European Financial Reporting Advisory Group

Paper 07-02

This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in 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.

EQUITY INSTRUMENTS – IMPAIRMENT AND RECYCLING

EFRAG

DISCUSSION PAPER

[MONTH 2018]

EFRAG

European Financial Reporting Advisory Group

European Financial Reporting Advisory Group (EFRAG) issued this Discussion Paper.

Copies of the Discussion Paper are available from the websites of those bodies issuing it. EFRAG will also make available in printed form a limited number of copies of the Discussion Paper.

The paper invites comment on its proposals via the 'Questions for Respondents'. Such comments should be submitted by using the 'Express your views' page on EFRAG website by clicking here or should be sent by post to:

EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

so as to arrive no later than [Comment Deadline Date]. EFRAG will place all comments received on the public record unless confidentiality is requested.

Our Research Activities in Europe

This paper is part of EFRAG's research activities. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. EFRAG carries out this research work in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- influencing the development of global financial reporting standards;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

Detailed information about our research activities and current projects is available on the EFRAG website.

Table of Contents

Executive Summary

ES1 International Financial Reporting Standard 9 ('IFRS 9') *Financial Instruments*, which is effective for most entities for periods beginning on or after 1 January 2018, requires that equity instruments are measured at fair value in the statement of financial position and that changes in fair value are presented in profit or loss ('FVPL'). For equity instruments that are not held for trading or contingent consideration recognised by an acquirer in a business combination, an entity may however make an irrevocable election to present changes in the fair value in other comprehensive income ('OCI') on an instrument-by-instrument basis (the 'FVOCI election'). Entities do not assess these instruments for impairment and cannot reclassify gains or losses previously recognised in OCI on de-recognition of these instruments – also referred to as 'recycling'.

ES2 In its endorsement advice on IFRS 9, EFRAG noted concerns from long-term investors that neither the FVPL category nor the FVOCI election would properly reflect their performance. The International Accounting Standards Board ('IASB') explained that allowing recycling would create the need to assess these equity instruments for impairment and noted that assessing impairment of available-for-sale ('AFS') financial assets in IAS 39 *Financial Instruments: Classification and Measurement* had created application problems.

ES3 The European Commission ('the EC') requested EFRAG to investigate the potential effects on long-term investment of the IFRS 9's requirements on accounting for equity instruments. In the first phase of the project ('the assessment phase'), the EC asked EFRAG to collect quantitative data on the current holdings of equity instruments and their accounting treatment and investigate if entities expect that the new accounting requirements will affect their decisions in relation to investment in equity instruments. EFRAG presents a summary of the key findings of the assessment phase in Appendix 3.

ES4 In the second phase of the project, EFRAG is considering if IFRS 9 may be improved in relation to the treatment of equity instruments held for long-term investment purposes. As part of its due process, EFRAG is now publishing this Discussion Paper ('DP') to gather constituents' views on possible alternative models for equity instruments designated at FVOCI, with the intent to allow recycling when they are derecognised. EFRAG will consider the feedback from constituents in developing its technical advice to the EC.

ES5 In this DP, EFRAG expresses a preliminary view that recycling enhances the relevance of reported profit or loss in a long-term investment business model. EFRAG also expresses a preliminary view that recycling without some form of impairment model would not be appropriate from a conceptual standpoint.

ES6 The DP illustrates two alternative models:

a) a dual presentation model, in which all declines in fair value below the purchase cost would be immediately recognised in profit or loss and changes in fair value above the purchase cost would be recognised in OCI and recycled on disposal; and

b) an impairment model similar to the model of IAS 39 for financial instruments classified as AFS, but with additional guidance to reduce subjectivity.

ES7 EFRAG does not express a preliminary view as to which of these two models is preferable. In EFRAG’s view, each alternative would improve the impairment requirements of IAS 39, by reducing the subjectivity that created application problems.

ES8 This DP also considers other aspects relevant to the alternative models, including:

a) reversals of impairment losses;

b) the use of rebuttable presumptions instead of quantitative triggers; and

c) the unit of account for assessing impairment.

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this DP, particularly in relation to the questions set out below. Comments are more helpful if they:

a) address the question as stated;

b) indicate the specific paragraph reference, to which the comments relate; and/or

c) describe any alternative approaches EFRAG should consider.

EFRAG should receive all comments by [Submission date].

Question 1 – Recycling gains or losses on disposal

The DP (paragraphs 2.3 – 2.11) argues that recycling gains or losses previously recognised in OCI when equity instruments carried at FVOCI are derecognised allows for a better depiction of the performance of long-term investors.

Q1.1 Do you support the reintroduction of recycling? If not, why not?

Question 2 – Significance of impairment to the reintroduction of recycling

The DP (paragraphs 2.12 – 2.18) argues that recycling without some form of an impairment model would not be appropriate from a conceptual standpoint.

Q2.1 Do you agree that, from a conceptual standpoint, recycling should be accompanied by some form of impairment model? If not, why not?

Question 3 – Alternative models

In paragraphs 4.9 – 4.24 the DP describes two models:

- a dual presentation model in which all declines in fair value below the purchase cost would be immediately recognised in profit or loss and changes in fair value above the purchase cost would be recognised in OCI and recycled on disposal; and

- an impairment model similar to the model of IAS 39 for financial instruments classified as AFS, but with additional guidance to reduce subjectivity.

Q3.1 What should be, in your view, the general objective and main features of a robust impairment model for equity instruments (relevance, reliability, comparability…)?

Q3.2 Which of the two models do you prefer? Please explain.

Q3.3 Do you have suggestions for a model other than those presented in the DP? If so, please describe it and explain why it would be preferable.

Question 4 – Quantitative impairment triggers

In paragraphs 4.16 –4.24, the DP discusses the introduction of quantitative impairment triggers. Triggers reduce the extent of judgment in assessing whether a decline in fair value below cost represents objective evidence of an impairment, especially if set within the IFRS Standard. This enhances comparability (across entities and over time) but may reduce relevance.

Q4.1 Do you support the inclusion of quantitative impairment triggers? If not, why not? If so, should an IFRS Standard specify the triggers, or should management determine them?

Q4.2 If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

Question 5 – Reversals of impairment losses

The DP proposes that the model would require reversal of impairment losses through profit or loss in particular circumstances and illustrates some different reversal mechanisms.

Q5.1 Do you agree that impairment losses should be reversed in particular circumstances? If not, why not?

Q5.2 Which of the approaches in paragraphs 5.2 to 5.11 do you support and why?

Question 6 – Other characteristics of the model

The DP discusses a number of other characteristics, including:

- whether to identify specific sub-sets of equity instruments to develop specific accounting requirements (paragraphs 4.2 – 4.8). EFRAG rejected the suggestion on the ground of complexity;
- the use of rebuttable presumptions instead of automatic triggers (paragraphs 5.12 –5.14); and
- the unit of account for assessing impairment (paragraphs 5.15 – 5.25).

Q6.1 Do you believe that the same impairment model should apply to all equity instruments carried under the FVOCI election? If not, why not and what alternative(s) would you propose?

Q6.2 Do you have comments on these other characteristics?

Q6.3 Are there other aspects that EFRAG should consider?

