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Issues to include in the forthcoming discussion paper
Issues Paper

Objective

1 The objective of this paper is to discuss and confirm with EFRAG TEG what issues to include or not for exposure in the forthcoming discussion paper in relation to the European Commission's ('EC') request.

Background

2 At the October 2017 EFRAG TEG meeting, the EFRAG Secretariat presented to EFRAG TEG a tentative outline of the publication in relation to the second phase of the EC's request for technical advice. This publication will include a discussion of a number of topics related to impairment of investments in equity instruments to obtain constituents' views. EFRAG aims to report to the EC is by the end of the first half of 2018. Given that EFRAG needs to consult with its constituents, the discussion paper should be published around February 2018.

3 During past EFRAG TEG meetings, the EFRAG Secretariat presented several issues. Considering the views and preferences expressed by EFRAG TEG in those meetings, this issues paper presents the EFRAG Secretariat's recommendations on whether issues should be included or not for exposure. The EFRAG Secretariat seeks EFRAG TEG's approval on its recommendations.

4 The EFRAG Secretariat has drafted certain sections of the consultation document, which are included in the Appendix to this paper.

The underlying impairment model choices

5 The EFRAG Secretariat initially discussed with EFRAG TEG if there are specific characteristics of the instruments that could be used to develop an impairment model. This would have resulted in differentiating among different sub-sets of equity investments (for example, the purpose of the investment, the expected holding period of the investment and the level of fair value hierarchy in which the equity instrument is measured).

6 Many EFRAG TEG and EFRAG User Panel members expressed the view that any impairment model should:

(a) be more objective than the current impairment mode of IAS 39 *Financial Instruments: Classification and Measurement*; and

(b) be a single impairment model that would apply to all equity instruments.

7 In light of those views, the EFRAG Secretariat recommends to limit the choice in the consultation document to only impairment models that meet the above criteria and explain why that choice has been limited. The two choices that meet the criteria of the above paragraph are:

(a) a more rigorous Available-for-Sale ('AFS') impairment model; and

(b) a dual measurement impairment model.

Question for EFRAG TEG

8 Does EFRAG TEG agree that the impairment choice in the consultation document should be limited to a more rigorous AFS impairment model and a dual measurement model?

Other considerations

9 The upcoming consultation document will include certain impairment considerations beyond the main choice of an impairment model as each impairment model contains aspects that can operate differently. These considerations were discussed in the June and September EFRAG TEG meetings. The first consideration below only applies to the more rigorous AFS impairment model and the other considerations apply to both models.

Entity-defined or IFRS Standard defined

10 A more rigorous AFS impairment model would quantitatively define 'significant' and 'prolonged' to increase the model's objectivity. This defining can be done in one of the following ways:

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

(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 where the IFRS Standard sets a maximum limit for both terms, and reporting entities select a threshold equal or lower than the maximum.

11 The EFRAG Secretariat's recommendation is to include all the above options in the consultation document.

Question for EFRAG TEG

12 Does EFRAG TEG agree with the EFRAG Secretariat's recommendation to include all the above options in the consultation document without expressing any particular preference?

Rebuttable presumptions

13 As mentioned above, EFRAG TEG prefers a single impairment model for all equity instruments. However, some TEG members also noted concerns that not all markets or instruments are similar. The EFRAG Secretariat has developed two rebuttable presumptions that would recognise potential differences in the volatility of an instrument or market without reintroducing more subjectivity. The two rebuttable presumptions that were identified are:

(a) a recovery of the share price to the original cost between the end of the reporting period and the date the financial statements are authorised for issue; and

(b) the share price is below the threshold at the reporting date, but the original cost of the investment remains within its recent trading range over a specified time period just preceding the reporting date.

14 The EFRAG Secretariat does not recall any support for the first rebuttable presumption. As a result, the EFRAG Secretariat recommends including only the second rebuttable presumption in the consultation document, as some constituents might also express concerns of applying a bright-line to all equity instruments in all markets.

Question for EFRAG TEG

15 Does EFRAG TEG agree with the EFRAG Secretariat's recommendation to exclude the first and include only the second rebuttable presumption in the consultation document?

Unit of account

16 Two unit of account issues have been previously discussed. The first one dealt with cost basis of an investment in an equity instrument in the situation where an entity acquires an investment in an equity instrument over time at different costs. In determining impairment, cost could be on an average cost basis or on an individual tranche basis. The determination of the cost basis in this situation could also impact a gain or loss on a partial disposal of the investment.

17 Given that this cost basis determination is not currently addressed in IFRS Standards, the EFRAG Secretariat planned to include a relevant discussion in the consultation document, concluding that the model should not prescribe a cost formula and should leave the choice to the entity.

