Project	**Tentative agenda decisions**
Topic	**IAS 39 Financial Instruments: Recognition and Measurement — Meaning of 'significant or prolonged'**

Introduction

Objective of this paper

1. The objective of this paper is to obtain decisions from the IFRIC on this issue on how to proceed. As such, this paper:
   (a) provides background information on this issue;
   (b) analyses the alternatives;
   (c) makes staff recommendations; and
   (d) asks the IFRIC whether they agree with the staff recommendations.

Background

2. In March 2009 the IFRIC received a request to add an item to its agenda to provide guidance on the conceptual meaning of 'significant or prolonged' in the context of recognising impairment on available-for-sale equity securities in accordance with IAS 39.

3. The full text of the request is included as Appendix A (with the permission of the submitter) as the request is referred to in the submitter's public comment letter on the IASB's request for views on the FASB's FSP on impairment. The request clearly identifies the questions surrounding the issue and the different approaches leading to diversity in practice. Accordingly, the staff has not included a summary here.

4. As noted in the request, in June 2005 the IFRIC considered an agenda request regarding the interpretation of this phrase. However, the June 2005 agenda request asked for guidance in the specific circumstance in which an impairment loss had already been recognised, rather than the more general application of the requirement.

> The IFRIC considered whether to develop guidance on how to determine whether under paragraph 61 of IAS 39 (as revised in March 2004) there has been a 'significant or prolonged decline' in the fair value of an equity instrument below its cost in the situation when an impairment loss has previously been recognised for an investment classified as available for sale.
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> The IFRIC decided not to develop any guidance on this issue. The IFRIC noted that IAS 39 referred to original cost on initial recognition and did not regard a prior impairment as having established a new cost basis. The IFRIC also noted that IAS 39 Implementation Guidance E.4.9 states that further declines in value after an impairment loss is recognised in profit or loss are also recognised in profit or loss. Therefore, for an equity instrument for which a prior impairment loss has been recognised, 'significant' should be evaluated against the original cost at initial recognition and 'prolonged' should be evaluated against the period in which the fair value of the investment has been below original cost at initial recognition.
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> The IFRIC was of the view that IAS 39 is clear on these points when all of the evidence in the requirements and the implementation guidance of IAS 39 are viewed together.

5. After the March request was received, the staff confirmed with others its assertion that there is considerable diversity in practice. Some appears to be driven by regulatory guidance issued in various jurisdictions. This diversity is causing concern to users of financial statements. The wide variety of impairment approaches for equity instruments being applied by entities reporting in accordance with IFRSs has been reported to and discussed with members of the IASB's capital markets group by several users.

Staff analysis

6. In analysing the request and making a recommendation on whether the IFRIC should add the issue to its agenda, the staff has considered the request first in the context of the IFRIC's general response to questions of this nature and in the light of the current environment. Secondly, the staff analyses the technical issues based on its preliminary conclusions on possible approaches the IFRIC could consider.

Possible approaches to the issue

IFRIC's response to requests for guidance on IAS 39

7. Historically, the IFRIC has been very reluctant to add issues to its agenda concerning IAS 39. In general, it has concluded that:

   (a) given the guidance in IAS 39 and its relating application and implementation guidance, the answer was clear or that it did not expect diversity in practice, or

   (b) addressing the issue would result in providing implementation guidance rather than an interpretation of the requirements. For example, the IFRIC did not add to its agenda a request to provide guidance on how to evaluate hedge effectiveness.

8. When the IFRIC has concluded that an issue did result in diversity in practice, it has referred the issue to the Board so that the problematic paragraphs in the standard could be amended or amplified.

9. In the staff's view, paragraph IAS 39.58 sets out clearly the principle that all financial assets must be assessed at each balance sheet date to determine if there is any objective evidence that they are impaired. If such evidence exists, an impairment loss is recognised in profit or loss. Paragraph IAS 39.61 referenced in the agenda request provides guidance on the first part of the requirement – determining whether objective evidence of impairment exists.

10. The Board added paragraph 61 to IAS 39 as part of the improvements to that standard in 2003. The Board did not include any additional application guidance to the standard at that time, although several IGC questions and answers related

to the impairment of available-for-sale assets were carried forward into the Guidance on Implementing IAS 39.

Other standard setting activity

11. The staff notes that the application of impairment requirements inevitably requires the use of judgement. However, in the period since the revised IAS 39 became effective in 2005 until recently, conditions have not generally required entities to consider the possibility of impairment. In the staff's view this explains the absence of requests for guidance until now.

