**EFRAG TEG meeting**
**29 June 2017**
**Paper 02-02**
**EFRAG Secretariat: F. Poli, J. Waldier, I. Chatzieffraimidou**

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.

# A lower of cost and fair value approach and users' concerns - Issues Paper

## Objective

1 The objectives of this paper 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; and

(c) discuss the feedback from a recent EFRAG User Panel meeting and ways to address the concerns expressed.

## Content of the EC request

2 EFRAG received a request from the EC for technical advice on the issue. The request has two distinct phases:

(a) Problem definition - due by the end of 2017; and

(b) Possible solutions - due by mid-2018

3 Phase 1 consists of information about the significance of the equity portfolio for long-term investors under IAS 39 *Financial Instruments: Recognition and Measurement* and the possible effects of the application of IFRS 9 *Financial Instruments*.

4 In Phase 2 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 an important element of a 'recycling' approach, 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.

5 The EFRAG Secretariat will collect information that will include, but not be limited to, information on (years 2015 and 2016):

(a) the proportion of equity investments held by insurance companies and other long-term investors that is considered to be held for the long-term;

(b) how the term 'long-term' is interpreted in this context and what information is disclosed about the long-term business model/portfolios in the financial statements;

(c) the accounting classification under IAS 39 and historical data on amounts of other comprehensive income ('OCI') and recycled gains/losses under IAS 39;

(d) reasons why long-term investors dispose of long term equity instruments; and

(e) the basis for recognising impairment losses on equity instruments under IAS 39 and the amounts recognised.

6 Moreover, the EC requested assessing whether and to what extent long-term investors will use the fair value through other comprehensive income ('FVOCI') option, and whether they expect to change their investment decisions because of the ban on recycling.

7 It should be noted that there is no generally accepted definition of long-term investment and that the FVOCI is available to any equity instruments, regardless of the holding period. The EC has indicated that EFRAG should inquire on what basis entities consider themselves to be long-term investors.

8 The EFRAG Secretariat observes that addressing the request from the EC poses some challenges. In particular:

(a) the level of granularity of the data goes beyond what is required under IFRS and reporting practices, based on a review of a limited sample of financial statements; and

(b) investment decisions are driven by many factors and it is difficult to isolate the specific impact of accounting requirements, even more so in relation to expected behavioural changes.

9 The EFRAG Secretariat envisages launching a public consultation before the summer break to seek relevant information. Given that part of the data collection concerns possible changes in behaviours, the EFRAG Secretariat considers that it would be helpful to include some structured interviews (similar to those conducted in the outreach for the Dynamic Risk Management project).

**Question for EFRAG TEG**

10 Does EFRAG TEG have any input on possible sources of gathering the information of the EC request?

**A 'lower of cost and fair value' impairment approach**

*Introduction*

11 After the initial discussion, EFRAG TEG asked the EFRAG Secretariat to do further work on a 'lower of cost and fair value' impairment approach.

12 Under this approach:

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

(b) changes in fair value above the original cost would be recognised in OCI and recycled on derecognition.

13 In paragraphs 29-33 below, we discuss the issue of reversals of declines below the original cost.

*Advantages and disadvantages*

14 Since this approach does not differentiate between declines in fair value, the amount recognised in profit or loss in a period is simply an algebraic 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.

15 In some cases, the amount recognised in profit or loss would not represent the change in value over the period – assume 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.

16 The amount recognised in profit or loss would neither necessarily represent the difference between current fair value and carrying amount (which is how impairment loss is defined under IAS 36 *Impairment of Assets*) nor an 'other than temporary' loss. A question may arise if the amount should be characterised as an impairment loss or labelled differently.

17 This approach effectively removes all judgment from the impairment assessment and overcomes any concern about the possible lack of objectivity and comparability, which we understand is the main reservation about the application of the existing requirements for available-for-sale ('AFS') instruments.

18 On the other hand, the FVOCI option was introduced to address the concern that the FVPL measurement basis created undue volatility in profit or loss, which some entities believe does not reflect their business model. The approach would maintain volatility as long as the current fair value is lower than the original cost.

