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The significance of an impairment model to the re-introduction of recycling and a modified IAS 39 approach - Issues Paper

Objective

1 The objectives of this paper are to:

(a) discuss specific details of a ‘modified IAS 39’ impairment approach for equity instruments; and

(b) discuss the significance of an impairment model to the re-introduction of recycling.

2 The EFRAG Secretariat is still working to identify other approaches to impairment for equity instruments. We have reached out to other jurisdictions to collect information on other approaches in use. The last part of this paper illustrates for information purposes the approaches in US and Japanese GAAP.

A ‘modified IAS 39’ impairment approach

Introduction

3 After the initial discussion, EFRAG TEG asked the EFRAG Secretariat to do further work on a few impairment approaches, including a ‘modified IAS 39’ impairment approach.

4 The modified approach attempts to make the terms ‘significant’ and ‘prolonged’ more objective and operational in practice. These terms could be defined either by the entity as an accounting policy, or by the standard as a specified single quantitative threshold that is required to be applied on a consistent basis.

Considerations

5 Each of the various impairment approaches include elements that can operate differently. The July 2017 paper that considered the ‘lower of cost and fair value’ approach addressed the following elements:

(a) whether the impairment assessment is made for each individual instrument or on a portfolio basis;

(b) which cost formula to use for multiple purchases; and

(c) if and how to allow for impairment reversals.

6 Moreover, when presenting the ‘lower of cost and fair value’ approach to EFRAG TEG, the EFRAG Secretariat was advised to investigate the interaction of the model with fair value hedge accounting.

7 The same considerations apply to the 'modified IAS 39 approach' but this paper does not focus on them; it rather addresses some other elements that may pertain to impairment of equity instruments. It is noted that the 'modified IAS 39 approach' is intended to allow for impairment reversals.

Term other than 'significant or prolonged'

8 Some suggest that one way IAS 39 *Financial Instruments: Recognition and Measurement* might be modified is by providing more discipline around the assessment of the 'significant or prolonged' criteria. One of the main criticisms of these terms is that they led to diversity in practice. The EFRAG Secretariat's review of a sample of financial statements has confirmed that entities use different quantitative thresholds, which may or may not apply to similar equities. The thresholds were quire wide in range, with 'significant' ranging from 20 percent to over 50 percent and 'prolonged' from six months to three years.

9 That diversity in practice has presumably played a role in the IASB's prohibition of recycling for investments in equity instruments designated as fair value through other comprehensive income ('FVOCI') under IFRS 9 *Financial Instruments*.

10 US GAAP previously used a term 'other-than-temporary' to access impairment of available for sale ('AFS') instruments. Some have suggested that this term might be substituted in place of 'significant or prolonged'. However, 'other-than-temporary' is also a subjective criterion and arguably even more so than the IFRS criteria.

11 The US SEC staff once provided guidance on factors that indicate that an 'other-than-temporary' impairment of an AFS instrument has occurred. The first factor provided was the length of time and extent to which the market value of the instrument was lower than the purchase cost.

12 It is likely that many multinational reporting entities that had dual US GAAP and IFRS reporting requirements made the same impairment judgments for AFS investments using both terms. If the objective of the impairment approach is to reduce the subjectivity of the impairment assessment the meaning of the term used would need to be clearly defined.

Entity-defined or standard-defined

13 To make the IAS 39 modified approach more objective, the thresholds for 'significant' or 'prolonged' could be specified. A 'significant' decline can be defined as a specific percentage decline from cost and 'prolonged' can be defined as a specific time period where the fair value is below the cost. This defining can be done in one of three ways:

(a) the standard would specifically define the values associated with these terms; or

(b) the 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 standard sets a maximum limit for both terms, and reporting entities select an accounting policy within the parameters of the standard.

14 The first option, similar to the 'lower of cost and fair value' impairment approach would substantially reduce judgment from the assessment of impairment of equity investments. It is effectively the same thing as the 'lower of cost and fair value' approach except that the quantitative thresholds for both significant and prolonged would be higher than zero.

15 The second option permits the reporting entity to make a judgment as to the appropriate threshold, but once that judgment is made the threshold would be applied consistently for all equity instruments designated as FVOCI. The accounting policy should be disclosed if investments are material. EFRAG Secretariat thinks the policy should be viewed as material for those entities that have elected to use the option, since it relates to an entity-specific application of an aspect of IFRS 9. Also, leaving the choice to entities would allow for reassessment over time.

16 Under the last option, the standard sets the upper limit for both ‘significant’ and ‘prolonged’. For example, the standard could set the upper limit for ‘significant’ as no higher than 30 percent and ‘prolonged’ as no longer than one year. The reporting entity then sets its own accounting policy.

