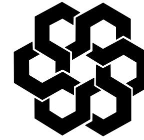

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement***

Subject: **Impairment triggers and reversals of impairment losses for available-for-sale equity instruments (Agenda Paper 6A2)**

Introduction

1. This paper presents and analyses suggestions that participants have raised in the round tables held in November and December 2008 in response to the credit crisis with regard to (i) the impairment triggers and (ii) reversals of impairment losses for available-for-sale (AFS) equity instruments. AP6A1 addresses AFS debt instruments.

2. This paper focuses on whether any of the accounting issues raised by participants require the urgent and immediate attention of the boards to improve financial reporting and help enhance investor confidence in financial markets. The paper addresses this objective by using the following structure:

   (a) participant's suggestion:

      (i) concern

      (ii) proposed solution

(b) staff summary analysis

(c) staff recommendation

Issue 1: Impairment trigger

Participant's concern

3. Some participants raised concerns about the impairment trigger of 'significant or prolonged' decline in fair value that is used for AFS equity instruments (paragraph 61 of IAS 39). The concerns were that:

   (a) the trigger was arbitrary, and always resulted in an impairment loss (unlike US GAAP – see below);

   (b) there was diversity in practice in the application of what is 'significant' and what is 'prolonged'; it appears some entities use bright-lines (many of which are different) whereas others do not;

   (c) the trigger's structure of two alternative criteria ('significant' or 'prolonged') resulted in:

      (i) an unduly harsh test against the background of the high volatility of the financial markets owing to the credit crisis; and

      (ii) different recognition of impairment compared to US GAAP (that uses the 'other than temporary impairment' trigger).

Proposed solution

4. Some participants suggested that the Board considers changing the trigger. For example, to a 'significant and prolonged' trigger (which would arguably make it similar to the US GAAP requirement). Others suggested introducing greater discretion into the decision as to when impairment should be recognised.

Staff summary analysis

5. The staff agrees the current impairment trigger for equity investments is arbitrary to some extent. However, the staff believes that any impairment trigger for equity investments is going to be arbitrary. The Board noted this in its deliberations on the revised version of IAS 39 (2003) (refer to paragraph BC106 in the Basis for Conclusions of IAS 39).

6. The staff notes that the impairment trigger of 'significant or prolonged' was introduced in response to calls for guidance from practitioners because the previous version of IAS 39 had not included specific impairment triggers for AFS equity instruments. At that time he Board concluded the criterion to be 'reasonable'.

7. The staff questions whether a better arbitrary trigger for equity investments can be identified, especially since differentiating impairment losses from other fair value changes for equity instruments is elusive (if not impossible). The staff believes that any criterion intended to identify impairment losses for equity instruments inevitably will be arbitrary.

8. In the view of the staff, changing the current trigger to 'significant and prolonged' will neither make the recognition trigger less arbitrary or eliminate (or reduce) the diversity in how the current trigger is applied in practice. However, it will result in later recognition of impairment losses – something that almost all users who participated in the round table meetings objected to.

9. One possibility could be to adopt the US GAAP criterion of 'other than temporary'. However, that criterion has resulted in significant additional accounting literature being issued to assist in that assessment. Despite that additional guidance, the assessment still requires significant judgement and continues to be problematic.

10. The staff further notes that there is some interaction between the IAS 39 trigger issue and the issue of whether to allow reversals of impairment losses for AFS equity instruments (refer to the next section of this paper on reversals of impairment losses). For example, if every fair value change below cost

would be accounted for using the fair value through profit or loss approach there would be no more triggers for impairment of AFS equity instruments. However, the Board did consider this in the Improvements project, and rejected it (see subsequent comments).

11. The staff also notes the importance of this issue with regard to the regulatory capital requirements for many financial institutions. While almost all round table participants stated that the objective of financial reporting is, and should be, different from the objectives of prudential regulators and that accounting should not automatically have regulatory capital implications – today that separation is not always evident and sometimes accounting does trigger regulatory capital requirements. This is especially the case for recognised impairment losses for available for sale assets.