*Considerations*

*Individual instrument or portfolio basis?*

19 The unit of account for the measurement of financial instruments is the individual instrument. Under both IFRS 9 and IAS 39, equity instruments are generally measured at fair value on the statement of financial position. If an impairment approach is accepted for equity instruments accounted for at FVOCI, equity instruments would continue to be measured individually at fair value on the statement of financial position. Any impairment recognised would not change that measurement of the equity instrument on the statement of financial position; it would only determine a loss amount that would be recycled from OCI to profit or loss.

20 Under a lower of cost or fair value approach, impairment could be considered on either an individual equity instrument level or portfolio level.

21 Recognising impairment on the individual equity instrument level would be consistent with the way the equity instruments are measured on the statement of financial position. Recognising impairment on a portfolio level would limit impairment to when the portfolio itself had a cumulative decline in fair value. One issue with a portfolio level approach is that it would need to be determined whether all equity instruments of an entity designated as FVOCI should be treated as a single portfolio or whether entities can have multiple portfolios.

22 These two alternatives can be illustrated in an example. Assume an entity 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** | |

23 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.

*Cost formula for multiple purchases*

24 Another issue arises to determine the cost basis when the equity holding has been purchased in tranches over a period of time. A weighted average cost basis or on an individual tranche basis (such as FIFO or another method) could be used.

25 The cost basis has an impact on both recognition and measurement of impairment. For example, assume an entity acquires 200 shares in another entity over time. The entity initially acquires 100 shares at EUR 60 and later another 100 shares at EUR 80. If the fair value at year-end is EUR 75, this would be higher than the average cost of EUR 70, and no loss in value would be recognised. If the fair value is compared to the original cost of each tranche, the entity would recognise a loss of EUR 500 on the second tranche.

26 IAS 39 does not provide guidance on the 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. If the lower of cost or fair value approach was used for equity instruments, either the weighted average cost method or the individual tranche method could be prescribed or left to the reporting entity to decide.

27 An advantage of providing guidance on the treatment of using a weighted average cost approach or the individual tranche approach is that it would provide consistency between entities.

28 One advantage of not prescribing a single method (i.e. weighted average cost or individual purchase) is that it may allow entities to align their financial reporting and tax treatments when a gain or loss are recognised upon disposal and the reversal of any related deferred tax.

*Reversals*

29 For any impairment approach, including the lower of cost and fair value approach there is the issue of how to deal with any recovery of the fair value of an asset after an impairment is recognised. There are three alternative ways to deal with a fair value recovery after an impairment is recognised:

(a) full reversal after the fair value recovers to an amount equal to or higher than initial cost;

(b) partial reversal for fair value increases above the carrying value and below the initial cost; or

(c) no reversal until disposal.

30 Using a full reversal approach to impairment, any impairment previously recycled to profit or loss on an equity instrument remains in equity until the fair value recovers to an amount equal to or exceeding its original cost. This approach may decrease volatility in an entity's reported profit or loss, as reversals would be less frequent.

31 A partial reversal approach effectively results in treating all equity instruments designated as FVOCI having a fair value less than cost the same as FVPL as all fair value changes will impact profit or loss until the equity instrument's fair value recovers to an amount equal to or exceeding its original cost. This approach is consistent with IAS 36 and one advantage is that the cumulative impairment loss in profit or loss equals the negative difference between the fair value and the original cost.

32 With a no reversal approach, any impairment recognised in profit and loss remains even if the equity instrument recovers in value to an amount exceeding its original cost. This approach is based on the view that impairment creates a new cost basis.