18 The second unit of account issue dealt with measuring impairment on an individual instrument basis or a portfolio basis. Many EFRAG TEG members supported measuring impairment on an individual instrument basis. Although this issue may also be perceived as stirring up an old debate that has been resolved for some time, for a complete discussion of the unit of account issue, the EFRAG Secretariat recommends to include this unit of account issue in the consultation document.

Question for EFRAG TEG

19 Does EFRAG TEG agree with the EFRAG Secretariat's recommendation to include the discussion on the portfolio or individual instrument's basis in the consultation document?

Reversal of impairment

20 Another aspect previously discussed is whether impairment should be reversed when the fair value of an equity instrument recovers. This would apply to the second approach – under the dual measurement, any change below original cost in recognised in profit or loss. Four options are possible:

(a) no reversal would be allowed;

(b) the entity would reverse prior impairment losses only after the value recovers to the original cost (limited reversal);

(c) the entity would reverse prior impairment losses only after the value recovers to the threshold (limited reversal with threshold); and

(d) the entity would start reversing the impairment as soon as the value recovers (ongoing reversal).

21 Many EFRAG TEG members preferred the ongoing reversal method for impairments. As a result, the EFRAG Secretariat recommends to include all four options in the public consultation, but express a preference for ongoing reversal as described above.

22 Under (c) and (d) there is an additional issue that was not discussed with EFRAG TEG about the measurement of the impairment. The issue would be if recovery up to the threshold should trigger the reversal of the full impairment, so that on a cumulative basis there would be no impairment when the current fair value exceeds the threshold. This issue was raised during the FIWG meeting and has now been added to the drafting.

Question for EFRAG TEG

23 Does EFRAG TEG agree with the EFRAG Secretariat's recommendation to include all the above options in the public consultation, but express a preference for ongoing reversal as described above?

Appendix – Extracts from the forthcoming discussion paper

1 This Appendix includes the drafting of certain sections of the consultation document, in particular those related to the issues discussed above.

Underlying impairment model choices

Identifying sub-sets of investments

2 EFRAG initially discussed if there are specific characteristics of the instruments that could be used to develop an impairment model. This would have resulted in differentiating among different sub-sets of equity investments. EFRAG considered three different criteria that could be used: the purpose of the investment, the expected holding period of the investment and the level of fair value hierarchy in which the equity instrument is measured.

3 The first criterion is based on the argument that entities acquire equity instruments of other entities for a variety of reasons. Some investments are acquired solely or primarily to collect a stream of expected cash flows in the form of dividends and disposal. This is often the case for equity instruments that offer a high dividend yield. Other entities acquire equity instruments for reasons other than primarily collecting dividends or even expectations of realising a short-term trading gain. 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.

4 The IASB discussed restricting the use of the fair value through other comprehensive income (‘FVOCI’) election to strategic investments but eventually rejected it. More recently, in the context of the primary financial statements project, the IASB staff has suggested the introduction of an ‘investing category’ and to identify it assets that generate a return for the entity individually and largely independently from other resources held by the entity.

5 The notion of ‘strategic investment’ may have been used to develop an impairment model closer to the one in IAS 36 *Impairment of Assets* where assets are grouped in cash generating units for the purpose of the impairment test. The argument for this would have been that the return on strategic investment is not merely linked to their independent cash flows (dividends and disposal gains), but to the synergies with other assets of the entity.

6 Finally, EFRAG concluded that it should develop a single impairment model applicable to all equity instruments, because any distinction would introduce an additional element of judgment and complexity. EFRAG noted that the use of FVOCI election is freely available to all equity instruments other than those held for trading and entities are not restricted in its use.

A more rigorous AFS impairment model

7 The first impairment model attempts to make the terms ‘significant’ and ‘prolonged’ more objective and operational in practice. Initially other terms were considered as

replacements for 'significant' and 'prolonged' but these considered also included some element of subjectivity.

8 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.

Entity-defined or IFRS Standard-defined

9 To make the IAS 39 modified approach more objective, the thresholds for 'significant' and 'prolonged' would need to be specified. A 'significant' decline would need to 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 where the IFRS Standard sets a maximum limit for both terms, and reporting entities select a threshold equal or lower than the maximum.

10 The first option would substantially reduce judgment from the assessment of impairment of equity investments. It is effectively the same thing 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.

11 The second option permits the reporting entity to make a judgment as to the appropriate threshold, but once that judgment is made the threshold needs to be applied consistently for all equity instruments designated as FVOCI. The selected threshold should be disclosed as part of a material accounting policy for any entity that elects to use the FVOCI option, since it relates to an entity-specific application of an aspect of IFRS 9 *Financial Instruments*.

