

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

EFRAG Research Project Equity Instruments - Impairment and Recycling Cover note

Objective of the session

- 1 The objectives of this session are to:
 - (a) consider the request for technical advice from the European Commission ('EC') and how the EFRAG Secretariat plans to address it;
 - (b) discuss specific details of a 'lower of cost and fair value' impairment approach for equity instruments;
 - (c) discuss the feedback from a recent EFRAG User Panel meeting and ways to address the concerns expressed; and
 - (d) consider a first draft of the outline of a future EFRAG publication.

Background of the project

Objective of the project

- 2 IFRS 9 *Financial Instruments* was issued by the IASB in July 2014 and is effective for annual periods beginning on or after 1 January 2018. For equity instruments, other than those held for trading and contingent consideration recognised in a business combination, the IASB has introduced an irrevocable option at inception on an instrument-by-instrument basis that permits those instruments to be accounted for at fair value through other comprehensive income ('FVOCI') with no impairment losses recognised in profit or loss and no reclassification in profit or loss of gains or losses upon derecognition.
- 3 In the Basis for Conclusions of IFRS 9, the IASB notes 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 noted that the application of impairment requirements of available for sale ('AFS') in IAS 39 *Financial Instruments: Recognition and Measurement* was very subjective.
- 4 In its Endorsement Advice to the EC related to IFRS 9, EFRAG noted that the prohibition of recycling may be considered as limiting the relevance of the information, since profit or loss is the main indicator of performance, and could affect in particular long-term investors.
- 5 The objective of the project is to consider possible alternative approaches to the impairment of equity instruments designated at FVOCI under IFRS 9.

Scope of the project

- 6 During the development of the project, the following topics will be discussed:

- (a) the significance of an impairment model to the re-introduction of recycling of disposal gains or losses of equity instruments;
 - (b) improvements of the impairment test of AFS equity instruments in IAS 39; and
 - (c) identifying a different impairment model for equity instruments.
- 7 At this stage, the project assumes that:
- (a) fair value as the measurement basis for equity instruments be maintained; and
 - (b) the prohibition of recycling of disposal gains and losses limits the relevance of information.
- 8 The project does not intend to discuss extensively the relevance of profit or loss versus OCI and will leverage on the prior work performed by EFRAG in the context of the endorsement of IFRS 9 and its discussions on the revision of the Conceptual Framework.
- 9 In May 2017, EFRAG received a request from the EC for technical advice on the issue. The request has two distinct phases:
- (a) Phase 1, which is due by the end of 2017, consists of information about the significance of the equity portfolio for long-term investors under IAS 39 and whether the new requirements in IFRS 9 will affect asset allocation decisions.
 - (b) In Phase 2, which is due by the end of mid-2018, the EC wants EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If an impairment model is considered to be a precondition for recycling, then the EC wants EFRAG to consider possible alternatives of a robust impairment model. The EC requests EFRAG to consult publicly to the maximum extent possible within the given timeframe.

Past history

Past discussions of EFRAG TEG

- 10 EFRAG TEG discussed a paper outlining the project plan in September 2016 and supported the general direction of the project, as drafted in the project plan. It was suggested that the data collection should include a sample of insurance companies. It was also suggested to investigate if the impairment model in IAS 36 *Impairment of Assets* could be adapted to apply to strategic investments.
- 11 At its January 2017 meeting, EFRAG TEG discussed possible alternative approaches to the impairment of equity instruments designated at FVOCI under IFRS 9. At this meeting, EFRAG TEG agreed that developing an impairment model would be a pre-requisite to allow recycling of gains or losses on disposal. Moreover, many EFRAG TEG generally supported the development of an approach that would apply to all equity instruments rather than addressing a specific subset. Some EFRAG TEG members favoured a 'lower of cost or fair value' impairment approach for equity instruments.
- 12 At its March 2017 meeting, EFRAG TEG discussed aggregated quantitative data related to AFS equity instruments of large European listed companies. Many EFRAG TEG members confirmed their view that an impairment approach was needed as a pre-requisite to consideration of recycling of gains or losses on derecognition of equity instruments. Several EFRAG TEG members continued to support an approach that would result in profit or loss reflecting a lower of cost or fair value approach.

Past discussions of the EFRAG User Panel

- 13 The EFRAG User Panel discussed an issues paper in October 2016. The objective of that session was to gather a preliminary input from users to help the EFRAG Secretariat in its initial analysis. The EFRAG User Panel generally noted that it was

difficult to draw a line between short-term and long-term equity investments and therefore, they were more in favour of developing an impairment solution that would apply to all equity instruments.

- 14 In May 2017, EFRAG User Panel members discussed the notion of impairment of equity instruments and the conceptual basis of a 'lower of cost and fair value' impairment approach for equity instruments. EFRAG User Panel members did not express any explicit support for any impairment model. They rather expressed concerns that recycling of disposal gains in profit or loss of equity instruments could be used in an opportunistic way to manage earnings..

Past discussions of EFRAG FIWG

- 15 EFRAG FIWG discussed an issues paper at its conference call in November 2016. The objective of that session was to gather preliminary input from the FIWG members to help the EFRAG Secretariat in its initial analysis. It was noted that the EFRAG Secretariat should also look at the issue of reversals of impairment losses. Some FIWG members were of the view that an instrument's position on the fair value hierarchy should not lead to a different impairment calculation.

Past discussions of the EFRAG Board

- 16 At its September 2016 meeting, the EFRAG Board decided to add the project to EFRAG's research agenda.
- 17 At its May 2017 meeting, the EFRAG Board discussed the approach to the request for technical advice from the EC. For Phase 1, the EFRAG Board agreed that the tight time table required the scope should be limited to the specific requests from the EC, and within that constraint made a number of suggestions as to what data could be collected. For Phase 2, the EFRAG Board noted the impact on the EFRAG research project and that EFRAG TEG would generate recommendations on possible improvements to the impairment model.

Future steps

- 18 Depending on the discussions made at this meeting, in a future meeting, the EFRAG Secretariat plans to bring to EFRAG TEG an issues paper to develop potentially some other new ideas for impairment models and to illustrate the findings of the information gathering of Phase 1 of the EC request.

Planned final outcome

- 19 The expected output of the project would be a discussion paper, which is expected to be published in the end of the first semester of 2018.

Agenda papers

- 20 In addition to this cover note, the following agenda papers have been provided for the session:
- (a) 02-02 *Issues paper on a lower of cost and fair value approach and users' concerns* TEG 17-06-29; and
 - (b) 02-03 *Issues paper on a tentative outline of a future publication* TEG 17-06-29.

Appendix 1: Tentative project timeline

Sep '16	Oct '16	Nov '16	Dec '16	Jan '17	Feb '17	Mar '17	Apr '17	May '17	Jun '17	Jul '17	Aug '17	Sep '17	Oct '17	Nov '17	Dec '17	Jan '18	Feb '18	Mar '18	Apr-June '18		
EFRAG TEG agrees project plan																					
	Quantitative data and initial ideas for impairment approaches																				
				EFRAG TEG meeting																	
				Data collection from EFRAG FIWG and ideas for improvements to AFS																	
						EFRAG TEG meeting															
							Develop other possible impairment models and gather quantitative data														
								Input from users										Input from users			
									EFRAG TEG meeting						EFRAG TEG meeting						
																End of Phase 1					
																				End of Phase 2	