Staff recommendation

12. The staff does not believe there to be an 'easy' or short-term 'fix' to the recognition triggers for impairments of equity investments that would both improve financial reporting and enhance investor confidence in the markets.

13. In fact, one investor at the round table noted the diversity in application of the current recognition trigger requirements and the negative effect on comparability and transparency; it seems to the staff that introducing even greater flexibility as to when an impairment loss for an equity investment should be recognised is problematic.

14. That being said, this is clearly an issue the Board should consider as part of the overall project on financial instruments, which will include an approach to improve impairment requirements.

15. This issue also needs to be considered together with the question of whether to allow reversals of impairment losses on AFS equity instruments (refer to the next section of this paper). The current inability to reverse impairment losses on equity investments places greater pressure on the willingness of an entity to recognise them in the first place.

16. The issue under US GAAP is slightly different. As noted above, there is no automatic impairment recognition trigger in US GAAP (unlike IAS 39). However, the staff does not believe that adopting the other than temporary impairment criterion for IFRS purposes is a feasible short-term alternative. This is because it would require incorporating extensive US GAAP literature, which still could not ensure that IFRS practice would be the same as the practice that has already developed among preparers applying the criterion in accordance with US GAAP. Moreover, the staff does not believe that a short-term project would give IFRS preparers enough time to implement the necessary extensive changes. Finally, using this criterion could not avoid the arbitrariness that is inherent in any impairment trigger.

17. **Question to the Board: Does the Board believe that a short-term amendment to the existing recognition triggers for equity instruments would improve financial reporting and enhance investor confidence? If so, what recognition trigger do you propose, and how would that improve financial reporting and enhance investor confidence?**

Issue 2: Reversals of impairment losses

Participant's concern

18. Some participants raised concerns about IAS 39's prohibition of reversing impairment losses on AFS equity instruments. The concerns were:

    (a) that non-reversal of impairment losses for AFS equity instruments is inconsistent with the requirements for other instruments and categories that require reversals;

    (b) that the prohibition of reversing impairment losses has a detrimental side-effect that creates a risk of undermining the impairment test for AFS equity instruments. The currently high volatility of the financial markets and the extent of the fair value decline create an expectation that (at least) a part of the fair value decline will reverse. Thus, entities feel they get into a 'trap' once they recognise any impairment losses for an AFS equity instrument because any subsequent fair value gains cannot be recognised

in profit or loss, which results in a mismatch. This may result in delaying recognition of impairment losses for as long as possible; and

(c) the impact on regulatory capital.

Proposed solution

19. Some participants suggested that the Board should remove the prohibition of reversing impairment losses on AFS equity instruments. That is, following recognition of an impairment loss, any subsequent increase in the fair value of the equity investment should be recognised in profit or loss (subject to the reversal in profit or loss not exceeding the originally recognised impairment).

20. Some participants advocated an automatic reversal following an increase in fair value, and others advocated a trigger for any reversal.

Staff summary analysis

21. When deliberating the revised version of IAS 39 (2003) the Board discussed this issue. The Board noted that already the assessment of whether a fair value decline constitutes an impairment is difficult and that any impairment trigger is arbitrary to some extent (refer to paragraph 5 of this paper).

22. The Board also discussed several alternatives of how to account for increases in fair value after an impairment loss was recognised (paragraph BC130 in the Basis for Conclusions of IAS 39):

> 'The Board could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value. Therefore, it decided that precluding reversals of impairment on available-for-sale equity instruments was the only appropriate solution. In its deliberations, the Board considered:
>
> (a) limiting reversals to those cases in which specific facts that caused the original impairment reverse. However, the Board questioned the operationality of applying this approach (ie how to decide whether the same event that caused the impairment caused the reversal).
>
> (b) recognising all changes in fair value below cost as impairments and reversals of impairment through profit or loss, ie all changes in fair value below cost would be recognised in profit or loss, and all changes above cost would be recognised in equity. Although this approach achieves

> consistency with IAS 16 and IAS 38, and eliminates any subjectivity involved in determining what constitutes impairment or reversal of impairment, the Board noted that it would significantly change the notion of 'available for sale' in practice. The Board believed that introducing such a change to the available-for-sale category was not appropriate at this time.'

