Project	**Comment letters on tentative agenda decisions**
Topic	***IAS 39 Financial Instruments: Recognition and Measurement* – Meaning of 'significant or prolonged'**

Introduction

1. In May 2009, the IFRIC published its tentative decision not to add to its agenda an issue to clarify the meaning of 'significant or prolonged' in recognising impairment on available-for-sale equity securities in accordance with paragraph 61 of IAS 39. The IFRIC received nine comment letters.

2. To assist the IFRIC in assessing (a) whether to confirm its tentative decision not to add this issue to its agenda and (b) whether to amend the wording of the agenda decision before it is finalised, this paper summarises the comments from respondents and the staff's analysis and recommendations on those two questions.

Comment analysis

WHETHER TO CONFIRM TENTATIVE AGENDA DECISION

3. Six of the respondents explicitly support the IFRIC's decision not to add the issue to its agenda[1]; one suggests adding it (Standard Bank) and the other two[2] do not propose changing that decision. A later section of this paper discusses the clarifications requested or some changes suggested to the decision wording.

[1] E&Y, NZICA, KPMG, Mazars, D&T, CESR

[2] OIC, CNC

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

4. The staff notes that the IFRIC discussed most of the arguments raised by the respondents about whether to add the issue to its agenda at its May meeting. Those who agree with the decision not to take this issue onto the agenda cite reasons similar to those in the tentative agenda decision. Several also believe that the examples noted will reduce diversity in practice once the decision is finalised by eliminating inappropriate application of the requirements of IAS 39.[3] One such respondent shares that belief despite prior preference to not include extensive commentary in IFRIC agenda decisions regarding the application of the standards.[4]

5. One respondent disagrees and supports adding the issue to the agenda to develop further guidance.[5] Despite the Board possibly permitting earlier application of the new standard from the accelerated project on IAS 39, that respondent believes its proposed mandatory effective date on or after 1 January 2012 will result in a further period of diversity for at least two and a half years.

6. Another respondent believes that 'the manner and timing with which the IFRIC has addressed this issue is inappropriate'[6] because this decision is essentially the same as an interpretation by including examples. This respondent believes that an IFRIC agenda decision is not the proper means on such a sensitive issue. It also believes that the IFRIC concluded on some examples without considering the contexts or conducting a thorough analysis of the accounting practices used by entities. That respondent suggests that IFRIC should review its conclusions and forward this issue to the Board.

7. The staff notes that the one respondent that explicitly supports adding this issue to the agenda requests that the IFRIC consider amending IAS 39 to (a) permit the reversal of impairment losses through profit or loss and (b) require the recognition of impairment when the decline in fair value below cost is 'significant *and* prolonged'. Both proposed amendments are beyond the

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[3] E&Y, KPMG, D&T, CESR
[4] KPMG
[5] Standard Bank
[6] OIC

mandate of the IFRIC as an interpretive body and are more appropriately addressed in the Board's project on IAS 39. That respondent also requests the IFRIC to consider providing additional guidance on three other points. The staff analysis in the next section will discuss those other comments more fully.

8. The staff analysis presented at the May IFRIC meeting anticipated the fastest timing for a possible interpretation would result in a publication in April 2010 with a possible effective date of July 2010, assuming the IFRIC approved a draft Interpretation at this meeting. That timing would allow entities to adopt an interpretation one year sooner than the new standard from the Board's project on IAS 39. At that meeting, the IFRIC also discussed that any interpretation developed would be a piecemeal change and questioned whether its publication would receive sufficient support from Board members.

Question 1
Based on the summary of comments and reasons discussed in paragraphs 4-8 above, the staff recommends that the IFRIC confirm its tentative agenda decision after considering whether the tentative wording should be amended before being finalised. Does the IFRIC agree?

WHETHER TO AMEND THE TENTATIVE WORDING

9. The IFRIC tentative agenda decision also included some examples of inappropriate interpretations that might exist in practice. Six of the respondents request additional clarifications or suggest some changes to the IFRIC's proposed agenda decision wording. Those suggestions are about issues that mainly include:

   (a) *unit of account* [7]– clarifying whether different impairment criteria should be set for each equity investment or for categories of investments.

