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Paper 04-01
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EFRAG Research Project Equity Instruments - Impairment and Recycling
Cover note

Objective of the session

1 The objectives of this session are to:

(a) discuss possible presentation and disclosure alternatives in case a robust impairment model could not be developed and ask EFRAG TEG members if they would accept to include them for exposure in the consultation document to obtain constituents' views (Agenda paper 04-02); and

(b) provide a verbal update to EFRAG TEG on the interviews held with some of the respondents to EFRAG's public consultation.

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, EFRAG noted that the default requirement to measure all equity investments at fair value through profit or loss may not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG observed that IFRS 9 provides an option to measure some equity instruments at fair value through other comprehensive income, however, this was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance.

5 However, based on limited evidence, EFRAG assessed it was unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9.

6 The objective of the project is to consider possible alternative approaches to the impairment of equity instruments designated at FVOCI, with the view to allow recycling of gains and losses on disposal.

Scope of the project

7 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; and

(b) identifying an impairment model for equity instruments.

8 The EFRAG Secretariat has started from some premises:

(a) equity instruments are measured at fair value on the statement of financial position;

(b) the FVOCI designation is neither removed nor made obligatory;

(c) the prohibition of recycling of disposal gains and losses limits the relevance of information; and

(d) the project is not discussing any changes in the definition of an equity instrument under IFRS Standards.

9 The project will not address in general 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 for Financial Reporting.

10 In May 2017, EFRAG received a request from the European Commission ('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 the first half of 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 the EFRAG Board

11 At its September 2016 meeting, the EFRAG Board decided to add the project to EFRAG's research agenda.

Past discussions of EFRAG TEG

12 EFRAG TEG had several meetings to discuss the project and tentatively agreed to the following:

(a) the scope of the project and the project plan;

(b) the reintroduction of recycling comes with the development of an effective impairment model;

(c) any approach should apply without distinction to all equity instruments (other than held-for-trading). In other words, the project will not try to define sub-sets of equity instruments – such as strategic investments or long-term investments – and develop specific requirements for these;

(d) the discussion paper will include:

- (i) a 'dual measurement' approach, under which all changes in fair value above the original cost are recognised in OCI, and all changes below are recognised in profit or loss;
- (ii) an approach based on the impairment model for AFS financial assets under IAS 39, with a discussion of some alternative features such as the use of automatic impairment triggers.

(e) any approach should allow for the reversals of losses.

13 EFRAG TEG also discussed the outline of the publication for the second phase of the request from the EC.

Past discussions of the EFRAG User Panel

14 The EFRAG User Panel expressed some reservations to the project, as they noted that recycling gains on disposal allows entities to decide the timing of recognition. The EFRAG User Panel agreed that any impairment solution should be applicable to all investments in equity instruments. They did not express support for a specific model.

Past discussions of EFRAG FIWG

15 The EFRAG FIWG supported the reintroduction of recycling of disposal gains. They suggested that the project should also look at the issue of reversals of impairment losses.

Planned final outcome

16 The expected output of the project would be two papers, one summarising the data collection efforts and another discussing the identified alternative impairment approaches.

Next steps

17 The EFRAG Secretariat will bring the Phase 1 report to the Board for approval at its December meeting.

Agenda papers

18 In addition to this cover note, agenda paper 04-02 *Issues paper on presentation and disclosure alternatives TEG 17-11-23* has been provided for the session.