DP

1.16 In **Chapter 2** EFRAG discusses the relevance of recycling and the interrelation between recycling and impairment.

1.17 **Chapter 3** presents EFRAG's considerations in developing an impairment model for equity instruments and the reasons the impairment models were narrowed to two main choices. This chapter also explains how the two proposed impairment models would work and their advantages and disadvantages.

1.18 In **Chapter 4**, EFRAG discusses the following other characteristics related to the models proposed in Chapter 3:

a) reversal of impairment losses;

b) rebuttable presumption to a bright line approach; and

c) unit of account: individual investment or portfolio and cost formula.

1.19 In its search for a possible impairment model for equity instruments, EFRAG considered the notion of impairment in other IFRS Standards as well as impairment practices in European and other jurisdictions. These are presented in **Appendix 1**.

1.20 In **Appendix 2**, EFRAG considers the existing presentation and disclosure requirements in IFRS Standards and discusses if and how they could provide relevant information on potential impairment and performance.

1.21 In **Appendix 3**, EFRAG discusses other application issues:

a) interrelation with hedging requirements;

b) timing of impairment tests and interaction with interim reporting; and

c) interrelation with foreign currency exchange rates.

1.22 In **Appendix 4**, EFRAG has summarised the key findings from the assessment phase of the EC request and the implications of those findings.

1.23 EFRAG has commissioned an academic literature review to investigate the available evidence on how accounting requirements may affect asset allocation decisions, and how the presentation of recycling gains in profit or loss or OCI is relevant for long-term investors. **Appendix 5** presents a summary of this review.

Chapter 2: Importance of recycling and impairment

2.1 The revised *Conceptual Framework for Financial Reporting* is expected to state that:

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 explains why it considers there is a clear basis for identifying the period in which recycling should occur and why the amount recycled would enhance the relevance and faithful representation of profit or loss. In addition, in this chapter EFRAG argues that a robust impairment model is a precondition to the reintroduction of recycling.

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 short-term trading activities.

2.4 In a long-term investment business model, entities purchase 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 As a consequence, EFRAG argues that the prohibition of recycling disposal gains and losses may limit the relevance of reported profit or loss. This is because gains and losses obtained over the investment period are indicative of the performance of the investor and useful for assessing management's stewardship of the entity's resources.

2.6 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. In the case of equity instruments accounted at FVOCI, EFRAG considers that there is a clear basis to identify the appropriate period. As discussed above, in a long-term business model, assets are sold to obtain the ultimate cash flow. In EFRAG's view, the period in which that cash flow is obtained is clearly identifiable (i.e. it is not arbitrary) and is economically significant.

2.7 The FVOCI election implicitly acknowledges that, although fair value information is relevant from the perspective of 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. Under a long-term investment business model, reporting unrealised changes in the value of the assets in OCI would reflect the change in the entity's exposure to market price risk. Accumulated OCI represents capital appreciation gains accumulated since the acquisition of the assets.

2.8 EFRAG's Endorsement Advice to the EC on IFRS 9 was consistent with the views outlined above. EFRAG noted that while 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), the default requirement to measure all equity investments at fair value through profit or loss might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries.

2.9 EFRAG's views outlined above were also supported by several respondents to EFRAG's questionnaire, undertaken in the assessment phase of this project. These entities often identified themselves as long-term investors and claimed the existence of an 'economic linkage' between their holdings of equity investments and some of their liabilities.

2.10 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 purchased 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').

2.11 While EFRAG acknowledges the counter-arguments in paragraph 2.10 above, EFRAG's overall assessment is that recycling enhances the relevance of reported profit or loss in a long-term investment business model.

Interrelation between recycling and impairment

2.12 In the following paragraphs, EFRAG argues that an impairment model should be regarded as a precondition to the reintroduction of recycling of gains or losses from OCI into profit or loss. In reaching this view, EFRAG also considered whether presentation or disclosure approaches could provide an appropriate alternative to an impairment model.

2.13 IFRS Standards generally have some form of impairment requirement for assets other except those measured at FVPL. This applies to assets carried at cost such as inventory, property, plant and equipment, intangible assets and amortised cost debt instruments. In addition, impairment requirements also apply to other assets accounted for at FVOCI, including property, plant and equipment, intangible assets and debt instruments accounted for at FVOCI. EFRAG notes that a 'recycling plus impairment' model aligns reported profit or loss for the FVOCI category with reported profit or loss under cost-based accounting.