   (b) *expected recovery* [8]– clarifying whether recoveries after the reporting date but before the issuance of financial statements should be considered.

[7] Mazars, CESR, CNC

(c) *functional currency* [9]– clarifying whether the group should reconsider an assessment by its subsidiary holding a foreign currency denominated security when functional or reporting currencies are different.

(d) *setting criteria and applying judgement* [10]– clarifying other factors that should be considered when setting criteria for determining whether a decline is 'significant or prolonged'

***Unit of account** – clarifying whether different impairment criteria should be set for each equity investment or for categories of investments*

10. Several respondents agree that each equity investment is unique and that setting criteria for determining whether a decline is 'significant or prolonged' requires judgement. However, their conclusions seem mixed. One respondent is concerned that the combination of these two concepts referred to in the wording may lead preparers to set different criteria for each individual equity investment, thereby reducing the quality of financial statements and transparency of disclosures.[11] Others think that the assessment of 'significant or prolonged' should differ by the characteristics of each investment because it is difficult to apply the same rule to investments of a given portfolio.[12]

11. The staff thinks that the process of setting criteria for determining whether a decline in value is significant or prolonged is one that requires an entity to exercise more than one judgement. The first judgement may apply when an entity decides which criteria it will use to categorise investments by similar risk profiles, eg by geography, industry, price volatility, etc. The second judgement may apply when an entity decides which criteria are relevant for each category of investments to identify individual equity investments that require further analysis, eg any quantitative thresholds of percentage or duration of decline, etc.

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[8] E&Y, D&T, Standard Bank
[9] Mazars, D&T
[10] E&Y, Mazars, Standard Bank, CESR, CNC
[11] CESR
[12] Mazars, CNC

12. The staff agrees that each equity investment has its own unique risk profile. IAS 39 requires the measurement of impairment loss as the difference between the original acquisition cost and fair value on the reporting date. The impairment conclusion and amount recognised at the same reporting date could differ for each equity investment held.

13. At times, specific facts and circumstances for an individual equity security may contradict a preliminary conclusion from the assessment process above. The staff thinks that accepting such an exception would require a careful analysis of all objective facts and circumstances. Therefore, in the staff's view, an entity must assess each equity security held for impairment and, at the same time, apply the judgement and criteria it sets consistently.

14. The staff thinks that the entity should apply the types of criteria discussed in paragraph 11 consistently based on objective facts, as supported by some respondents.[13] After applying those criteria, the conclusion that a decline of an equity instrument is 'significant' or 'prolonged' (ie impaired) is a matter of fact, not judgement.

Question 2
Based on the summary of comments and reasons discussed in paragraphs 10-14 above, the staff concludes that the IFRIC did not intend different impairment criteria to be set for each equity investment and proposes revisions in Appendix A to reflect that clarification. Does the IFRIC agree?

***Expected recovery** – clarifying whether recovery in value of a specific security after the reporting date but before the issuance of financial statements should be considered*

15. Several respondents commented on the relevance of a specific security's expected recovery, particularly an actual recovery after the reporting date but before issuing financial statements. Some believe that such evidence before

[13] CESR, CNC

issuance date can be considered[14] but others believe it should not be included[15] in the assessment of 'significant or prolonged' at the reporting date.

16. The staff agrees that an expected recovery of either the market in general, or the specific security, is not included in the assessment. The staff notes that paragraph 58 of IAS 39 requires the impairment assessment at the end of each reporting period. Paragraphs 67-68 of IAS 39 require an impairment loss to be recognised for available-for-sale financial assets as the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss previously recognised in profit or loss.

17. Paragraphs 10 and 11 of IAS 10 discuss non-adjusting events after the reporting period. Paragraph 11 includes an example that a decline in market value of investments between the end of the reporting period and the issuance date of financial statement does not normally relate to the condition of the investments at the end of that reporting period. IFRIC 10 *Interim Reporting and Impairment* considered the issue that arose at the subsequent financial reporting date when conditions changed such that a loss would not have been recognised, or a smaller loss would have been recognised, if the impairment review were first carried out at that date. The IFRIC concluded that the impairment losses recognised at interim dates should not be reversed at subsequent reporting dates.