Question 7 – Enhancing presentation and disclosure requirements

Chapter 3 and Appendix 1 of the DP discusses whether and how enhanced presentation and disclosure requirements could provide better information on performance from a long-term investing perspective, including potential impairments of equity instruments. However, EFRAG’s preliminary view is that enhancing the presentation and disclosure requirements would not be an adequate substitute for improving the depiction of performance in profit or loss.

Q7.1 Do you agree with EFRAG analysis and conclusion?

Q7.2 Are there other improvements in presentation and disclosure that you would support?

Chapter 1: Objective and background

The objective of the Discussion Paper

1.1 The main objective of this Discussion Paper ('the DP') is to gather constituents' views on possible alternative models for the impairment of equity instruments designated at FVOCI in accordance with IFRS 9, with a view to allow recycling.

1.2 Throughout this DP, EFRAG refers to 'impairment'. In the context of this DP, 'impairment' is used to describe an event or set of circumstances in which a negative change in fair value is presented in profit or loss prior to the instrument's derecognition; and 'impairment loss' refers to the recognition of the negative change in profit or loss.

The accounting requirements in IAS 39 and IFRS 9 for equity instruments

1.3 The IASB issued IFRS 9 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. The entity may apply the FVOCI election on an instrument-by-instrument basis.

1.4 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 impairment. However, dividends that are a return on investment from the instruments are recognised directly in profit or loss.

1.5 Under IAS 39, equity instruments, other than those held-for-trading, were classified as Available-for-Sale ('AFS'). These instruments were measured at fair value and changes in fair value were presented in OCI. However, AFS accounting under IAS 39 differs from the accounting under IFRS 9's FVOCI election in the following two ways:

a) under IAS 39, an entity was required to assess at the end of each reporting period whether there is any objective evidence that an equity instrument classified as AFS was impaired. When an entity assessed that an instrument was impaired, the decrease in value below the original historical cost was reclassified to profit or loss as an impairment loss. Impairment losses should not be subsequently reversed; and

b) on disposal the cumulative gain or loss in OCI was recycled to profit or loss.

1.6 Accordingly, entities that classified some or all of their equity instruments as AFS under IAS 39 are required to modify their accounting treatment in one of the following ways:

a) if these instruments are carried at FVPL under IFRS 9's default accounting requirement, all changes in fair value will immediately be recognised in profit or loss; or

b) if the entity uses the FVOCI election, changes in fair value are never recognised in profit or loss.

1.7 In the Basis for Conclusions to IFRS 9, the IASB concluded that gains and losses should be recognised only once in comprehensive income, and noted that recycling would create the need to assess these equity instruments for impairment. The IASB observed that the impairment requirements for equity instruments classified as AFS under IAS 39 were considered to be very subjective.

What are we looking at, and why?

1.8 In its Endorsement Advice to the European Commission ('the EC') on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL might 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. EFRAG had previously stressed the importance of profit or loss as a main indicator of financial performance.

1.9 If neither option in IFRS 9 is attractive to some long-term investors, this may create an incentive for those investors to reduce their holdings of equity instruments. In its endorsement advice, EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9. EFRAG noted that broader economic considerations, such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders, are likely to outweigh any accounting concerns. EFRAG acknowledged that its assessment was based on the limited evidence available at that time.

1.10 After the completion of its 2015 Proactive Agenda consultation, EFRAG added a project on equity instruments to its work plan, specifically related to recycling and impairment of investments in equity instruments with an objective to consider alternative models to the impairment of equity instruments.

1.11 The EC completed the endorsement process of IFRS 9 with the adoption of Commission Regulation No 2016/2067 on 22 November 2016. During the endorsement process, the European Parliament and some Member States called for close monitoring of the impact of IFRS 9 to ensure that it serves the European Union's long-term investment strategy.

1.12 In May 2017, EFRAG received a request from the EC for technical advice. The request has two distinct phases:

a) the first phase ('the assessment phase') consisted of information about the significance of the equity portfolio for long-term investors under IAS 39 and whether the new requirements in IFRS 9 are expected to affect asset allocation decisions. EFRAG reported its findings from this phase to the EC in January 2018 and presents a summary of the main findings in Appendix 3. The assessment phase has confirmed that some entities expect to modify their asset allocation decisions, while others do not; and

b) in the second phase, the EC requests 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 an important element in order to re-introduce recycling, then EFRAG should consider how the impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches.

1.13 The EC also requests EFRAG to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could be used to provide users with the information needed to make the necessary adjustments to the reported profit or loss.

1.14 As part of its due process, EFRAG is now publishing this DP to obtain input from constituents on the topic. EFRAG will consider the feedback in developing its technical advice to the EC.

1.15 The objective of this DP is not to re-open the discussion on the general classification and measurement requirements in IFRS 9. EFRAG considers IFRS 9 to be an improvement in financial reporting compared to IAS 39 and has limited its deliberations to the application of recycling and impairment in the context of the FVOCI election. Accordingly, EFRAG considered that the following premises in IFRS 9 should be kept:

a) fair value is the appropriate measurement basis for equity instruments in the statement of financial position; and

b) the FVOCI election is available on an optional basis – in other words, the election should neither be removed nor made obligatory.

1.16 The DP does not address or suggest any change to the definition of an equity instrument under IFRS Standards.

Structure of the DP

1.17 In **Chapter 2** EFRAG discusses the relevance of recycling and the interrelation between recycling and impairment.

1.18 In **Chapter 3** EFRAG considers whether there could be alternative ways to improve reporting of financial performance via the use of existing or enhanced presentation and disclosure, and explains why it believes that recognition is conceptually preferable.

1.19 **Chapter 4** presents EFRAG's considerations in developing an impairment model for equity instruments and explains why EFRAG narrowed the models to two main choices. This chapter also explains how the two proposed models would work and their advantages and disadvantages.

1.20 In **Chapter 5**, EFRAG discusses the following other characteristics related to the models proposed in Chapter 4:

a) reversals of impairment losses;

b) the use of rebuttable presumptions instead of quantitative triggers; and

c) the unit of account for assessing impairment.

1.21 In **Appendix 1**, EFRAG considers in detail how presentation and disclosure could be used to provide information in relation to performance or impairment losses.

1.22 In **Appendix 2**, EFRAG discusses other application issues:

a) interrelation with hedging requirements and the effects of changes in foreign exchange rates; and

b) timing of impairment tests and interaction with interim reporting.

1.23 In **Appendix 3**, EFRAG has summarised the key findings from the assessment phase of the EC request and its main takeaways.

1.24 In its discussions over an impairment model for equity instruments, EFRAG considered the notion of impairment in other IFRS Standards as well as accounting guidance in European and other jurisdictions and presents them in **Appendix 4**.

1.25 EFRAG has commissioned an academic literature review to investigate the available evidence on how accounting requirements may affect asset allocation decisions, and how the presentation of recycling gains in profit or loss or OCI is relevant for long-term investors. **Appendix 5** presents a summary of this review.

Chapter 2: Importance of recycling and impairment

2.1 The revised *Conceptual Framework for Financial Reporting* is expected to state that:

a) profit or loss is the primary source of information about an entity's financial performance for the period;

b) income and expenses should be included in profit or loss unless the relevance or faithful representation of the information in profit or loss for the period would be enhanced by including a change in the current value of an asset or a liability in OCI;

c) income and expense included in OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur; and

d) in principle, income and expenses included in OCI should be recycled when doing so would enhance the relevance or faithful representation of the information in profit or loss for that period.