12. However, in the current environment, the spotlight is on the identification and measurement of impairment. Diversity in the application of the impairment requirements results in inconsistency in financial reporting in an important area, undermining confidence. The fact that impairment requirements differ between IFRSs and US GAAP has been the subject of considerable public attention and debate. Various groups have urged the IASB and FASB as a matter of priority to develop a common standard that will eliminate the variety of impairment methodologies that exist within both sets of standards.

13. The Boards both added a joint project to their active agendas to develop a replacement for their existing standards with the objective of improving the decision-usefulness for users of financial statements, which will also lead to reducing complexity. In March the Boards agreed to accelerate the development of a common standard 'that would address issues arising from the financial crisis in a comprehensive manner'.

14. Consequently, although the request states that the submitter is not aware of any planned or current IASB project which would provide guidance on the meaning of 'significant or prolonged', the Boards' common standard must address impairment if it is to be comprehensive. It is not possible to predict whether the 'significant or prolonged' notion will be included in the new standard. However, the IFRIC could certainly refer this request to the Boards for their consideration in the development of the new requirements and whatever application guidance they consider appropriate.

Timing

15. At its April meeting, the IASB indicated that it intends to have new proposals developed by the beginning of the fourth quarter of 2009. If this timetable is achieved, it might be possible to issue a new standard by 2010. Also at the April meeting, the IASB rejected the possibility of interim 'piecemeal' changes to the existing standards for financial instruments.

16. The staff believes that an IFRIC interpretation of the impairment requirements of IAS 39 is likely to be considered such a piecemeal change. Consequently, even if the IFRIC added the issue to its agenda and developed a draft Interpretation, the staff is concerned that there would not be a sufficient number of Board members who would support its publication for comment.

17. Even if the IFRIC added the issue to its agenda and the Board did not object to the development of an Interpretation, the fastest anticipated timing for the project would be as follows:

    (a) Add to agenda – May 2009

    (b) Approve draft Interpretation for publication – July 2009

    (c) Draft Interpretation published – August 2009 – for comment by November 2009

    (d) IFRIC consideration of comments received and staff recommendations for changes – January 2010

    (e) IFRIC approval of final Interpretation for publication and Board ratification – March 2010

    (f) Publication – April 2010 – with a possible effective date of July 2010.

18. On the other hand, the staff has been made aware of the urgent need to reduce diversity in the application of IAS 39 in this area. People consulted about this issue have indicated that even if the potential conflict with the Board's major project did not exist, both the alternatives of developing an IFRIC Interpretation or adding guidance to IAS 39 through the Annual Improvements project would not be a sufficiently timely response.

Proposed approach

19. The staff shares the submitter's concern about diversity in practice and notes that users are questioning the application of IFRSs by particular financial institutions. The staff also notes that in responding to requests for guidance on both IAS 39 and other standards, in several instances the IFRIC has adopted an approach that might prove helpful in this situation.

20. In those instances the IFRIC did not provide guidance on how entities should apply the requirements. However, the agenda decision did include the emphasis of the relevant principle and the IFRIC's views on applications that were clearly not in accordance with the standard. The most recent example of this approach was the IFRIC's response to the request for guidance on the determination of fair value measurement of instruments in inactive markets in November 2008 (final decision in March 2009).

21. The staff believes that the IFRIC could identify a number of the interpretations described in the request as clearly inappropriate applications of IAS 39. Eliminating these interpretations would significantly reduce diversity in practice without requiring the time-consuming development of what would essentially be implementation guidance rather than an Interpretation.

Recommendation and question for the IFRIC
Based on the analysis above, the staff recommends that the IFRIC not add the issue to its agenda. However, the agenda decision should clearly identify the relevant principles in IAS 39 and the approaches described in the submission that are not appropriate applications of the standard. Does the IFRIC agree with the staff recommendation? If not, what approach would the IFRIC like to follow?

Inappropriate interpretations

22. Assuming that the IFRIC agrees with the staff's recommendation on the approach to the request, the staff has analysed the interpretations described in the request to identify those that are clearly not in accordance with IAS 39.

23. In considering this issue it is important to remember that the request considered only available-for-sale equity instruments. When an impairment is identified,

IAS 39 is explicit that the loss recognised in profit or loss is the difference between the instrument's acquisition cost and its fair value (less any impairment losses previously recognised in profit or loss). The IFRIC has previously noted the guidance available on determining fair value. The issue considered in the request relates to the identifying whether objective evidence of impairment exists. IAS 39.61 states:

> ... 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. [emphasis added]

24. Given this explicit statement in the standard, the staff believes that is not possible for an entity to consider such a decline 'only as an indicator of possible impairment', as suggested in paragraph A4(a). In addition, agenda paper 8 for this IFRIC meeting points out the differences in impairment approaches between IAS 39 and IAS 28.