2.14 EFRAG considers that an impairment model enhances the relevance of profit or loss for stewardship purposes. IAS 39's underlying objective for recognising an impairment losses on an equity instrument is 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, and 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 realised loss. EFRAG considers that inclusion of losses that have been incurred enhances the relevance of profit or loss as the primary source of information about an entity's financial performance in the period, including from a stewardship perspective.

2.15 EFRAG also considers 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. An impairment model results in declines in fair value being recognised in profit or loss prior to ultimate disposal when they relate to identifiable adverse changes in the issuer's economic condition. An impairment model accordingly requires a distinction to be made between unrealised losses that are 'impairments' and those that are not. In EFRAG's view, making such a distinction provides relevant information to users of financial statements by providing insight into whether a decline in fair value is more or less likely to reverse in the future.

2.16 A robust and operational impairment model also eliminates or reduces any accounting-related incentive to maintain loss-making equity investments for an indefinite period of time. 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.

2.17 Any impairment model has the effect that the accounting treatment of unrealised gains and losses is asymmetric. Gains are recognised in profit or loss only upon sale, while some losses are 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. In EFRAG's view, recognition in profit or loss of impairment losses on a revised equity-FVOCI category that also includes recycling is consistent with the notion of prudence.

2.18 For these reasons, EFRAG considers that an impairment model should be regarded as a precondition to the reintroduction of the recycling of gains or losses from OCI into profit or loss. In EFRAG's view, the recognition of impairment losses combined with recycling of disposal gains or losses leads to better performance reporting. Further, the Basis for Conclusions to IFRS 9 indicates that the IASB believes that allowing recycling would create the need to assess these equity instruments for impairment.

2.19 In making this assessment, EFRAG also considered alternative presentation or disclosure approaches that could provide users with the necessary information to make the adjustments deemed necessary to the reported profit or loss, in the absence of a robust impairment model. These alternative presentation and disclosure requirements are illustrated in Appendix 2. However, EFRAG concluded that these alternative approaches would not be an adequate substitute for a robust impairment model.

2.20 EFRAG has therefore considered how the impairment model could be made less subjective than the one in IAS 39 for AFS equity instruments. EFRAG acknowledges that it is difficult to develop an impairment model that is at the same time relevant for all equity instruments and also objective and fully comparable. Full comparability likely requires the introduction of quantitative thresholds that may limit relevance.

Chapter 3: Alternative impairment models

3.1 In developing this DP, EFRAG considered several alternative impairment models. This chapter discusses those considerations and the reasons EFRAG narrowed the alternative impairment models to two main choices.

3.2 The objective of this DP is not to question every aspect of the accounting treatment of equity instruments. EFRAG considers IFRS 9 to be an improvement in financial reporting compared to IAS 39 and has limited its deliberations to the application of recycling and impairment in the context of the FVOCI election. Accordingly, EFRAG has considered possible alternative models on the premise that other aspects of IFRS 9's accounting requirements would not be reassessed, and specifically that:

a) fair value is the appropriate measurement basis for equity instruments in the statement of financial position; and

b) the FVOCI election should be maintained and should be on a voluntary basis.

Identifying sub-sets of investments

3.3 EFRAG initially discussed whether different impairment approaches should be used depending on specific characteristics of the instruments to which the FVOCI election is applied. This would have required the identification of different sub-sets of equity investments.

3.4 EFRAG considered different criteria for determining sub-sets including one based on the purpose of the investment. This criterion is based on the argument that entities acquire equity instruments of other entities for a variety of reasons. Entities acquire some investments 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). Other entities acquire equity instruments for reasons other than or in addition to realising an investment return. The following are just some of the other reasons an entity might acquire equity instruments of another entity:

a) gain influence over the investee, this could be a competitor, supplier, customer, or part of a distribution chain;

b) 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.

3.5 In developing IFRS 9, the IASB discussed restricting the use of the FVOCI election to strategic investments but eventually rejected it. 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 other comprehensive income. 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.