23. Thus, the Board's options are to retain the status quo or to revisit the alternatives that were discarded when revising IAS 39. The Board indicated that at the time of its deliberations it did not consider using the fair value through profit or loss approach for any fair value changes below the instrument's cost (ie alternative (b) in paragraph BC130 – refer to the previous paragraph of this paper) appropriate.

24. US GAAP currently does not allow reversals of impairment losses. Therefore, for AFS equity instruments IFRSs and US GAAP are consistent in this respect. However, like the IASB staff, the FASB staff is currently looking at various aspects of impairment of AFS instruments raised in the round tables, including this one. Also, as noted previously, there is some interaction between this issue and the issue of the impairment trigger 'significant or prolonged' decline in fair value that is used for AFS equity instruments. In particular, the prohibition of reversals appears to have a detrimental consequence in practice in that it puts significant pressure on the impairment triggers, ie entities are more reluctant to recognise an impairment loss because they cannot reverse it if the fair value of the equity instrument recovers later on. This was amplified by IFRIC 10 *Interim Financial Reporting and Impairment*, which prohibits reversals of impairment losses recognised in a previous interim period.

25. Any short-term change to permit reversals of equity impairments would diverge from US GAAP. However, any such move may also reflect the greater flexibility under US GAAP in terms of impairment recognition than that that exists under IFRSs.

Staff recommendation

26. The staff recommends that the Board not change the reversal of impairments for equity instruments in the short-term, but address the issue as part of the

overall project on financial instruments, which will include an approach to address impairment.

27. The experience with the impairment approach for AFS equity instruments, in particular in the context of the stressed equity markets, may be reason enough for the IASB to revisit its previous decisions on reversals. Allowing reversals could ease the pressure on the impairment triggers and, thus, help avoid the detrimental consequences for impairment recognition in practice.

28. Allowing reversals would also address some of the issues arising from the regulatory capital treatment of recognised impairment losses. This would be seen by some as the Board responding in a practical way to the situation we face today – that accounting does have regulatory capital implications – despite the fact that many, including almost all round table participants, believe that that should not be the case.

29. The staff also notes that when the equity markets rebound, the Board will inevitably be asked to consider this issue again.

30. So, in summary, there may be some practical benefits to permitting reversals, as a short-term change in advance of the comprehensive reconsideration of impairment.

31. However, the staff does question whether any reversal of an impairment loss that arose because of an arbitrary recognition trigger would improve financial reporting or enhance investor confidence.

32. As noted, the recognition trigger is arbitrary and there is diversity in how that trigger is applied. It is therefore impossible to determine whether the specific facts that caused the original impairment have reversed.

33. Any reversal trigger will also be arbitrary; this will only exacerbate diversity in application and impair investor confidence. (Also, the only reversal trigger that participants could suggest was that an increase in fair value following recognition of impairment was 'significant or prolonged').

34. Alternatively, having no reversal trigger would suggest that there should also be no recognition trigger. That is, having no recognition trigger would be tantamount to an 'at fair value through profit or loss' approach for fair value changes below cost if the impairment triggers were removed (which the Board discarded in its deliberations on IAS 39 as revised 2003).

35. In summary, there is a trade-off between:

(a) permitting reversals of impairment losses; and

(b) easing the pressure on the impairment triggers (refer to paragraph 24 of this paper).

36. **Question to the Board: Does the Board believe that proposing a short-term amendment to permit the reversal of impairment losses for equity instruments would improve financial reporting and enhance investor confidence? Why or why not?**