Rebuttable presumption

17 It could be argued that a modified IAS 39 impairment approach creates a bright line by defining significant or prolonged. While this bright line, whether created by the accounting standard or the entity, removes much of the subjectivity that was part of the impairment decision, it does 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).

18 One way to mitigate the 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’ threshold.

19 Circumstances that could lead to a rebuttal of the impairment presumption 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. An illustrative example is included in paragraph 20.; or

(b) 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. An illustrative example is included in paragraphs 24-27.

20 The **first option** would mitigate volatility from very temporary declines in fair value. For example, assume an entity acquires 1,000 shares in another entity on 15 June for their fair value of EUR 60,000 (or EUR 60/share). Shortly after the acquisition, the fair value of the shares was EUR 57. The share price remains below EUR 60 through year-end and close at EUR 57 and prolonged is defined as a 6 month period. On 5 January of the following year, the share price recovers to EUR 61.

21 With an absolute impairment presumption, the reporting entity would recognise an impairment of the investment in the equity instrument of EUR 3,000 in profit or loss (‘PL’). If the presumption was rebuttable based on the share price recovery after year-end, impairment would not be necessary.

22 It may be questioned whether considering the recovery of the share price after the reporting period conflicts with IAS 10 *Events After the Reporting Period,* which distinguishes between adjusting and non-adjusting events. Paragraph 11 of IAS 10 indicates that a decline in fair value of investments after the reporting date does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently.

23 The EFRAG Secretariat notes that, in the 'modified IAS 39 approach' we are trying to distinguish those declines in value that are impairment from those that are not, based on whether the decline is reversible. It may be argued that a recovery of the value after reporting date indicates that the decline was not irreversible. EFRAG Secretariat notes that paragraph 9 of IAS 10 states that the sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

24 The **second option** would help differentiate investments in more volatile shares or markets. For example, assume an entity acquires 500 shares of a start-up biotech entity on 25 September for their fair value of EUR 47,500 (or EUR 95/share). At 31 December of the same year, the fair value of the shares was EUR 37,500 (or EUR 75/share). Significant was defined as 20% and the time period for the trading range was defined as 3 months. During the last three months of the year the share price ranged between EUR 68 and EUR 112.

25 In the example, with an absolute impairment presumption the reporting entity would recognise an impairment of the investment in the equity instrument of EUR 10,000 in PL. 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.

26 The second option 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 option may only defer an inevitable impairment to the next reporting period.

27 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 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 of EUR 15,000.

28 The EFRAG Secretariat notes that the application of the second option could prove problematic to unlisted equities since daily prices are not available.

Advantages and disadvantages

29 This approach retains the concepts of current practice and attempts to remove much of the subjectivity that is presumed to be the basis for the prohibition of recycling in IFRS 9. Compared to the 'lower of cost and fair value' approach, 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 instruments original cost.

30 There is an unavoidable trade-off in this kind of approach. On one side, a single quantitative threshold set by a 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.

Questions for EFRAG TEG

31 Does EFRAG TEG have any comment on the EFRAG Secretariat analysis on the modified IAS 39 approach?

32 Does EFRAG TEG consider there is any other aspect of the modified IAS 39 approach that the EFRAG Secretariat should analyse?

The significance of an impairment model to the re-introduction of recycling

33 One of the premises in the EFRAG Research project is that recycling on disposal should be allowed only if there is a sufficiently robust impairment model. However, the EC request for technical advice asks EFRAG to assess if the premise is needed.

34 The Basis for Conclusion of IFRS 9 indicates that the IASB believes that allowing recycling would create the need to assess these equity instruments for impairment. The IASB did provide a criticism of the application of the current impairment requirements of IAS 39 by pointing out its subjectivity, but did not provide a rationale in the Basis for Conclusion as to why an impairment model is necessary for recycling.

35 The introduction of an impairment requirement for an asset carried at FVOCI introduces complexity, as it creates the need to distinguish between those decreases in fair value that are impairment losses and those that are not. It is therefore important to assess whether this complexity is unavoidable.

Relevance and predictive value

36 First, it is important to emphasise that this EFRAG Research project is based on several premises. Two of the key premises include:

(a) fair value is the appropriate measure for equities to report the financial position;

(b) FVOCI better reflects certain long-term business models; and

(c) PL is the main indicator of performance.

37 If those premises are accepted, it follows that short-term volatility in the share price of equity instruments may not be the most relevant information to assess performance, especially for entities with long-term investment outlook. It also follows that since PL is the main indicator of performance then at some point it is necessary to recognise in PL any gains or losses on these investments in equity instruments, because cash flows from the divestment of these equity instruments provides relevant information.