25. Because each equity investment is unique, each must be considered separately for impairment – there is no portfolio approach to such an evaluation. The fact that the decline in the price of an investment is in line with the overall level of decline in the relevant market does not mean that the investment is not impaired as suggested in paragraph A4(c). The fact that it is difficult if not impossible to disentangle the reasons for an increase in value of an equity instrument (between the reversal of an impairment and other increases in fair value) is the reason the Board precluded the reversal of such impairments. This is in contrast to debt instruments when changes in overall market factors may result in a price decline without indicating that a particular instrument is impaired. Other commentators point out that the Japanese Nikkei index reached its peak at 38,900 in December 1989 prior to that market's crash, and as of the time of writing this paper stands at 8,100. During the intervening period it trended downwards to a low of 8,000 in March 2003 with a brief recovery to 17,900 in May 2007. It has not exceeded 20,000 since March 2000.

26. Forecasts of expected recovery of values, regardless of their expected timing, are not part of the factors to be considered in the assessment of objective evidence of impairment. Consequently, the staff does not believe that it is possible to

factor an anticipated period recovery into the assessment of 'prolonged' as suggested in paragraph A4 (e).

27. In relation to the question in paragraph A4(g), (IAS 39 paragraph AG83 states: 'the gain or loss that is recognised in other comprehensive income ... includes any related foreign currency component'. Guidance on Implementing IAS 39 IG E.4.9 – Impairment of non-monetary available-for-sale financial asset clarifies that:

> ... Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognised in other comprehensive income is also reclassified from equity to profit or loss.

28. The staff therefore believes it is clear that the fair value of an equity instrument that is considered in determining whether a decline is significant or prolonged in accordance with IAS 39.61 must be in the functional currency of the investor. It is that amount against which any impairment is recognised in profit or loss.

29. The staff also believes that, although the determination of what constitutes a significant or prolonged decline will require judgement, this is not an accounting policy choice as suggested in paragraph A4(i). IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states:

> When an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS.

IAS 39 requires an entity to determine whether there is objective evidence of impairment in an available for sale equity instrument by considering whether there has been a significant or prolonged decline in its value, so an entity must apply that policy.

30. An entity will obviously develop internal guidance for the application of that policy to assist in the identification of situations that require further analysis in the same way that they specify capitalisation policies for PP&E. Because the judgements made in determining whether there is objective evidence of impairment can significantly affect the amounts an entity recognises in its financial statements, the entity would provide disclosure about those judgements

in accordance with paragraph 122 of IAS 1 *Presentation of Financial Statements*:

> An entity shall disclose ... the judgements, apart from those involving estimations ... that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

31. Paragraphs A5 and A6 of the submission discuss possible interpretations of the phrase 'significant or prolonged'. Some of these interpretations suggest that it can be interpreted instead as 'significant *and* prolonged', thus requiring the satisfaction of both conditions. The staff believes that this interpretation is clearly inappropriate.

32. First, and most importantly it is a contradiction of the plain English meaning of the words. Second, it ignores the fact that this wording was a deliberate choice made by the Board in the Improvements to IAS 39 project finalised in 2003. The exposure draft of the improvements issued in 2002 proposed to add guidance on impairment to the 2000 version of the standard. Paragraph 110A of the ED stated 'A significant *and* prolonged decline in the fair value of an investment ...'. In finalising the amendments to IAS 39, the Board changed the wording to 'or'.

33. Consequently, although there is obviously some interaction between the notions of 'significant' and 'prolonged' in concluding whether there is objective evidence that an investment is impaired, in the staff's view only the interpretation set out in paragraph A6(a) is appropriate.

Recommendation and question for the IFRIC
The staff recommends that the tentative agenda decision include the conclusions set out in paragraphs 22 to 33. Does the IFRIC agree with the staff conclusions in paragraphs 22 to 33? Which of these issues would the IFRIC like included in the tentative agenda decision? Are there other issues in the submission that the IFRIC would like to include?

34. The staff has not proposed wording for the tentative agenda decision in this paper. It can be provided for review as part of the preparation of *IFRIC Update* after the meeting based on the IFRIC's decisions. If that process does not result in agreement, the staff will bring the proposed wording to the July meeting for discussion.

Appendix A — IFRIC Potential agenda item request

Meaning of ‘significant or prolonged’

A1. Ernst & Young would like to request IFRIC to address the following issue with respect to the meaning of ‘significant or prolonged’ in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39).

The issue

A2. IAS 39 requires entities that hold equity securities classified as available-for-sale (AFS) to assess whether these instruments are impaired.

A3. The last sentence of paragraph 61 of IAS 39 states 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”. In this regard, we note that there is no application guidance on the meaning of ‘significant or prolonged’.