3.6 In its discussions, EFRAG considered whether a customised impairment model could be developed for a sub-set of 'strategic investments'. For these instruments, it may have been effective to use a model similar to the one in IAS 36 *Impairment of Asset*s, with the allocation of these strategic investments to a cash generating unit ('CGU'). The basis for this would be that these strategic investments 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

3.7 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;

d) if there is a residual negative difference, allocate it pro-rata to the other assets in the CGU.

3.8 There could be additional complexities in determining the allocation of the impairment loss when for instance the CGU includes goodwill.

3.9 Finally, EFRAG concluded that trying to define a sub-set of strategic investments would introduce too much judgment and complexity. Therefore, the models proposed in this DP are intended to apply to all equity instruments carried at FVOCI.

Two 'bright-line' choices

3.10 The two impairment models presented in the DP effectively remove most of the subjectivity of the impairment determination by using more prescriptive impairment triggers or what some view as bright-lines. One of these models is based on the existing impairment model of IAS 39, but with additional guidance to reduce subjectivity, and the second choice is referred to as a dual measurement model.

A less subjective AFS impairment model

3.11 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.

3.12 For equity instruments, IAS 39 provided some additional examples of objective evidence. 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'. 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. Accordingly, this DP refers to the 'significant or prolonged' trigger as the 'AFS impairment model'.

3.13 The first impairment model proposed in the DP is aligned to the AFS impairment model, 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.

3.14 If the aim is to reduce the subjectivity of the impairment assessment, the IFRS Standard should be more prescriptive and leave less room for judgment. One of the challenges in applying judgment in this specific context is that IAS 39 does not define the impairment of equity instruments in terms of a specific probability threshold that 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 judgment in a principle-based system, these challenges lead to a risk that the judgment on 'significant or prolonged' becomes arbitrary. EFRAG's findings in the assessment phase of this project provided evidence of diverse application of 'significant or prolonged' and therefore add weight to this concern (see Appendix 4 of the DP).

3.15 To make the AFS impairment model more objective, the thresholds for 'significant or prolonged' would need to be defined or described in more specific terms. A 'significant' decline could be defined as a specific percentage decline from the purchase cost and 'prolonged' as a specific time period where the fair value has been below the purchase cost. This defining can be done in one of three ways:

a) the IFRS Standard would specifically define the thresholds associated with these terms; or

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, for example an approach whereby the IFRS Standard sets an upper limit for both terms, and reporting entities select a threshold equal or lower than the limit.

3.16 The first option would substantially eliminate judgment from the assessment of impairment of equity investments (putting aside any judgment involved in measuring the instrument's fair value). It is effectively the same approach as the dual measurement approach discussed later in the chapter except that the quantitative thresholds for both significant and prolonged would be higher than zero.

3.17 The second option permits the reporting entity to make a judgment as to the appropriate threshold, but once that judgment is made, the entity needs to apply the threshold consistently for all equity instruments designated as FVOCI. An entity that elects to use the FVOCI option should disclose the selected threshold, since it relates to an entity-specific application of an aspect of IFRS 9.

3.18 Under the third option, the IFRS Standard would specify the upper limit for both 'significant' and 'prolonged', for example, 30 percent and 12 months. The reporting entity then selects its own thresholds equal or lower than the upper limit.

3.19 Under each of the options, the defined threshold would be applied to equity instruments on a 'significant or prolonged' basis similar to IAS 39.

Advantages and disadvantages

3.20 This approach retains the concepts of current practice but removes much of the subjectivity that the IASB referred to in its arguments for prohibiting recycling in IFRS 9. Compared to the dual measurement model discussed below, this method relies on a 'trigger' before impairment is recognised, which limits what some may consider undue volatility for minor changes in fair value below the equity instrument's original cost.

3.21 There is an unavoidable trade-off in this kind of approach. On one side, a single quantitative threshold set by an IFRS Standard leads to full uniformity and eliminates judgmental assessments, but moves away from a principles-based approach and may limit relevance. For example, an IFRS Standard defined 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.

3.22 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. However, allowing entities to define these thresholds can potentially lead to divergence and less comparability.

Dual measurement model

3.23 Under this model, the equity instrument is carried at fair value in the statement of financial position, but the changes in the period are accounted as follows:

a) all declines in fair value below the purchase cost would be immediately recognised in profit or loss; and

b) changes in fair value above the purchase cost would be recognised in OCI and recycled on disposal.

