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Paper 07-01
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EFRAG Research Project Equity Instruments - Impairment and Recycling
Cover note

Objective of the session

1 At its December 2017 meeting, EFRAG TEG discussed a number of prior decisions in relation to the impairment approaches and their characteristics to be included in the forthcoming discussion paper in relation to the possible solutions phase of the European Commission's ('EC') request.

2 The objective of this session is to discuss a draft of the discussion paper and agree to recommend it to the EFRAG Board.

Background of the project

Objective of the project

3 The IASB issued IFRS 9 *Financial Instruments* in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI election'). This FVOCI election is not available for equity instruments that are held for trading or are contingent consideration recognised in a business combination. The entity may apply the FVOCI election on an instrument-by-instrument basis.

4 If the entity applies the FVOCI election, changes in fair value are presented in other comprehensive income ('OCI'). These changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess these instruments for impairments. Dividends from the instruments are however recognised directly in profit or loss.

5 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') equity instruments in IAS 39 *Financial Instruments: Recognition and Measurement* were very subjective.

6 In its Endorsement Advice on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL may not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance.

7 EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9. However, EFRAG

acknowledged that its assessment was based on the limited evidence available at that time.

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

Scope of the project

9 During the development of the project, the following topics are 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.

10 For the purposes of this project, the EFRAG Secretariat will not challenge or reconsider the following aspects of IFRS 9's requirements on accounting for investments in equity instruments:

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

(b) the FVOCI election is neither removed nor made obligatory.

11 The project will not address any changes in the definition of an equity instrument under IFRS Standards.

12 In May 2017, EFRAG received a request from the EC for technical advice. The request had two distinct phases: an assessment phase and a possible solutions phase:

(a) in the assessment phase, the EC asked EFRAG to collect quantitative information about current holdings of equity instruments and their accounting treatment. The EC also requested EFRAG to obtain information of the entities' expectations in relation to:

(i) the extent to which they plan to use the FVOCI election and the factors that will influence their choices; and

(ii) the anticipated effects of the new requirements in IFRS 9 on their decisions to invest in equity instruments or other categories of financial assets and their holding periods (including quantification where possible).

(b) in the possible solutions phase, the EC asked EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is a precondition to re-introduce recycling, then EFRAG is asked to consider how the existing impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches, possibly by looking at other national or third-country Generally Accepted Accounting Principles. EFRAG is also asked to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could be used to provide users with the necessary information to make the adjustments deemed necessary to the reported profit or loss.

Past history

Past discussions of the EFRAG Board

13 At its September 2016 meeting, the EFRAG Board decided to add the project to EFRAG's research agenda. During 2017, the EFRAG Secretariat provided regular updates to the EFRAG Board regarding the progress of the project.

14 At its December 2017 meeting, the EFRAG Board considered the draft report for the assessment phase of the project requested by the EC and decided that the report should include a summary of the issues raised and inferences that can be drawn from

the data collected. The EFRAG Board considered the revised report at its conference call in January 2018.

Past discussions of EFRAG TEG

15 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 equity instruments under IAS 39.

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

16 At is November 2017 meeting, EFRAG TEG discussed the outline of the publication for the second phase of the request from the EC and two possible presentation and disclosure requirements developed in response to part of the request for technical advice of the EC. EFRAG TEG members generally agreed to include these approaches in a future consultation document to obtain constituents’ views.

17 At its December 2017 meeting, EFRAG TEG discussed a number of prior decisions in relation to the impairment approaches and their characteristics to be included in the forthcoming discussion paper. EFRAG TEG members agreed that the approaches to be included should be limited to the two previously discussed (as described above). EFRAG TEG members also noted that the consultation process might lead to calls to consider other approaches at a later stage. EFRAG TEG members generally suggested that the discussion paper should not express a preferred view for each issue discussed. The discussion paper should, however, include only proposals that have some conceptual and practical merit, and describe their advantages and limitations.

Past discussions of other EFRAG TEG Working Groups

18 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. EFRAG User Panel members did not express support for a specific model.

19 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, foreign currency issues and whether the timing of issue of financial statements should impact the impairment assessment.

Planned final outcome

20 The expected outputs of the project would be:

(a) an assessment phase report, which will be sent to the EC and be made public on EFRAG’s website;

(b) a possible solutions phase discussion paper, which will be exposed to gather constituent's views and be made public on EFRAG's website; and

(c) a possible solutions phase position paper, which will be sent to the EC and be made public on EFRAG's website.

Next steps

21 The EFRAG Secretariat will bring the discussion paper to the EFRAG Board at its February 2018 meeting.

Agenda papers

22 In addition to this cover note, agenda paper 07-02 *First draft of EFRAG's Research Discussion Paper on possible solutions phase TEG 18-01-17* has been provided for the session.