33 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 80 and a loss of EUR 20 has been recognised in profit or loss. On 31 December 2016 and 2017 the fair value of the shares was EUR 90 and EUR 110 respectively. The following table illustrates how the full, partial and no reversal method would work:

| *Amounts are in EUR* | **Full reversal** | **Partial reversal** | **No reversal** |
|---|---|---|---|
| **Year 2015** | | | |
| Statement of financial position | 80 | | |
| Profit or loss | 20 | | |
| Cumulated OCI reserve | - | | |
| **Year 2016** | | | |
| Statement of financial position | 90 | 90 | 90 |
| Profit or loss | - | 10 | - |
| Cumulated OCI reserve | 10 | - | 10 |
| **Year 2017** | | | |
| Statement of financial position | 110 | 110 | 110 |
| Profit or loss | 20 | 10 | - |
| Cumulated OCI reserve | 10 | 10 | 30 |

**Questions for EFRAG TEG**

34 Does EFRAG TEG have any comment on the EFRAG Secretariat analysis on the lower of cost and fair value approach?

35 Does EFRAG TEG consider there is any other aspect of the lower of cost or fair value approach that the EFRAG Secretariat should analyse?

**Feedback from the EFRAG User Panel**

36 The EFRAG User Panel discussed the project in May 2017. The objective of the session was to get members' views on impairment of equity instruments carried at FVOCI. EFRAG User Panel members did not express any explicit support for any specific impairment approach.

37 They rather expressed concerns that recycling of disposal gains could be used to manage earnings, by timing the sale of equity instruments to offset negative items such as impairment losses on other assets. There could even be an incentive to sell some equity instruments and repurchase them soon after the reporting date.

38 The EFRAG Secretariat notes that these concerns go beyond the project research question and EFRAG TEG would need to decide if they should be addressed. However, in the following paragraphs the EFRAG Secretariat describes current and potential requirements that could mitigate these concerns.

39 Although the FVOCI option is available to all equity instruments that are not held for trading[1], the IASB introduced some disclosure requirements to provide information on the extent and the accounting impact of the use of the designation. Paragraphs 11A and 11B of IFRS 7 *Financial Instruments: Disclosures* require entities to disclose the following:

(a) which investments have been designated to this category;

(b) the reason for using the presentation alternative;

(c) the fair value at the end of the reporting period;

(d) dividends recognised during the period;

(e) any transfers of the cumulative gain or loss within equity during the period and the reason; and

(f) if an entity derecognised investments in equity instruments measured at FVOCI during the period:

(i) the reasons for disposing the investment;

(ii) the fair value of the investments at the date of derecognition; and

(iii) the cumulative gain or loss on disposal.

40 The EFRAG Secretariat considers that the following additional disclosures could provide helpful information:

(a) indication of any significant amount of disposal gains related to transactions that took place in the closing days of a reporting period, similar to the disclosure requirement in paragraph 42G of IFRS 7 for transferred financial assets;

(b) a reconciliation of the changes in OCI in the format below:

| *Amounts are in EUR* | **Gross losses (debit)** | **Gross gains (credit)** | **Total** |
|---|---:|---:|---:|
| **Opening balance** | **1,200** | **(4,800)** | **(3,600)** |
| Fair value change | (25) | (375) | (400) |
| Recycling G/L – disposals | (50) | 600 | 550 |
| - Impairments | (500) | - | (500) |
| **Ending balance** | **625** | **(4,575)** | **(3,950)** |

41 In a lower of cost or fair value impairment approach, the table would only include changes in the credit balance of OCI.

42 The table would illustrate the reporting entity's net unrealised gain or loss and allow users to appreciate the size of the movements in the period. In addition, the disclosure requirement about the reason for disposing the investment could be strengthened by also requiring entities to explain how these transactions reflect their business model. The EFRAG Secretariat considers that this disclosure could provide greater insight on whether entities de-invest consistent with their business model or these transactions could potentially be used to manage earnings.

43 A more restrictive approach would be to introduce constraints the amount of gains that can be recycled upon disposal. A simple way would be to allow recycling only after an investment has been held for a minimum period. Alternatively, the amount of gains allowed to be recycled could be capped against a percentage of the purchase price or a ratio between gains and historical dividends.

[1] nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies.

**Questions for EFRAG TEG**

44 Does EFRAG TEG concur that the Research project should also address the concern expressed by the User Panel in relation to the possible earning management issue?

45 Does EFRAG TEG consider that the disclosure requirements in IFRS 7 are already adequate to address concerns expressed by the EFRAG User Panel? If not, does EFRAG TEG recommend to develop additional disclosures and/or restrictions on the recycling?