3.24 In developing IAS 39, the IASB considered such a dual measurement model. The Board noted at the time that it would 'significantly change the notion of 'available for sale' in practice' and believed such a change was not appropriate at this time. However, the AFS notion is no longer an issue, as it is not contained in IFRS 9.

Advantages and disadvantages

3.25 This approach does not differentiate between declines in fair value below cost that are accounted for in OCI and those accounted for as impairments in profit or loss. The amount recognised in profit or loss in a period is simply the difference between:

a) the (negative) difference between the fair value at reporting date and the original cost; and

b) the cumulative difference recognised in profit or loss in prior periods.

3.26 In some cases, the amount recognised in profit or loss would not represent the change in value over the period. For example, consider an original cost of EUR 100, a fair value at the end of the prior period of EUR 105 and a current fair value of EUR 98. Under this approach, the entity would recognise EUR 5 in OCI and EUR 2 in profit or loss.

3.27 This approach effectively removes all judgment from the impairment assessment (again putting aside any judgment involved in measuring the instrument's fair value), and would seem to overcome any concerns about the possible lack of objectivity and comparability.

3.28 On the other hand, the IASB introduced the FVOCI option to address the concern that the FVPL measurement basis created volatility in profit or loss, which some entities believe does not reflect their business model. The approach would have the effect that volatility is reported is profit or loss when, and for as long as, the current fair value is lower than the original cost. For this reason, this approach may not be as attractive to long-term investors, whose performance would still be exposed to short-term volatility (on the downside).

Chapter 4: Other characteristics

4.1 Chapter 3 describes the main features of two possible alternative impairment models. In both cases, a number of other characteristics also need to be considered, some of which could have a significant effect. This chapter discusses these characteristics and the alternatives ways each model might operate.

Reversal of impairment losses

4.2 IAS 39 did not allow for the reversals of impairment losses for AFS equity instruments. In EFRAG's view, the conceptual arguments for and against reversals merit re-examination. In addition, some consider that this prohibition may have contributed to a resistance to recognise impairment losses and in turn put more pressure on the 'significant or prolonged' criterion.

4.3 Under the dual measurement model, if the fair value recovers after a decline, the positive change is automatically recognised in profit or loss up to the purchase cost. EFRAG considered whether, under the less subjective AFS model, reversals should be allowed and if so, starting from when. EFRAG notes that allowing for reversals would put less pressure on the assessment of impairment and may lead to less resistance to recognise a loss. On the other side, allowing reversals has the potential effect of adding volatility.

4.4 A no reversal approach would maintain any impairment recognised in profit and loss even if the fair value recovers back to the purchase cost. This approach is based on the view that impairment creates a new cost basis. IAS 39's Basis for Conclusions explained the prohibition on reversals on the basis of difficulties in distinguishing a reversal of an impairment from other increases in value.

4.5 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. This approach may decrease volatility in an entity's reported profit or loss, as reversals would be less frequent.

4.6 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.

4.7 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**

4.8 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 purchase cost by year-end.

4.9 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 some form of new assessment. These issues might require further development.

Rebuttable presumption to a bright line approach

4.10 Some might argue that a single threshold does not consider that some equities are more volatile than others. Applying a single threshold to all equities makes the model quite rigid and may result in an impairment loss for a decline in vale that, for more volatile equities, may be expected to reverse in future.

4.11 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 purchase cost of EUR 95.

4.12 This rebuttable presumption would not result in subjective judgment because it is still based on observable evidence. Nonetheless, EFRAG notes that this approach is not consistent with a 'significant or prolonged' approach in that the fact pattern described is a scenario in which the decline in value is significant but is not prolonged. Also, introducing this type of rebuttable presumptions introduces more complexity.

Unit of account – individual investment or portfolio

4.13 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 does not change the measurement basis on the statement of financial position, but only the presentation of a loss.

4.14 EFRAG has considered the level of aggregation at which an assessment of impairment should be made. Both models 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.

4.15 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. 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:

Amounts are in EUR	**Cost**	**Fair value**
Equity instrument A	60	75
Equity instrument B	25	40
Equity instrument C	50	45
Total	**135**	**150**

4.16 Measuring impairment on an individual instrument level, the entity would recognise in profit or loss an impairment of EUR 5 for equity instrument C. There would be no impairment loss if the impairment test was conducted on a portfolio basis since the fair value of the portfolio exceeds its cost.