18. 'Significant or prolonged' is assessed based on a security's fair value relative to its original cost as of the reporting date. Therefore, the staff thinks that it is inappropriate to include a subsequent increase in value in the assessment at the reporting date unless such an increase directly links to new information that confirms conditions already existing at the reporting date. Given the varying factors that affect market behaviour and investment decisions about a specific entity, the staff questions whether it is possible to demonstrate such a direct link.

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[14] E&Y, Standard Bank

[15] D&T

Question 3
Based on the summary of comments and reasons discussed in paragraphs 15-18 above, the staff concludes that the expected or actual recovery of a specific security after reporting date should not be included in the assessment of 'significant or prolonged' at the reporting date. Does the IFRIC agree?

Functional currency *– clarifying whether the group should reconsider an assessment by its subsidiary holding a foreign currency denominated security when their functional or reporting currencies are different*

19. One respondent disagrees with the tentative decision that 'significant or prolonged' should be assessed in the functional currency of the entity holding the security due to currency being even more volatile than the stock market. That respondent believes that the assessment should be in the foreign currency in which a security is denominated unless the economic situation of the foreign country shows that the loss in local currency value is non-reversible.[16]

20. Another respondent requests the IFRIC to clarify whether a group entity should be regarded as being the entity holding a security invested in by its subsidiary. Answering this question determines whether a group reporting entity should reconsider an assessment by its subsidiary that holds a foreign currency denominated security when its functional or reporting currency is different from that of the subsidiary.[17] Depending on the relative strength or weakness of the two functional currencies, that respondent thinks the translation of the net assets of the subsidiary into the functional currency of the ultimate parent as clarified by IFRIC 16 may lead to the following two results of such impairment:

    (a) the reversal of an impairment loss in the separate financial statements of the subsidiary in the consolidated financial statements, or

[16] Mazars
[17] D&T

(b) the recognition of an impairment loss in the consolidated financial statements that is not recognised in the subsidiary's separate financial statements.

21. The staff will first discuss the accounting for such equity investments (foreign currency transactions) by its direct investor entity, ie the subsidiary in the comment above. IAS 39 does not address such issues in detail and the IFRIC's conclusion in the tentative decision included some related guidance in IAS 39. Unless specified in IAS 39, the staff thinks that an entity's accounting for the subsequent measurement (including impairment) of a foreign currency denominated equity security should be no different from the principles in IAS 21 that apply to other assets.

22. Those requirements differ depending on whether the asset is a monetary item (defined in paragraph 8 as an asset 'to be received or paid in a fixed or determinable number of units of currency') or a non-monetary one (all other items). Because an investment in equity securities is a non-monetary item, its translation at subsequent reporting dates depends on whether it is measured at historical cost in the foreign currency (not re-translated) or at fair value (remeasured at the exchange rate on the reporting date).

23. Because available-for-sale equity securities are measured at fair value, they are translated at closing rate. The changes in fair value of an available-for-sale equity investment are recognised in equity. Measuring impairment losses for such a security denominated in foreign currency should not differ from those denominated in an entity's own functional currency, except that the amount of loss being removed from equity for recognition in profit or loss also includes cumulative gains or losses from foreign currency translation.

24. Based on the above, the staff thinks that paragraphs AG83 and Q&A E.4.9 of IAS 39 already clarify the accounting by an entity in its financial statements for an available-for-sale equity security it holds that is denominated in a foreign currency. The 'significant or prolonged' assessment must be in the functional currency of the investor. This conclusion was noted in the staff analysis presented at the May meeting and in the IFRIC decision.

25. Because the impairment loss of such a security is the difference between its acquisition cost (translated at the historical exchange rate at acquisition date) and fair value (translated at the current exchange rate at reporting date), the staff notes that the entity holding that security may consider that there is an impairment in its functional currency but not in the security's foreign currency, and vice versa. The staff further notes that the amount of any impairment loss recognised will never be in the foreign currency of the security itself when that differs from the functional currency of the investor entity.

26. When such an entity is a subsidiary that is a foreign operation of a group entity, IAS 21 applies to the translation of the financial statements of the subsidiary entity for consolidation by the reporting group entity. When the subsidiary's functional currency is different from that of the parent, all exchange differences from translation are recognised in equity until the group entity's disposal of its net investment in the subsidiary.