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

<u>Advantages and disadvantages</u>

13 This approach retains the concepts of current practice but removes much of the subjectivity that is presumed to be the basis for the prohibition of 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.

14 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; on the other side, allowing entities to define thresholds, even within a pre-determined range, can potentially lead to divergence and less comparability.

Dual measurement model

15 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 other comprehensive income ('OCI') and recycled on disposal.

Advantages and disadvantages

16 Since this approach does not differentiate between declines in fair value, 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.

17 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.

18 This approach effectively removes all judgment from the impairment assessment and would seem to overcome any concern about the possible lack of objectivity and comparability, which EFRAG understands is the main reservation about the application of the existing requirements for AFS equity instruments.

19 On the other hand, the FVOCI option was introduced to address the concern that the fair value through profit or loss ('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. 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).

Other considerations

Rebuttable presumption to a bright line approach

20 Some might argue that bright lines that are introduced by either a more rigorous AFS impairment model or a dual measurement impairment model do not distinguish between price declines that could be expected to be temporary. All investments in equity instruments would be treated the same regardless of the characteristics of the equity instruments (i.e. the industry of the investee, the market in which the investee operates or the historical volatility of the instrument).

21 One way to mitigate a bright line approach (without introducing greater subjectivity to the impairment assessment) is to allow that the impairment presumption can be rebutted under certain circumstances, when an equity instrument's decline in fair value has met the defined trigger for 'significant or prolonged' or dual measurement threshold.

22 Circumstances that could lead to a rebuttal of the impairment presumption is when the share price is below the threshold at the reporting date, but the original cost of the investment remains within its trading range over a specified time period just preceding the reporting date.

23 This would help differentiate investments in more volatile shares or markets from other investments. For example, 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.

24 In the example, with an absolute impairment presumption the reporting entity would recognise an impairment of the investment in the equity instrument of EUR 20 in profit or loss under the dual measurement impairment model. The same impairment would be recognised under a more rigorous AFS impairment model significant was defined as 20% and the time period for the trading range was defined as 3 months. If the presumption was rebuttable based on the price range, impairment would not be necessary because during the previous three months the investee's trading range included the initial purchase cost of EUR 95.

25 This rebuttable presumption retains the objectivity of the two bright-line choices in this paper and would likely differentiate investments in shares of more established entities, industries or markets that generally trade in more narrow trading ranges from investments that are more volatile. On the other hand, for some investments the rebuttable presumption may only defer an inevitable impairment to the following reporting period.

26 For example, assume the fair value of the shares of the start-up entity in the example above declined mostly in December and the shares remained below the acquisition cost through 31 March of the following year at EUR 65. Also assume the trading range for the preceding three months (January - March) the share price ranged between EUR 56 and EUR 76. The trading range in this example would not rebut the presumption that the investment in the shares was impaired since the initial cost of the shares (EUR 95) was higher than the highest value in the trading range (EUR 76) and the entity would be required to recognise an impairment.

Unit of account – individual investment or portfolio

27 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 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 measurement of a loss.

28 EFRAG has considered what the level of aggregation should be to assessment of impairment. Both models could be applied at the level of the individual tranche, the individual investment (i.e., the total holding in equity instruments of an individual issuer) or at the total class of equity instruments carried at FVOCI.

29 Applying the two models at the level of the total class 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.

30 One issue with using a portfolio level approach is that it would need to be determined whether all equity instruments of a reporting entity designated as FVOCI should be treated as a single portfolio even if those instruments are held and managed in multiple portfolios.

31 EFRAG considers more appropriate and prudent to apply the model on the individual investments, to avoid offsetting losses on equity instruments performing poorly.

Unit of account – cost formula

32 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.

33 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.

34 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 is 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.

35 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.

36 EFRAG concluded that the model should not prescribe a cost formula and should leave the choice to the entity, similarly to what happens under IAS 2 *Inventories*. It would also make easier to align financial reporting and tax treatments.

Reversal of impairment losses

37 IAS 39 does not allow for the reversals of impairment losses. Some consider that this prohibition may have led to a less rigorous application of impairment requirements.

38 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 IAS 39 model, reversals should be allowed and if so, starting from when.

39 A no reversal approach would maintain any impairment recognised in profit and loss even if the fair value recovers up to the purchase cost. This approach is based on the view that impairment creates a new cost basis.

40 A limited 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.

41 An ongoing reversal approach would allow recognition of reversals as soon as the fair value starts recovering.

42 To illustrate the three 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**

43 There is one additional issue about the amount of reversal for 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 cumulated 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.

44 EFRAG concluded that the model should allow for reversals and reversals should be allowed as soon as the fair value starts recovering.

45 An ongoing 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.