4.17 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.

4.18 EFRAG also assesses that such an approach would require substantial further development in order to be robust and operational.

Unit of account – cost formula

4.19 EFRAG also considered whether the model should specify a cost formula for an individual investment when it has been purchased in multiple tranches – such as a weighted average cost basis or a first-in-first-out (‘FIFO’) basis.

4.20 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.

4.21 If the fair value at year-end is EUR 75, this would be higher than the average cost of EUR 70, and under the dual measurement 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.

4.22 IAS 39 does not provide guidance on this issue, which applies both to the measurement of impairment and gain or loss on partial disposals. Entities presumably have 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.

4.23 EFRAG does not see a compelling reason for either cost formula. If the reporting entity determines which cost formula to use it would enable the entity to align its financial reporting and tax treatments.

Appendix 1 – Notion of impairment under accounting standards

How is ‘impairment’ defined in IFRS Standards?

Goodwill and other intangible assets

1 IAS 36 requires that an impairment test be conducted for goodwill annually at CGU level. A CGU is the smallest grouping of assets with identifiable cash flows. The test compares the CGU’s carrying amount, including goodwill, with its expected recoverable amount. If the test suggests that there is an impairment loss, the loss amount is first allocated to reduce goodwill. Reversal of the impairment loss allocated to goodwill is prohibited.

2 Other intangible assets with indefinite lives are also required to be tested annually for impairment by comparing the carrying amount of the asset with its expected recoverability. Unlike goodwill however, subsequent impairment reversals are allowed.

Tangible assets

3 Tangible assets under IAS 36 are assessed for impairment each reporting period. An important aspect of IAS 36 is to determine whether any indicators exist, that might require an impairment test. IAS 36 provides guidance for indicators of impairment, which can be both external and internal factors.

4 If any of the indicators have been triggered, then an impairment test is made to determine the recoverable amount for individual assets if possible. Otherwise, assets are grouped into CGUs to determine the recoverable amount for the CGU. The recoverable amount of the asset or CGU is the higher of the asset’s or CGU’s fair value less cost to sell and its value in use. The value in use is an estimate of the discounted future cash flows the entity expects from the asset or CGU. The value in use is subject to judgment and entity-specific.

Debt instruments

5 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 expected credit losses that are possible in the upcoming 12-month period plus the expected credit losses for the full lifetime if the credit loss has increased since initial recognition.

Other assets

6 Inventories, under IAS 2, are measured at the lower of cost or net realisable value. Net realisable value is determined based on the expected selling price in the ordinary course of business less estimated selling costs.

7 Deferred tax assets, under IAS 12 *Income Taxes*, are reviewed at each reporting period. Deferred tax assets are reduced if it is not probable there will be sufficient taxable profit will be available in the future to utilise the asset. If it is determined that it is unlikely there will be insufficient taxable income in future tax periods to utilise the tax asset, the asset is written down to the amount likely to be recovered.

8 A loss on an asset recognised under construction contracts under IFRS 15 *Revenue from Contracts with Customers* to the extent that the carrying amount of the asset exceeds the remaining amount of the excess consideration the entity expects to receive over its expected remaining costs to provide goods or services under the contract.

Impairment approaches in European jurisdictions

9 EFRAG collected information on impairment approaches of equity instruments from some European jurisdictions. The general principle is that short-term equity investments are generally carried at FVPL, while long-term equity instruments are carried at cost less 'other than temporary' losses in value.

10 There are exceptions to the general principle. Some jurisdictions require all investments in listed equity instruments to be carried at FVPL; some allow short-term investments in unlisted equity instruments to be carried at cost if the fair value cannot be assessed reliably.

11 Based in EFRAG investigation, a few European jurisdictions have introduced quantitative triggers to assess when a decrease in the fair value is not temporary. The Slovenian Accounting Standards uses a 20% threshold and a 12-months threshold to assess that a decline in fair value is significant and long-term. The Spanish Accounting Standards use a presumption that an equity instrument is impaired if there is a decrease in fair value by more than 40% of the instrument's cost or over a period exceeding 18 months.

Impairment approaches in other jurisdictions

US GAAP

12 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. 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.