2.2 In this chapter, EFRAG explains its preliminary view that recycling would enhance the relevance and faithful representation of profit or loss and why it considers there is a clear basis for identifying the period in which recycling could occur. In addition, in this chapter EFRAG explains its preliminary view that recycling without some form of impairment model would not be appropriate from a conceptual standpoint.

Long-term business model and measuring performance

2.3 In July 2015, EFRAG issued a Bulletin *Profit or loss versus OCI*, which identified four groups of business models, one of which was the long-term investment business model. The business models used, for example, by banks and insurance entities would generally belong to this group, although banks may also short-term trading activities.

2.4 In a long-term investment business model, entities purchase assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar 'condition' as when it was bought. Cash flows are generated by holding the asset (e.g. in the form of dividends, or income from letting others use the asset) and from sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective.

2.5 EFRAG notes that both dividend distributions (which are included in profit or loss) and gains on disposal from the sale of equity instruments represent a form of realisation of the fair value the instruments. Therefore, it could be argued that both events should be presented in the same way.

2.6 The FVOCI election implicitly acknowledges that, although fair value information is relevant from the perspective of the statement of financial performance, short-term changes in the value of particular equity instruments may not be relevant to periodic financial performance for some entities. Accumulated OCI represents capital appreciation gains accumulated since the acquisition of the assets.

2.7 Based on these premises, EFRAG assesses that the prohibition of recycling cumulative gains or losses at the time of disposal may limit the relevance of reported profit or loss. Gains and losses reported in profit or loss on disposal are indicative of the performance of the investor and useful for assessing management's stewardship of the entity's resources.

2.8 EFRAG's Endorsement Advice to the EC on IFRS 9 was consistent with the views outlined above. EFRAG noted that while the current value of the assets provides relevant information to assess the financial position of the entity (as the ultimate cash inflow is through sale), the default requirement to measure all equity investments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries.

2.9 As noted in paragraph 2.1c) above, the forthcoming revised *Conceptual Framework for Financial Reporting* is expected to state that income and expense included in OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur. In the case of equity instruments accounted at FVOCI, EFRAG considers that there is a clear basis to identify the appropriate period. As discussed above, in a long-term business model, assets are sold to obtain the ultimate cash flow. In EFRAG's view, the period in which that cash flow is obtained is clearly identifiable (i.e. it is not arbitrary) and is economically significant.

2.10 EFRAG notes that some constituents do not support recycling. Some argue that reporting in profit or loss the full gain accumulated since an asset was originally purchased does not properly reflect performance in the period of disposal. They consider that holding decisions are as important as selling decisions, and that the accumulated gain or loss relates to performance over the entire holding period and not the period of disposal. Some also express the concern that recycling of gains under IAS 39 creates opportunity for selective profit-taking at the end of the reporting period (sometimes referred to as 'earnings management').

2.11 While EFRAG acknowledges the counter-arguments in paragraph 2.10 above, EFRAG's overall assessment and preliminary view is that recycling enhances the relevance of reported profit or loss in a long-term investment business model.

Interrelation between recycling and impairment

2.12 In the following paragraphs, EFRAG explains its preliminary view that recycling without some form of impairment model would not be appropriate from a conceptual standpoint. In reaching this preliminary view, EFRAG also considered whether presentation or disclosure approaches could provide an appropriate alternative to an impairment model (refer to Chapter 3).

2.13 IFRS Standards generally have some form of impairment requirement for assets, other than those measured at FVPL. This applies to assets carried at cost such as inventory, property, plant and equipment, intangible assets and amortised cost debt instruments. Impairment requirements also apply to other assets accounted for at FVOCI, including property, plant and equipment, intangible assets and debt instruments accounted for at FVOCI. EFRAG notes that a 'recycling plus impairment' model aligns reported profit or loss for the FVOCI category with reported profit or loss under cost-based accounting.

2.14 EFRAG considers that an impairment model enhances the relevance of profit or loss for stewardship purposes. IAS 39's underlying objective for recognising an impairment losses on an equity instrument is to reflect in profit or loss the effect of objectively identifiable, adverse changes in the issuer's economic condition. For example, IAS 39 stated that objective evidence of impairment for an investment in an equity instrument included information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. Accordingly, in principle an impairment loss on an equity instrument is an incurred loss and is therefore economically similar to a loss on disposal. EFRAG considers that inclusion of incurred losses enhances the relevance of profit or loss as the primary source of information about an entity's financial performance in the period, including from a stewardship perspective.

2.15 EFRAG also considers that an impairment model provides information that is relevant for the assessment of future cash flow prospects. The returns generated in a long-term business model are linked to the ultimate cash flows from the sale of assets. An impairment model results in declines in fair value being recognised in profit or loss prior to ultimate disposal when they relate to identifiable adverse changes in the issuer's economic condition. In EFRAG's view, making such a distinction provides relevant information to users of financial statements by providing insight into whether a decline in fair value is more or less likely to reverse in the future.

2.16 A robust and operational impairment model also eliminates or reduces any accounting-related incentive to maintain loss-making equity investments for an indefinite period. Allocation decisions would therefore be less affected by accounting requirements and this would reduce the opportunity costs for shareholders that management does not pursue better investments.

2.17 Any impairment model has the effect that the accounting treatment of gains and losses is asymmetric. Gains are recognised in profit or loss only upon sale, while some losses are recognised in profit or loss earlier. If recycling was required without an impairment model then both gains and losses would be recognised in profit or loss only upon sale. 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. In EFRAG's view, recognition impairment losses in profit or loss is consistent with the notion of prudence.

2.18 For these reasons, EFRAG's preliminary view is that the reintroduction of recycling without some form of impairment model would not be appropriate from a conceptual standpoint. In EFRAG's preliminary view, the recognition of impairment losses combined with recycling of the cumulative loss previously recognised in OCI on disposal leads to better performance reporting.

Chapter 3: Enhancing presentation or disclosure requirements

3.1 EFRAG acknowledges that it is difficult to develop an impairment model that is at the same time relevant and ensures full comparability among entities. It may be argued that given the range of equity instruments and the differences in features, markets and volatility, no single model is appropriate in all circumstances.

3.2 For this reason, the EC asked EFRAG to consider what could be done if an appropriate impairment model is not found. For example, could additional presentation and disclosure requirements achieve the same objectives? How much of this information would already be available under the existing presentation and disclosure requirements?

3.3 The additional presentation and disclosure requirements necessary to deliver a particular information objective depend both on the starting point (in other words the information provided in the primary financial statements on the basis of the applicable requirements on recognition and measurement) and the desired objectives. EFRAG has assessed three scenarios detailed in Appendix 1. These scenarios assume either that recycling is reintroduced in the absence of an impairment model, or that both recycling and impairment are not allowed. The analysis in Appendix 1 includes a description of the information that users would need to adjust profit or loss as reported, in order to depict profit or loss on the basis of FVOCI with recycling and impairment.