38 If the realisation of adequate cash flows upon disposal is important in a long-term business model, then there needs to be an assessment as to whether those cash flows will materialise in the future. Deferring the recognition of an expected loss indefinitely does not provide relevant information needed for users to assess these business models and is not conducive to prudent accounting. An impairment model is therefore important as it provides a framework to make the needed assessment as to whether future cash flows from the asset are recoverable.

Asymmetrical prudence

39 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.

40 If there is no impairment requirement, there would be no asymmetrical recognition of gains and losses for assets carried at FVOCI. Both gains and losses would be recognised in PL only when realised.

41 IFRS Standards generally have impairment requirements for assets carried at cost, which results in asymmetrical treatment of unrealised gains and losses. This applies to inventory, property, plant and equipment, intangible assets and debt instruments.

42 The following tables illustrate the treatment of gains and losses under the different accounting approaches:

FVOCI without recycling or impairment	**Realised**	**Unrealised**
Gains	OCI	OCI
Losses	OCI	OCI

Cost with impairment	**Realised**	**Unrealised**
Gains	PL	N/A
Losses	PL	PL

FVOCI with recycling and impairment	**Realised**	**Unrealised**
Gains	PL	OCI
Losses	PL	PL

FVOCI with recycling and without impairment	**Realised**	**Unrealised**
Gains	PL	OCI
Losses	PL	OCI

43 If we compare the results, only recycling and impairment allow to align FVOCI to amortised cost in relation to items recognised in PL.

44 Once it is agreed that for the purpose of the financial position, the fair value measurement is relevant, it then follows that an impairment requirement is appropriate (unless changes in FV are recognised in PL). In its endorsement advice for IFRS 9, EFRAG noted that the fair value measurement of financial assets that do not meet the contractual cash flow characteristics test leads to relevant information for the following reasons:

(a) equity investments and derivatives have no contractual cash flows which can be used as a basis for amortised cost; and

(b) cost provides little information with predictive value about timing, amount and uncertainty of cash flows relating to these instruments.

45 Recognition of impairment losses in PL would provide information that is predictive of future cash flows from disposals, assuming that the impairment model manages to identify those decreases in fair value that are not likely to reverse.

Question for EFRAG TEG

46 Does EFRAG TEG agree with the analysis and the conclusions above?

Impairment of equity instruments: models from other jurisdictions

47 For information purposes, the EFRAG Secretariat has collected information on the impairment requirements for financial instruments in other jurisdictions.

US GAAP

48 The FASB issued Accounting Standards Update 2016-01 *Financial Instruments– Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* effective for periods starting on or after December 15, 2017 (the 'ASU').

49 Under the ASU, equity instruments with readily determinable fair values shall be carried at fair value with changes recognised in earnings.

50 If the fair value is not readily determinable, an entity (other than those following 'specialised' accounting models, such as investment companies and broker-dealers) may elect to measure an equity instrument at cost less cumulated impairment adjusted for subsequent price changes. The price changes must be observable from orderly transactions for the identical or a similar investment of the same issuer. The election is discontinued when a readily determinable fair value becomes available.

51 For equity instruments to which the election is applied, the entity shall write down the carrying amount to fair value if a qualitative assessment indicates that the investment is impaired. The qualitative assessment is required at each reporting period, and indicators include, but are not limited to:

(a) a significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee;

(b) a significant adverse change in the regulatory, economic, or technological environment of the investee;

(c) a significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates;

(d) a *bona fide* offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment; and

(e) factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

52 The ASU removes the notion of 'other than temporary' impairment which was previously applied to equity instruments without a readily determinable fair value.

Japanese GAAP

53 Under Japanese GAAP, equity instruments that are not held for trading are classified in a residual category (similar to the AFS category in IAS 39). Equity instruments in the residual category are carried at fair value, with changes in fair

value charged through OCI. If the fair value is extremely difficult to obtain, the instruments are carried at cost.

54 For equity instruments carried at fair value, an entity shall recognise an impairment loss when the fair value has declined significantly, unless the fair value is expected to recover.

55 An entity applies judgment to assess if a decline is significant. 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;

(b) if the fair value has declined more than 50%, the investment is presumed to be impaired, unless the entity can prove otherwise.

56 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; or

(c) the investee has incurred losses for the past two years and is expecting a loss in the next.

57 For equity instruments carried at cost, an entity shall recognise an impairment loss when the value has declined significantly, unless it can demonstrate that it is recoverable.

58 An entity shall assess the value of the investment by determining the fair value of its share of net assets in the investee. If the value is less than 50% of the cost, the decline is deemed to be significant.

59 An entity shall demonstrate if the value is recoverable by considering the future business plans. In order to be recoverable, the plans must be feasible and reasonable and the recovery should occur within 5 years.

Question for EFRAG TEG

60 Does EFRAG TEG have any comments on the US GAAP and Japanese GAAP impairment models?