13 The notion of 'other than temporary' impairment that was previously applied to equity instruments classified as AFS is no longer in use.

Japanese GAAP

14 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.

15 For equity instruments carried at FVOCI, an entity uses judgment 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.

16 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.

17 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.

Appendix 2 – Analysis of existing disclosure requirements

1 EFRAG considered the existing presentation and disclosure requirements in IFRS Standards and discusses whether they could provide relevant information on potential impairment and performance. In particular:

a) whether an entity could analyse fair value changes over time in OCI between positive and negative changes on equity investments so that investors could form a view about the performance of the equity investments; and

b) whether an entity could disclose fair value changes on equity instruments measured at FVPL with an analysis between realised and unrealised changes.

2 There are several disclosure requirements in IFRS Standards that apply to equity instruments designated at FVOCI. Some general disclosures include:

a) 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 notes*; and

b) the net gain or loss in the statement of comprehensive income or in the notes†.

3 IFRS 7 *Financial Instruments: Disclosures* also includes disclosure requirements specifically for investments in equity instruments designated to be measured at FVOCI‡:

a) which investments in equity instruments have been designated at FVOCI;

b) the reasons for using this presentation;

c) the fair value of each such investment at the end of the reporting period;

d) 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;

e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers;

f) the reasons for disposing any investment;

g) the fair value of any investment disposed at the date of derecognition; and

h) the cumulative gain or loss on disposal.

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

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

‡ IFRS 7 *Financial Instruments: Disclosures* paragraph 11.

4 Assume a reporting entity holds three investments in equity instruments designated at FVOCI, as follows:

	Original 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**

5 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).

6 In the following paragraphs EFRAG considers the extent to which the IFRS disclosure requirements described above (which are applicable when the FVOCI election is used) would enable users to adjust the results reported in accordance with three different accounting approaches ('scenarios'):

a) the FVOCI-equity requirements in IFRS 9 currently;

b) the FVOCI-equity requirements amended to require recycling but with no impairment requirement; and

c) no FVOCI category and all equity instruments at FVPL.

7 Each scenario is evaluated from 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 recognised in profit or loss upon impairment or disposal. Accordingly the user's objective is to adjust the profit or reported under the applicable scenario to reflect this view of performance.

First scenario - current IFRS 9

Under current IFRS 9 requirements:

a) entities carry their equity instruments at fair value and, as a default requirement, present changes in fair value in profit or loss;

b) entities can use the FVOCI election; and

c) when the FVOCI election is used entities are not required to assess the equity instruments for impairment and entities do not recycle gains or losses on disposal.

8 Under this scenario the hypothetical user referred to above would need to make the following adjustments:

a) add the cumulative gain on disposal for the equity instruments sold during the reporting period (Investment Y) of EUR35 to reported profit or loss; and

b) assess whether the fall in value of Investment Z of CU18 should be treated as an impairment loss and, if so, deduct EUR18 reported profit or loss.

9 The information under 8a) is required by IFRS 7.11B(c). The information under 8b) is not required. This assessment could be based on the debit balance of OCI, which would indicate the maximum loss exposure. Where the reporting entity holds more than a single 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 have to be specifically provided for equity instruments that have a debit OCI balance and are still held at the reporting date to determine if there is an impairment.

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. Accordingly:

- entities carry all their equity instruments at fair value in the statement of financial position;
- entities can elect to charge the fair value changes in profit or loss or OCI on an instrument-by-instrument basis;
- entities would not be required to assess impairment on any equity instruments, including FVOCI instruments; and
- entities would be required to recycle gains or losses on disposal.

10 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.

11 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.

12 As mentioned in the previous scenario, the hypothetical user would be unable to make an impairment assessment when there are more than one investment with a loss because the cumulative loss in OCI is reported in the aggregate. The hypothetical user could use the OCI balance to assess only a maximum loss exposure.

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.
- Therefore, there is no use of OCI and there is no need to determine an impairment loss.

13 Most of the IFRS 7 disclosure requirements described above would not be applicable under the assumption that all equity instruments are carried at FVPL.