3.4 When an entity applies IFRS 9's FVOCI election as it is today, EFRAG assessed that presentation and disclosure requirements in existing IFRS Standards provide some, but not all, of information users would need to make these adjustments. In particular, new disclosures would need to be added to enable users to assess potential impairment losses. An indication of the maximum loss exposure could be given by the debit balance of the OCI reserve for instruments still held at the reporting date. However, users of the financial statements would need information comparing the fair value (already required by IFRS Standards) to the original cost and information on how long the fair value has been below cost.

3.5 However, there is a more fundamental question on whether presentation and disclosure solutions can effectively replace a solution based on recognition and measurement. Some academic studies – not specific to this topic – found that while the notes to the accounts are important to professional equity investors, information recognised in the financial statements receives more attention than disclosures in the notes.

3.6 EFRAG's preliminary view is that enhancing the presentation and disclosure requirements would not be an adequate substitute for improving the depiction of performance in profit or loss directly. EFRAG has consistently held this position in the past in relation to other topics.

Chapter 4: Alternative impairment models

4.1 In developing this DP, EFRAG considered several alternative impairment models. This chapter revisits and summarises the discussion and explains why EFRAG narrowed the alternatives to two main choices. As mentioned earlier in this paper, the term ‘impairment’ is used to describe an event or set of circumstances in which a fair value loss on an equity instrument designated at FVOCI is recycled from OCI to profit or loss prior to the instrument’s derecognition.

Identifying different categories of investments

4.2 EFRAG initially discussed whether different impairment approaches should be used for different classes of equity instruments to which the FVOCI election is applied. This would have required the identification of different categories of investments.

4.3 EFRAG considered different criteria for defining categories, including the purpose of the investment. It may be argued that entities acquire equity instruments of other entities for a variety of reasons: sometimes it is solely or primarily to collect a stream of expected cash flows in the form of dividends and disposal gains (i.e. the purpose is to realise an investment return), sometimes for other reasons, including the following:

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.

4.4 In developing IFRS 9, the IASB discussed restricting the use of the FVOCI election to strategic investments but eventually abandoned the idea. EFRAG understands that the main reason was that the IASB could not find a clear definition. More recently, in the context of the IASB’s *Primary Financial Statements* project, the IASB staff has suggested the introduction of an ‘investing’ category within the statement of profit or loss and OCI. Gains and losses would be included in this category when they arise from assets that generate a return individually and largely independently from other resources held by the entity.

4.5 EFRAG debated whether ‘strategic investments’ could be assessed for impairment using a model similar to the one in IAS 36 *Impairment of Assets*, with these instruments being allocated to a cash generating unit (‘CGU'). The argument would be that they contribute to the return on other assets of the holder. Accordingly their recoverable amount should not be assessed on a standalone basis (i.e. considering only standalone dividends and disposal gains), but in combination the assets whose cash flows are affected by the related synergies.

4.6 In general terms the model would comprise the following steps:

a) include the original cost of the strategic equity instrument in the carrying amount of the CGU;

b) compare the carrying amount of the CGU to its recoverable amount;

c) if there is a negative difference, reclassify the change in fair value of the strategic equity instrument from OCI to profit or loss until the OCI balance is nil; and

d) if there is a residual negative difference, allocate it pro-rata to the other assets in the CGU.

4.7 There could be additional complexities in determining the allocation of the impairment loss when for instance the CGU includes goodwill.

4.8 Finally, EFRAG concluded that defining a category of strategic investments would introduce too much judgment and complexity. Entities can hold an investment in an equity instrument for many reasons and consider the investment strategic. In addition, the reason an entity holds an investment can change over time and, accordingly, a continuous reassessment would be needed potentially leading to differences in where gains or losses are presented.

The two main choices

4.9 Both the models presented aim at improving the impairment requirements of IAS 39, in particular by reducing the subjectivity that created application problems. In substance, the models use quantitative triggers, that some may view as bright-lines. The first alternative is referred to as dual presentation model, and the second is an impairment model similar to the one required in IAS 39 for financial instruments classified as AFS, but with additional guidance to reduce subjectivity.

Dual presentation model

4.10 Under this model, the equity instrument is carried at fair value in the statement of financial position and:

a) changes in fair value below the original purchase cost are charged to profit or loss; and

b) changes in fair value above the original purchase cost are recognised in OCI.

4.11 In developing IAS 39, the IASB considered a dual presentation model. The Board noted at the time that it would ‘significantly change the notion of ‘available for sale’ in practice’ and believed such a change was not appropriate at this time. However, the AFS notion is no longer an issue, as it is not contained in IFRS 9.

Advantages and disadvantages

4.12 Under this model, 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.

4.13 In some cases, the amount recognised in profit or loss would not represent the change in value over the period. For example, consider 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 scenario, the entity would recognise EUR 5 in OCI and EUR 2 in profit or loss.

4.14 This model effectively removes all judgment from the impairment assessment (again putting aside any judgment involved in measuring the instrument's fair value), and would seem to overcome any concerns about the possible lack of objectivity and comparability. However, the model does not attempt to determine if these negative changes in fair value are the effect of objectively identifiable, adverse changes in the issuer's economic condition. In that sense, it does not fully achieve the objectives of an impairment model as described above in chapter 2.

4.15 Moreover, the use of the FVOCI election eliminates volatility in profit or loss, which some entities believe does not reflect their business model. The dual presentation model would have the effect that volatility is reported is profit or loss when, and for as long as, the current fair value is lower than the original cost. For this reason, it may not be as attractive to long-term investors, whose performance would still be exposed to short-term volatility (on the downside).

An impairment model similar to IAS 39 with less subjectivity

4.16 IAS 39 included a general principle to recognise impairment losses on a financial asset when there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition (a 'loss event'). IAS 39 also included a non-exhaustive list of examples of types of objective evidence of a loss event.

4.17 For equity instruments, IAS 39 provided some additional examples of objective evidence. Objective evidence included 'information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered'. IAS 39 also stated that 'a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment'. EFRAG understands that this 'significant or prolonged' trigger has been the most determinative part of IAS 39's impairment guidance in the context of equity instruments classified as AFS in practice.

4.18 The impairment model proposed in the DP is conceptually consistent to IAS 39 but attempts to reduce the subjectivity around the use of 'significant or prolonged'. Initially EFRAG considered to replace 'significant or prolonged' with other terms, but other terms also included some element of subjectivity.

4.19 To reduce the subjectivity of the impairment assessment, the IFRS Standard should be more prescriptive and leave less room for judgment. One of the challenges in applying judgment is that IAS 39 does not define the impairment of equity instruments based on a specific likelihood that the original purchase cost will not be recovered. Further, the relationship between the general guidance on objective evidence and the 'significant or prolonged' trigger is not explained. While EFRAG supports the use of reasoned judgment in a principle-based system, these challenges lead to a risk that the judgment on 'significant or prolonged' becomes arbitrary. EFRAG's findings in the assessment phase of this project confirm that entities use different thresholds for 'significant or prolonged' and therefore add weight to this concern (see Appendix 3 of the DP). The ESMA report *Review of Financial of Financial Institutions in Europe* on the 2012 financial statements of 39 major European financial institutions also had similar findings.