A4. How should ‘significant or prolonged’ be interpreted? In particular, the following questions often arise in trying to interpret the words ‘significant or prolonged’:

(a) Should ‘significant or prolonged’ be regarded only as an indicator of possible impairment, subordinate to the general principle set out in paragraph 59, that a loss event should have “an impact on the estimated future cash flows” (and the reference in the previous sentence of the same paragraph that “the investment in the equity investment may not be recovered”) and so should be attributed less weight if there are other indicators suggesting that future cash flows are unlikely to be reduced? This would take into account the fact that the expected cash flows in question may be future dividends rather than the price that the security would achieve in the market (consistent with the impairment approach set out in paragraph 33 (b) of IAS 28 *Investments in Associates*) as, despite the name of the ‘available for sale’ category, many equity securities are not held with the intention of sale.

(b) Should what is deemed ‘significant’ vary depending on:

  (i) the security’s historical price volatility (on the basis that a decline in market price is less significant if such a decline is relatively ‘normal’ for that security);

  (ii) the period over which the decline has taken place (on the basis that a sudden drop is less significant than a sustained decline, this introduces an interplay between the concepts of significant and prolonged); and

  (iii) whether the price substantially recovered between the balance sheet date and the finalisation of the financial statements?

(c) Does the fact that the price of a security has declined in the same proportion as the overall market decline (regardless of the overall level of decline) imply that the decline is not significant – and therefore the security is not to be considered impaired as long as none of the other indicators set out in paragraphs 59 or 61 are applicable? The basis for this argument could be that market prices decline for reasons unconnected with a particular instrument, such as interest rates, market liquidity, global economic turmoil and the overall balance of supply and demand.

(d) A literal reading would imply that the assessment of ‘prolonged’ should be based on how long the security has been below cost as at balance sheet date. However, would it be possible to introduce a threshold, so that an asset is considered impaired only if the market price has been below cost by a certain amount for a prolonged period?

(e) Should the anticipated period of recovery be factored into the assessment of ‘prolonged’? ie, the quicker the expected recovery, the more likely that the decline is not ‘prolonged’ or vice-versa?

(f) Should the term ‘prolonged’ be regarded as only long enough to exclude market ‘noise’ (and so might be measured in months) or long enough to filter out the effects of entire market cycles (and so be measured in years)?

(g) Should ‘significant or prolonged’ be assessed in the currency in which the equity instrument is quoted or in the functional currency of the entity holding the security?

(h) BC 106, which clarifies the basis for the ‘significant or prolonged’ test, states that “today’s market price is the best estimate of the discounted value of the future market price” if “markets are reasonably efficient”. If the market is currently viewed as inefficient, is the decline in market price regarded only as an indicator of impairment or, should the decline in price always be factored into the impairment assessment?

(i) Should what is ‘significant or prolonged’ be an accounting policy choice which would permit any application, as long as it is appropriately disclosed and consistently applied?

Current practice:

A5. There is considerable diversity in the perceived meaning and application of ‘significant or prolonged’ in relation to impairment of equity instruments. Regulators have, in the current circumstances, introduced thresholds ranging from a 20% decline below cost *or* 6 months of sustained decline, to a decline of 40% below cost having been sustained for at least 18 months.

A6. The phrase ‘significant or prolonged’ has been interpreted in several ways:

(a) ‘significant or prolonged’ - the equity instrument is considered impaired if the decline meets either of the two criteria;

(b) ‘significant and prolonged’ - the equity instrument is considered impaired if the decline is consistently below a threshold for a prolonged period;

(c) ‘significant and prolonged’- the test is two-fold ie., both criteria need to be met for the equity instrument to be considered impaired.

A7. Which of these interpretations is more appropriate? Is such diversity in practice acceptable?

Reasons for the IFRIC to address the issue:

A8. We acknowledge that earlier in June 2005, the IFRIC decided not to develop guidance on how to determine whether there has been a 'significant or prolonged' decline in the fair value of an equity instrument.

A9. Ernst & Young would like to request the IFRIC to add to its agenda the conceptual meaning of (rather than provide application guidance on how to determine) 'significant or prolonged' and the relationship between the two notions, for the following reasons:

(a) The issue is widespread due to the economic turmoil and is relevant for all sectors.

(b) The notion of 'significant or prolonged' is being widely interpreted in current practice as illustrated above.

(c) A clarification from the IFRIC would improve consistency in the application of this sentence of the Standard.

(d) We believe the conceptual meaning of 'significant or prolonged' can be resolved efficiently and in a timely manner by an interpretation from the IFRIC and that such clarification is within the scope of the IFRIC.