14 Under this scenario the hypothetical user referred to above would need to make following adjustments:

a) adjust the realised disposal gain or loss of equity instruments disposed during the period (Investment Y) for an amount of EUR 30 to reflect prior period increases in fair value;

b) remove the current period fair value change from profit or loss for equity instruments held at the end of the reporting period (Investment X and Z) for a negative amount of EUR 3 (+15-18); and

c) assess whether the fall in value of Investment Z of CU18 should be treated as an impairment loss and retained in profit or loss and, if not, add an amount of EUR18 back to reported profit or loss.

15 New disclosures would be needed for all the adjustments. For the first adjustment, the entity would need to disclose the amount of prior period unrealised gains and losses that relate to instruments disposed during the period.

16 The information for the second adjustment would require an analysis of changes in fair value divided between realised and unrealised changes – 'realised changes' being changes in fair value of instruments that were disposed during the period.

17 While there is no specific disclosure 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.*'

18 An analysis could be either be presented in the statement of comprehensive income or disclosed in the notes. IAS 1 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*.'

19 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	(3)
Realised portion	5

20 After adjustment b) the hypothetical user would have available an OCI balance to use as a basis to assess impairment losses as described for the two prior scenarios.

Appendix 3 – Other application issues

Interrelation with hedging requirements

1 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.

2 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 change in fair value attributable to the hedged risk adjusts the carrying amount of the hedged item, and is recognised in profit or loss.

3 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.

4 For this reason, IFRS 9 has a specific provision for equities 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 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 purchases 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.

6 At the end of Year 1, the fair value of the equity has decreased from EUR 100 to EUR 80 and the fair value of the derivative has increased from EUR 0 to EUR 15.

7 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. The introduction of the impairment model would however require recognising the decrease of EUR 20 in profit or loss, while the requirement in IFRS 9.6.5.8 would result in recognising the increase of EUR 12 in OCI.

8 To avoid this outcome, the automatic trigger should be set net of the effect of the hedging. In other words, 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 purchase

price. Therefore, the entity would assess that it has not reached the trigger and the equity investment is not impaired.

9 However, in the case that the net change exceeded the quantitative threshold, the entity would recognise the full change in the equity investment in profit or loss, while the change in the hedging instrument would be in OCI

Timing of impairment tests and interaction with interim reporting

10 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.

11 Consider, for example that an entity that acquires an equity share for EUR 100 at the beginning of the reporting period. If the fair value of the share is 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.

12 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.

13 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.

Interrelation with foreign currency exchange rates

14 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.

15 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 measured. Exchange differences would form 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.

Appendix 4 – Summary of evidence collected

1 The EC requested EFRAG to investigate the potential effects of the requirements of IFRS 9 on accounting for investments in equity instruments on long-term investment. In the assessment phase, EFRAG was asked to collect quantitative data on the current holdings of equity instruments 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.

2 The objective of this Appendix is to present EFRAG's findings in relation to the scope assessment phase of the EC's request.

3 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 a sample of 2016 and 2015 annual financial statements. The samples included 30 and 38 entities respectively.

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 Euros. 166 billion Euros 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. Most respondents to the public consultation currently classify at least 60% of their equity instruments as AFS. Holdings of equity instruments are highly concentrated in a small number of 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 Euros, of which 57 billion Euros was classified as AFS. The rest is carried at FVPL. The AFS share calculated on the total sample is 18%, but individually most entities in the sample have at least a 55% AFS share.

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 For the sample of credit institutions included in the data received by the European Banking Authority, equity instruments classified as AFS represent 19% of total equity instruments in 2014, 2015 and the period ended on 30 September 2016.

9 Most of the equity instruments of the respondents from the insurance and the financial services industry 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. 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 companies 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 Euros, 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 2 billion Euros or 4% of earnings before tax.

14 Most respondents and entities in the sample use a combination of 'significant' and 'prolonged' decline in fair value 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 the net gain on disposal on equity instruments classified as AFS during the period reported a total of 5 billion Euros, which represents 19% of earnings before tax.

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 Euros, 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.

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.

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. EFRAG considers that the additional evidence collected in the assessment phase of this study does not refute this initial assessment. At the same time, it has been confirmed that some entities view the new requirements as possible impediments and these may affect their behaviours.

23 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, some make little or no use of the AFS classification and classify all 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 approaches and criteria to assess impairment of equity instruments. The data do not suggest a predominant practice to be used as a basis for a general accounting guidance.

Appendix 5 – Bibliography

[section to be developed following the completion of the literature review]

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