4.20 The impairment model could be made less subjective if the thresholds for 'significant or prolonged' were defined or described in more specific terms. A 'significant' decline could 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 could be done in one of three ways:

a) the IFRS Standard would specifically define quantitative thresholds;

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, under which the IFRS Standard sets an upper limit for both terms, and reporting entities select a threshold within the limit.

Advantages and disadvantages

4.21 This model removes much of the subjectivity that the IASB referred to in its arguments for prohibiting recycling in IFRS 9. It would substantially eliminate judgment when applying the 'significant or prolonged' part of the impairment guidance for equity investments (putting aside any judgment involved in measuring the instrument's fair value). In terms of mechanics, it is similar to the dual presentation model discussed earlier except that the quantitative thresholds for both significant and prolonged would be other than zero. Unlike the dual presentation model, this model makes a distinction between 'impairments' and other declines in fair value and can therefore be considered to reflect the notion that an impairment arises from an adverse change in the issuer's economic circumstances. EFRAG also notes that this model would generally lead to lower reported volatility in profit or loss than the dual presentation model.

4.22 There is an unavoidable trade-off in this kind of approach. On one side, a single quantitative threshold set by an IFRS Standard enhances comparability and reduces the risk of bias, but moves away from a principles-based approach and may limit relevance. For example, an IFRS Standard defined period for prolonged would not differentiate an investor with a 10-year average holding period from an investor with a 3-year average holding period.

4.23 The second option permits the reporting entity to make a judgment as to the appropriate threshold. Allowing entities to define thresholds, even within a pre-determined range, may improve relevance. Thresholds established by the reporting entity for ‘prolonged’ may better reflect the average holding period of the investor, and for ‘significant’ may better reflect the types of equity instruments held by the reporting entity.

4.24 However, allowing entities to define their own thresholds will lead to less comparability. The obligation to disclose the thresholds and apply them consistently would mitigate but not eliminate the fact.

Chapter 5: Other characteristics

5.1 Chapter 4 describes the main features of two alternative models. In both cases, a number of other characteristics also need to be considered, some of which could have a significant effect. This chapter discusses these characteristics and the alternatives ways each model might operate.

Reversal of impairment losses

5.2 IAS 39 did not allow any reversals of impairment losses for AFS equity instruments. IAS 39's prohibition on reversals was based on the view that impairment creates a new cost basis. IAS 39's Basis for Conclusions also explained the prohibition on reversals on the basis of difficulties in distinguishing a reversal of an impairment from other increases in value.

5.3 In EFRAG's view, the conceptual arguments against reversals merit re-examination. Reversals are not relevant under the dual presentation model, because if the fair value recovers after a decline, the positive change is automatically recognised in profit or loss up to the purchase cost.

5.4 EFRAG has expressed above the view above that an impairment should be recognised to reflect significant changes with an adverse effect on the issuer's perspectives, which may result in the cost of the investment not being recoverable. If the changes reverse and the conditions do not longer apply, EFRAG considers that the reversal of the losses in profit or loss would provide relevant information. EFRAG notes that, with the exception of goodwill, reversals of impairments are allowed in IFRS Standards.

5.5 EFRAG also notes that the prohibition to reverse may have contributed to a resistance to recognise impairment losses and in turn put more pressure on the 'significant or prolonged' criterion. Allowing for reversals may lead to less resistance to recognise a loss. On the other side, allowing reversals has the potential effect of adding volatility in profit or loss.

5.6 EFRAG's preliminary view is therefore that reversal of losses should be allowed. This could be made in different ways that we illustrate below.

5.7 A limited reversal 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.

5.8 An ongoing reversal approach would allow recognition of reversals as soon as the fair value starts recovering, with no consideration for whether the recovery is significant or prolonged.

5.9 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 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**

5.10 There is an additional issue related to 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 accumulated 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.

5.11 EFRAG also acknowledges that any reversal approach could give rise to other operational issues. For example, an impairment in one period might be followed by a recovery in value in another period that is accounted for as a reversal (in profit or loss). If this is followed by a new decline in value in another period, the question then arises as to whether that should automatically be considered an impairment, or should be subject to a new assessment. EFRAG has not attempted to address this and other detailed issues at this research stage but notes that further development might be required in due course.

Rebuttable presumption to a bright line approach

5.12 Some might argue that a single threshold does not take into account that some equities are more volatile than others. Applying a single threshold to all equities makes the model quite rigid and may result in an impairment loss for a decline in value that, for more volatile equities, may be expected to reverse in future.

5.13 If this is perceived to be an issue, the model could be further modified in different ways to better reflect the specificities of individual instruments. One way is by introducing a rebuttable presumption. For example, the impairment presumption could be rebutted when the share price of an equity instrument is below the threshold at the reporting date, but the original cost of the investment remains within a trading range over prior 90 days just preceding the reporting date. 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. In that case, an impairment would not be necessary because during the previous three months the investee's trading range included the initial purchase cost of EUR 95.

5.14 This rebuttable presumption would not result in subjective judgment because it is still based on observable evidence. However, it includes an operational and conceptual disadvantage that it could only be applied in practice to equity securities that are listed. Further, EFRAG notes that this approach is not consistent with a 'significant or prolonged' approach in that the fact pattern described is a scenario in which the decline in value is significant but is not prolonged.

Unit of account – individual investment or portfolio

5.15 The unit of account for the measurement of financial instruments is the individual instrument. Under IFRS 9, equity instruments are 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 presentation of a loss.

5.16 EFRAG has considered the level of aggregation at which an assessment of impairment should be made. Both models could be applied at different levels, for example: the level of the individual tranche (i.e., the holding in equity instruments of an individual issuer acquired on a particular date) the individual investment (i.e., the total holding in equity instruments of an individual issuer), particular portfolios of equity instruments carried at FVOCI, or the entire portfolio.

5.17 Applying the two models at the level of a portfolio 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. For example, consider an entity that 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**

5.18 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.

5.19 One issue with using a portfolio level approach is that it would need to be determined whether all equity instruments at FVOCI are treated as a single unit of account, even if those instruments are managed in separate portfolios. If the separate portfolios used for management purposes were the unit of account for the impairment calculation, the question would arise on whether transfers between portfolios would be acceptable.

5.20 In addition, a portfolio level approach weakens the link between an adverse change to the economic circumstances of an individual issuer and the recognition of an impairment loss.

Unit of account – cost formula

5.21 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.

5.22 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.

5.23 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 presentation model there would be no loss in value. If the fair value was 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.

5.24 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.

5.25 If the reporting entity determines which cost formula to use it would enable the entity to align its financial reporting and tax treatments.

Appendix 1 – Enhancing presentation and disclosure requirements

1 In this Appendix, EFRAG presents its detailed analysis of how enhanced presentation and disclosure requirements could provide better information on performance from a long-term investing perspective, including potential impairments of equity instruments.

2 Using an illustrative example, we assume the perspective of a hypothetical user that holds the view that performance is better reflected with current changes in fair value recognised in OCI and later recycled upon impairment or disposal. This view is consistent with the current treatment of equity instruments classified as AFS. EFRAG does not claim that all users would share this view.

3 We assume three different starting points ('scenarios'):

a) the entity applies the IFRS 9 requirements for equities designated at FVOCI;

b) the entity applies the IFRS 9 requirements for equities designated at FVOCI but with the re-introduction of recycling;

c) the entity is required to carry all equities at FVPL.