27. The staff is not aware of any requirements for a reporting entity to reconsider its foreign subsidiary's accounting assessment for recognition or measurement purposes in the consolidation process except in limited situations. For example, the group entity may record consolidation adjustments when the subsidiary's basis of its carrying amount is different from that of the parent's because of a previous business combination.

28. The staff is not troubled by the two accounting results for impairment when translating a foreign subsidiary's financial statements for group consolidation purposes that one respondent noted and as mentioned in paragraph 20. The staff notes similar results in the foreign subsidiary directly holding such a security in the analysis in paragraph 25. In addition, if a group entity should reconsider in its own functional currency the foreign subsidiary's impairment assessment of such a security under IAS 39, it should also reconsider the subsidiary's impairment assessments of all other assets that foreign subsidiary holds, including non-financial assets such as goodwill. Such reassessments are not required by IAS 21 or other IFRSs. Similarly, the staff thinks that the group entity's reporting currency (or presentation currency) being different would not result in a reconsideration of its foreign subsidiary's impairment assessment.

Question 4
Based on the summary of comments and reasons discussed in paragraphs 19-28 above, the staff concludes that a group entity should not reconsider its foreign subsidiary's impairment assessment when functional currencies differ. Does the IFRIC agree?

***Setting criteria and applying judgement** - clarifying other factors to be considered when setting criteria for determining whether a decline is 'significant or prolonged'*

29. Several respondents commented on the need for additional guidance or clarifying additional factors an entity should consider when setting the criteria for determining whether a decline in value is significant or prolonged and applying judgement. Those comments relate to additional guidance on 'significance'[18] or additional disclosures beyond those already required by paragraphs 20(a)(ii) and 20 (e) of IFRS 7,[19] whether an entity should consider a security's historical price volatility,[20] the reason for an investment (eg strategic to develop a business relationship)[21] or recoverability of future expected cash flows at times of market illiquidity,[22] among others.

30. The staff note that the 'significant or prolonged' impairment requirements in IAS 39 apply to all available-for-sale equity securities regardless of the reason for that investment or the market liquidity. The staff also notes that equity instruments with unquoted prices and fair values that cannot be reliably measured would be accounted for at cost, not at fair value as an available-for-sale security. Therefore, the staff thinks that it is inappropriate to consider the reason for the investment or recoverability of expected cash flows rather than applying the requirements of IAS 39 for available-for-sale security to assess impairment.

31. The staff believes that responding to some of these comments would require an interpretation to be developed. As noted in paragraphs 3-8, the staff does not

[18] Standard Bank
[19] CNC
[20] E&Y
[21] E&Y
[22] Standard Bank

think the IFRIC should do this. Consistent with the IFRIC discussion at the May meeting, setting criteria for identifying declines that are significant or prolonged is an internal process that requires judgement by each entity. As analysed earlier in paragraph 11, an entity may set different criteria for each category of securities with similar risk to assist in the identification of securities that may require additional analysis. Once set, an entity should apply the judgement and those criteria consistently to reach conclusions that are matters of fact. Similar judgement applies to an entity determining what additional disclosures beyond existing requirements are needed to comply with paragraphs 122-123 of IAS 1 (noted in the IFRIC tentative decision) and paragraph 20 of IFRS 7.

Question 5
Based on the summary of comments and reasons discussed in paragraphs 29-31 above, the staff thinks that the IFRIC should not provide further guidance on how to set criteria or apply judgement at this time. Does the IFRIC agree?

Other drafting comments

32. Other specific drafting comments received that are not already addressed in the summary and analysis above relate to the third bullet point in the IFRIC tentative agenda decision wording. One respondent believes that using separate sub-paragraphs would more clearly state the two different points addressed: a decline in relation to the overall market and forecasts of expected recovery.[23]

Question 6
Based on the comments and conclusions summarised in paragraphs 9-32 above, the staff proposed some revisions to the wording of the tentative agenda decision in Appendix A. Does the IFRIC agree?

[Appendix A has been omitted from this Observer note]

[23] E&Y