4 In all three scenarios, the user's objective is to adjust the accounting profit or loss in accordance with the user's view of performance as per paragraph 2 above. For each scenario, we explain what information would already be available under the current disclosure requirements, and what new requirements should be added.

5 There are already several disclosure requirements in IFRS Standards that apply to equity instruments designated at FVOCI. Some general disclosures include:

a) the carrying amount of each of the categories of financial assets and liabilities be disclosed in either the statement of financial position or in the notes*; and

b) the net gain or loss in the statement of comprehensive income or in the notes†.

6 IFRS 7 *Financial Instruments: Disclosures* also includes disclosure requirements specifically for investments in equity instruments designated to be measured at FVOCI‡:

a) which investments in equity instruments have been designated at FVOCI;

b) the reasons for using this presentation;

c) the fair value of each such investment at the end of the reporting period;

d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period;

e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers;

* IFRS 7 *Financial Instruments: Disclosures* paragraph 8.

† IFRS 7 *Financial Instruments: Disclosures* paragraph 20.

‡ IFRS 7 *Financial Instruments: Disclosures* paragraph 11.

f) the reasons for disposing any investment;

g) the fair value of any investment disposed at the date of derecognition; and

h) the cumulative gain or loss on disposal.

Illustrative example

7 Assume a reporting entity holds three investments in equity instruments designated at FVOCI, as follows:

	Original Cost	FV at the beginning of the period	FV at the end of the period
Investment X	50	60	75
Investment Y (disposed during the period)	50	80	-
Investment Z	50	50	32
Total	**150**	**190**	**107**

8 At the beginning of the reporting period, the entity would have a cumulative gain in OCI of EUR 40 for these three investments. During the current reporting period the entity sold investment Y for EUR 85, so the cumulative gain on the disposal is EUR 35 and the fair value change of the period for this investment is EUR 5. At the end of the reporting period the entity continued to hold equity instruments with a fair value of EUR 107 and a cumulative gain in OCI of EUR 7 (10+15-18).

First scenario - current IFRS 9 requirements with the use of FVOCI election

9 Under this scenario the hypothetical user referred to above would need to make the following adjustments:

a) transfer the cumulative gain previously recognised in OCI for the equity instruments sold during the reporting period (Investment Y) of EUR35 to profit or loss; and

b) assess whether the fall in value of Investment Z of CU18 should be treated as an impairment loss and, if so, deduct EUR18 reported profit or loss.

10 The first information is required by IFRS 7.11B(c). The second information is not already required. A way to enable this assessment would be to requirement entities to disclose the debit balance of OCI, which would indicate the maximum loss exposure. Where the reporting entity holds more than a single investment with a loss in OCI, the hypothetical user would be unable to make an impairment assessment because the cumulative losses are reported in the aggregate rather than by investment. Information on the cumulative loss would have to be specifically provided for equity instruments that have a debit OCI balance and are still held at the reporting date to determine if there is an impairment. The user would need information comparing the fair value (already required by IFRS 7) to the original cost and information on how long the fair value has been below cost.

Second scenario – FVOCI with recycling but no impairment

> **Assumptions**
>
> This alternative assumes that the requirements of IFRS 9's FVOCI category were to be amended by requiring recycling on disposal but with no impairment requirement.

11 Some of the IFRS 7 disclosure requirements described above would not be applicable under the assumption that recycling is required. For example, transfers of cumulative gain or loss within equity would not occur.

12 Under this scenario, the hypothetical user referred to above would need to make only one adjustment, i.e. assessing if an impairment loss should be added in relation to Investment Z.

13 As mentioned in the previous scenario, the hypothetical user would be unable to make an impairment assessment when there are more than one investment with a loss because the cumulative loss in OCI is reported in the aggregate. The hypothetical user could use the OCI balance to assess only a maximum loss exposure, but would also need information comparing the fair value (already required by IFRS 7) to the original cost and information on how long the fair value has been below cost.

Third scenario – all equity instruments at FVPL

> **Assumptions**
>
> This scenario assumes that entities carry all their equity instruments at fair value with the changes recognised in profit or loss.
>
> Nothing is recognised in OCI and there is no need to determine an impairment loss.

14 Most of the IFRS 7 disclosure requirements described above would not be applicable under the assumption that all equity instruments are carried at FVPL.

15 Under this scenario the hypothetical user referred to above would need to make following adjustments:

a) adjust the gain or loss on Investment Y which was sold in the period for an amount of EUR 30 to reflect prior period increases in fair value;

b) remove from profit or loss the net negative fair value change on the investments still held at the reporting period for EUR 3 (positive change of 15 EUR and negative change of 18 EUR); and

c) assess whether the decline in value of Investment Z of CU18 should be treated as an impairment loss and retained in profit or loss or removed.

16 New disclosures would be needed for all the adjustments. For the first and second adjustment, the entity would be required to present as separate line items gains and losses on instruments still held at the reporting period ('unrealised gains or losses') and gains or losses on instruments derecognised in the period ('realised gains or losses').

17 While there is no specific requirement to provide such an analysis, reporting entities have the ability to include supplemental information. IAS 1 *Presentation of Financial Statements* requires that for a fair presentation an entity '*provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.*'

18 An analysis could be either be presented in the statement of comprehensive income or disclosed in the notes. IAS 1 addresses the information included in OCI and paragraph 85 states: '*An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance*.'

19 Using the example above, the information could be provided as follows:

Net fair value change for the period (this amount would be in profit or loss in the assumptions)	2
Unrealised portion (related to Investments X and Z)	(3)
'Realised' portion (related to Investment Y)	5

20 After adjustment b) the hypothetical user would have available an OCI balance to use as a basis to assess impairment losses as described for the two prior scenarios.

Appendix 2 – Other application issues

Interaction with hedging requirements

1 The interaction between the measurement of equity instruments and the hedging requirements of IFRS 9/IAS 39 is a complex issue because of the different accounting options available to entities reporting under IFRS Standards:

a) the option to carry equity instruments either at FVPL or FVOCI; and

b) the option to continue applying the hedge accounting requirements in IAS 39 or apply those in IFRS 9.

2 In general terms, when a fair value hedge meets the qualifying criteria, the hedging relationship is applied as follows:

a) the changes in the fair value of the hedging instrument are charged to profit or loss; and

b) the change in fair value attributable to the hedged risk adjusts the carrying amount of the hedged item, and is recognised in profit or loss.

3 However, this general model is fit for hedged items that are otherwise carried at cost. If the hedged item is carried at FVOCI, the change in fair value attributable to the hedged risk is already incorporated in the carrying amount.

4 For this reason, IFRS 9 has a specific provision for equities designated at FVOCI. Paragraph 6.5.8 of IFRS 9 indicates that in this case, the changes in fair value of the hedging instrument are recognised in OCI. The following paragraphs assess the implications of recognising impairment losses in profit or loss.

5 In this case, the recognition of an impairment loss in profit or loss would conflict with the application of the fair value hedge. Assume the following example:

a) the entity purchases an equity instrument for EUR 100;

b) the entity has a derivative that hedges the changes in fair value of the equity instrument; and

c) an impairment loss is automatically triggered when the fair value decreases by more than 10% of the original price.

6 At the end of Year 1, the fair value of the equity has decreased from EUR 100 to EUR 80 and the fair value of the derivative has increased from EUR 0 to EUR 15.

7 If the entity was applying the fair value hedge requirements in IFRS 9 with no impairment, both changes in fair value would be recognised in OCI. The introduction of the impairment model would however require recognising the decrease of EUR 20 in profit or loss, while the requirement in IFRS 9.6.5.8 would result in recognising the increase of EUR 12 in OCI.

8 To avoid this outcome, the automatic trigger should be set net of the effect of the hedging. In other words, in the scenario above, the entity would assess that the decline in fair value is equal to (EUR 20-EUR 15) = EUR 5, which represents 5% of the original purchase price. Therefore, the entity would assess that it has not reached the trigger and the equity investment is not impaired.

9 However, in the case that the net change exceeded the quantitative threshold, the entity would recognise the full change in the equity investment in profit or loss, while the change in the hedging instrument would be in OCI.

Interaction with changes in foreign exchange rates

10 Under IAS 39, the reporting of changes in the carrying amount of a financial instrument in profit or loss or in OCI depended on various factors. These factors included whether it is an exchange difference or other difference in the carrying amount, whether the instrument is a monetary or non-monetary item and whether it is designated as part of a foreign currency cash flow hedge.

11 Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Exchange differences formed part of the change in the fair value of the instrument, which was recognised in OCI. Any foreign exchange component of that gain or loss on disposal of AFS equity instruments was recognised in profit or loss.

12 Paragraph B5.7.3 of IFRS 9 states that the gain or loss that is presented in OCI for equity instruments includes any related foreign exchange component. Paragraph B5.7.4 of IFRS 9 states that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss.

Timing of impairment tests and interaction with interim reporting

13 IAS 39 required an AFS equity instrument to be assessed for impairment at the end of each reporting period. This requirement suggested that an entity should perform the impairment review at the end of both the interim and annual periods. IAS 34 *Interim Financial Reporting* states that the frequency of an entity's financial reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results. This might suggest that an impairment loss recognised at an interim period could be reversed at the year-end.

14 Consider, for example that an entity that acquires an equity share for EUR 100 at the beginning of the reporting period. If the fair value of the share is had decreased to EUR 70 at the end of the half-year, it is very likely to conclude that the share had become impaired. Consequently, a loss of EUR 30 would be recognised in profit or loss. However, if the share price had recovered to EUR 100 by the end of the full financial year, the question arose, as to whether this loss should be reversed as there was a perceived conflict between IAS 39 and IAS 34.

15 The IFRS Interpretations Committee resolved this conflict when it published in 2006 the Interpretation IFRIC 10 *Interim Financial Reporting and Impairment.* IFRIC 10 required that impairments of AFS equity instruments recognised in an interim period should not be reversed.

16 EFRAG considers that IFRIC 10 would still apply if impairment of equity instruments were to be reintroduced without impairment reversal. If impairment of equity instruments were reintroduced with reversal, a revised IFRS 9 would likely supersede the IFRIC guidance.

Appendix 3 – Summary of evidence collected

1 The EC requested EFRAG to investigate the potential effects of the requirements of IFRS 9 on accounting for investments in equity instruments on long-term investment. In the assessment phase, EFRAG was asked to collect quantitative data on the current holdings of equity instruments and their accounting treatment and investigate whether, and to what extent, entities expect that the new accounting requirements will affect their decisions in relation to investment in equity instruments.

2 The objective of this Appendix is to present EFRAG's findings in relation to the scope assessment phase of the EC's request.

3 EFRAG's findings in relation to the assessment phase are mostly based on:

a) a public consultation conducted in 2017, which resulted in 26 respondents in total, including respondents from the insurance, the financial services and non-financial sectors, and covered the years 2014-2016; and

b) a review of samples of 2016 and 2015 annual financial statements. The samples included 30 and 38 entities respectively.

4 When using the data, it should be considered that the samples are not statistically representative, consistent with any other EFRAG public consultation.

Current holdings of equity instruments and accounting treatment

Long-term investing, amount and classification of equity instruments

5 Most respondents to the public consultation view themselves as long-term investors in equity instruments. Ten respondents indicated that all their equity instruments classified as AFS under IAS 39 are held for the long term.

6 The total amount of equity instruments held on average for years 2014-2016 by respondents is 753 billion Euros. 166 billion Euros are classified as AFS and therefore carried at fair value with the changes recognised in OCI. The rest is carried at FVPL, either because the instruments are held for trading or because the entities used the fair value option under IAS 39. While the overall ratio of 166 billion of equity instruments classified as AFS over the total equity instruments of 753 billion for the sample equals to 22%, at the individual level the ratio for most respondents is 60% or higher. Holdings of equity instruments are highly concentrated in a small number of the respondents.

7 The total amount of equity instruments held by the entities in the sample of the review of 2016 financial statements was 315 billion Euros, of which 57 billion Euros was classified as AFS. The rest is carried at FVPL. While the overall ratio of 57 billion of equity instruments classified as AFS over the total equity instruments of 315 billion for the sample equals to 18%, at the individual level the ratio for most respondents is 55% or higher.

8 The entities from the non-financials industry (both in consultation and the sample of financial statements) have higher percentage of equity instruments classified as AFS over total equity instruments.

9 EFRAG received data for a sample of credit institutions by the European Banking Authority, where equity instruments classified as AFS represent 19% of total equity instruments in 2014, 2015 and the period ended 30 September 2016.

10 Most of the equity instruments of the respondents from the insurance and the financial services industries are direct equity holdings. The non-financials hold the majority of their equity holdings classified as AFS indirectly, i.e. through a collective investment vehicle. As a consequence, these instruments may not be eligible for the FVOCI election.

OCI balances and changes in the period on equity instruments classified as AFS

11 Respondents reported a net accumulated OCI balance related to equity instruments classified as AFS amounting to 8% of the carrying amount of those instruments. The respective percentage was 11% for the sample of the 2016 annual financial statements. Four respondents and two entities in the sample had a net debit accumulated OCI balance.

12 Respondents reported a net change for the period of the accumulated OCI balance related to equity instruments classified as AFS amounting to 7% of earnings before tax (in absolute terms.

Impairment losses and assessment of impairment losses on equity instruments classified as AFS

13 12 respondents recognised impairment losses on equity instruments classified as AFS during the period amounting to 3 billion Euros, which ranged from 1% to 24% of those respondents' earnings before tax. Insurance entities reported higher impairment losses.

14 19 entities in the sample of 2016 financial statements recognised impairment losses amounting to 1,6 billion Euros or 3% of earnings before tax (in absolute terms).

15 Most respondents to the public consultation and entities in the sample use a criterion of 'significant' or 'prolonged' decline in fair value (as required by IAS 39) to assess impairment of equity instruments. The range of quantitative thresholds varies across industries.

Disposal of equity instruments classified as AFS

16 Respondents that provided information on the net gain on disposal on equity instruments classified as AFS during the period, reported a total of 5 billion Euros which represents 19% of earnings before tax (in absolute terms).

17 Entities in the 2016 sample of financial statements recognised a total net gain from disposal of equity instruments classified as AFS of 0,6 billion Euros, which represents 3% of earnings before tax.

Anticipated behavioural effects of the new accounting requirements

18 Most respondents indicated that a variety of factors, including business, economic and regulatory factors, affect their decisions to invest and hold equity instruments or other classes of assets.

19 Most respondents, across all industries covered, expect to use the election in IFRS 9 to designate investments in equity instruments for measurement at FVOCI to some extent. The choice to use the election depends on different factors, including the business purpose

of the investment, the expected volatility of the equity instrument and the economic linkage to other items.

20 The majority of respondents do not expect to modify their holding period for equities following the introduction of IFRS 9.

21 Respondents reported mixed views about the impact of the requirements on their asset allocation decisions. 12 entities (mainly insurance entities) expect to modify such decisions, although most did not specify to what extent. Some respondents indicated that they might shift some of their investment into different asset classes, including unquoted equities, as possible alternatives to quoted equities. They observed that returns from non-listed investments are mostly collected as dividends - which are recognised in profit or loss - and also that unlisted investments are less volatile.

22 Some respondents that expect to modify their asset allocation decisions explained that they view disposal gains as part of their performance and that IFRS 9's prohibition to recycle when using the FVOCI election results in accounting mismatches in profit or loss.

Key messages from the evidence

23 In its endorsement advice on IFRS 9, based on the limited evidence available at the time EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9. The assessment phase has confirmed that some entities expect to modify their asset allocation decisions, while others do not.

24 It should be noted that insurance entities are still at an early stage of assessment since they will apply IFRS 9 only in 2021.

25 In EFRAG's view, these are some of the key messages from the evidence gathered in the assessment phase:

a) the aggregate amount/value of equity instruments classified as AFS under IAS 39 by entities that consider themselves long-term investors is substantial. Our findings indicated a high level of concentration of holdings of equity instruments classified as AFS in a relatively small number of entities;

b) the importance of AFS accounting varies among entities that consider themselves long-term investors. For some, recycled gains and losses represent a significant proportion of net profits in the years examined. However, some make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9's requirements;

c) asset allocation decisions of long-term investors are driven by a plurality of factors;

d) entities that are concerned about the IFRS 9's requirements often point out to a form of 'economic linkage' between their holdings of equity investments and some of their liabilities; and

e) entities in practice use different criteria to assess impairment of equity instruments.

26 EFRAG will continue its work in accordance with the request for technical advice and will investigate if and how the new requirements may be improved.

Appendix 4 – Notion of impairment under accounting standards

How is 'impairment' defined in IFRS Standards?

Goodwill and other intangible assets

1 IAS 36 requires that an impairment test be conducted for goodwill annually at CGU level. A CGU is the smallest grouping of assets with identifiable cash flows. The test compares the CGU's carrying amount, including goodwill, with its expected recoverable amount. If the test suggests that there is an impairment loss, the loss amount is first allocated to reduce goodwill. Reversal of the impairment loss allocated to goodwill is prohibited.

2 Other intangible assets with indefinite lives are also required to be tested annually for impairment by comparing the carrying amount of the asset with its expected recoverability. Unlike goodwill however, subsequent impairment reversals are allowed.

Tangible assets

3 Tangible assets under IAS 36 are assessed for impairment each reporting period. An important aspect of IAS 36 is to determine whether any indicators exist, that might require an impairment test. IAS 36 provides guidance for indicators of impairment, which can be both external and internal factors.

4 If any of the indicators have been triggered, then an impairment test is made to determine the recoverable amount for individual assets if possible. Otherwise, assets are grouped into CGUs to determine the recoverable amount for the CGU. The recoverable amount of the asset or CGU is the higher of the asset's or CGU's fair value less cost to sell and its value in use. The value in use is an estimate of the discounted future cash flows the entity expects from the asset or CGU. The value in use is subject to judgment and entity-specific.

Debt instruments

5 Debt instruments and other non-equity financial assets under IFRS 9 that are not measured at FVPL are assessed for impairment using an expected credit loss model. The expected credit loss model is intended to reflect the pattern of deterioration or improvement in the credit quality of the financial instrument. Expected credit losses are measured through a loss allowance equal to expected credit losses that are possible in the upcoming 12-month period plus the expected credit losses for the full lifetime if the credit loss has increased since initial recognition.

Other assets

6 Inventories, under IAS 2 *Inventories*, are measured at the lower of cost or net realisable value. Net realisable value is determined based on the expected selling price in the ordinary course of business less estimated selling costs.

7 Deferred tax assets, under IAS 12 *Income Taxes*, are reviewed at each reporting period. Deferred tax assets are reduced if it is not probable there will be sufficient taxable profit will be available in the future to utilise the asset. If it is determined that it is unlikely there will be insufficient taxable income in future tax periods to utilise the tax asset, the asset is written down to the amount likely to be recovered.

8 A loss on an asset recognised under construction contracts under IFRS 15 *Revenue from Contracts with Customers* to the extent that the carrying amount of the asset exceeds the remaining amount of the excess consideration the entity expects to receive over its expected remaining costs to provide goods or services under the contract.

Impairment approaches in European jurisdictions

9 EFRAG collected information on impairment approaches of equity instruments from some European jurisdictions. The general principle is that short-term equity investments are generally carried at FVPL, while long-term equity instruments are carried at cost less 'other than temporary' losses in value.

10 There are exceptions to the general principle. Some jurisdictions require all investments in listed equity instruments to be carried at FVPL; some allow short-term investments in unlisted equity instruments to be carried at cost if the fair value cannot be assessed reliably.

11 Based in EFRAG investigation, a few European jurisdictions have introduced quantitative triggers to assess when a decrease in the fair value is not temporary. The Slovenian Accounting Standards uses a 20% threshold and a 12-months threshold to assess that a decline in fair value is significant and long-term. The Spanish Accounting Standards use a presumption that an equity instrument is impaired if there is a decrease in fair value by more than 40% of the instrument's cost or over a period exceeding 18 months.

Impairment approaches in other jurisdictions

US GAAP

12 US GAAP requires most equity instruments to be carried at fair value with changes recognised through profit or loss. For equity instruments using level three measurements whose fair value is not readily determinable, an entity may elect to carry the equity instrument at cost subject to impairment. For such instruments, there is a qualitative assessment each reporting period using indicators, such as significant deterioration in the earnings performance, a significant adverse change in the general market condition, factors that raise significant concerns about the investee's ability to continue as a going concern, etc.

13 The notion of 'other than temporary' impairment that was previously applied to equity instruments classified as AFS is no longer in use.

Japanese GAAP

14 Under Japanese GAAP, equity instruments that are not held for trading are carried at FVOCI (similar to the AFS category in IAS 39). If the fair value is extremely difficult to obtain, the instruments are carried at cost.

15 For equity instruments carried at FVOCI, an entity uses judgment to recognise an impairment loss when the fair value has declined significantly, unless the fair value is expected to recover. 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; and

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

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

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

Appendix 5 – Academic literature review

[section to be developed following the completion of the literature review]

EFRAG receives financial support of the European Union - DG Financial Stability, Financial Services and Capital Markets Union. The contents of this document is the sole responsibility of EFRAG and can under no circumstances be regarded as reflecting the position of the European Union.