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| Project | Financial Instruments – Recognition and Measurement |
| Topic | Impairment – interaction with other IFRSs (IAS 28 and IFRS 4) |

Introduction

Background

1. At its 17 September 2009 meeting, the IASB tentatively decided to issue in October 2009 an exposure draft (ED) proposing the expected cash flow (ECF) approach as the impairment method for financial assets measured at amortised cost. The proposal will replace the incurred loss model currently contained within IAS 39 *Financial Instruments: Recognition and Measurement* for financial assets measured at amortised cost.
2. The staff and some respondents to the Request for Information (RFI) have identified the following interaction between the incurred loss model in IAS 39 and impairment accounting in other IFRSs that warrants an analysis of the effect that replacing IAS 39 would have:
 - (a) After the application of the equity method, IAS 28 *Investments in Associates* requires the investor to use the *indicators* of the incurred loss model in IAS 39 to determine *whether* it is necessary to recognise any additional impairment loss¹.

¹ See IAS 28.31 and 33.

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

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- (b) IFRS 4 *Insurance Contracts* requires that the impairment test for credit risk from reinsurance assets be based on the incurred loss model in IAS 39² and one additional criterion.

Purpose

- 3. The purpose of this paper is to address the consequences of replacing the incurred loss model with the ECF approach for the requirements in IAS 28 and IFRS 4. This paper sets out staff recommendations, the rationale for them and asks the Board for decisions on how these interactions should now be dealt with.

Indicators of additional impairment loss in investment in associates

- 4. IAS 28 requires that after the application of the equity method, investors apply the impairment triggers under the incurred loss model in IAS 39 to determine *whether* it is necessary to recognise any additional impairment loss. The amount of impairment loss is then measured in accordance with IAS 36 *Impairment of Assets*.³
- 5. The proposed ECF approach uses a continuous re-estimates of (all) expected cash flows. It does not contain any triggers or thresholds with regard to impairment testing.
- 6. Therefore an issue arises where IAS 28 refers to the financial instrument impairment model for impairment triggers because no impairment triggers will exist under the ECF approach.
- 7. The staff believes the Board has at least the following alternatives in dealing with this issue (each of which is discussed further below):
 - (a) **Alternative 1:** retain the existing guidance in IAS 39;

² See IFRS 4.20 and IFRS 4.BC108.

³ See IAS 28.33.

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- (b) **Alternative 2(a)**: adopt the impairment indicators in IAS 36;
- (c) **Alternative 2(b)**: require annual impairment testing; and
- (d) **Alternative 3**: adopt the ECF approach.

Alternative 1 – Retain the existing guidance in IAS 39

8. Retaining the existing guidance in IAS 39 for the purpose of impairment testing for investments in associates in IAS 28 would not affect the proposed scope of the ECF approach. The proposed ECF approach is to be applied to financial assets measured at amortised that will be in the scope of the new financial instrument standard.
9. However, arguments against this alternative are:
 - (a) Keeping the incurred loss model triggers for the purpose of IAS 28 in parallel with the proposed ECF approach would increase complexity rather than reduce it. Furthermore, it may create confusion to users and preparers. If the Board wants to retain the incurred loss model triggers the staff believes that in order to mitigate complexity those triggers should be incorporated directly in IAS 28 as an amendment to that standard rather than by reference (as existing requirements do).
 - (b) One of the main criticisms of the incurred loss model is that the impairment triggers have not well as it is not always clear *when* events or triggers indicate impairment. In particular, the impairment trigger for equity instruments has created significant problems as the financial crisis has shown (and evidenced by a submission to the IFRIC).
10. The staff does not recommend that the board adopt this alternative.

Alternative 2(a) – Adopt the impairment indicators in IAS 36

11. Under IAS 28, the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset, by comparing its

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recoverable amount with its carrying amount⁴ *whenever* indicators of impairment under the incurred loss model in IAS 39 are present.

12. Adopting Alternative 2(a) (ie using impairment indicators in IAS 36 instead) would simplify existing accounting requirements and reduces complexity in financial reporting. Under this alternative, impairment indicators, testing and measurement of any additional impairment loss would be governed by one standard (IAS 36) rather than two separate standards (IAS 36 and IAS 39).
13. The staff also believes that for investments in associates the impairment indicators in IAS 36 are no less appropriate than those in IAS 39 (arguably even more suitable, eg the indicators regarding internal information and dividends received from the investee)⁵.
14. The staff recommends that the Board adopts this alternative.

Alternative 2(b) – Require annual impairment testing

15. Goodwill in an investment in an associate is not separately recognised but forms part of the carrying amount of the investment in an associate⁶. IAS 36 requires that goodwill acquired in a business combination be tested for impairment annually⁷. Therefore, one alternative could be to require entities to perform annual impairment testing for investment in associates. However, not all investment in associates may contain goodwill and mandating this alternative would be quite onerous for preparers.
16. The staff also considers that using the annual impairment test for goodwill would be inconsistent with the treatment of goodwill as an integral part of the investment in the associate rather than as an individual asset.
17. The staff does not recommend that the board adopt this alternative.

⁴ See IAS 28.33.

⁵ See IAS 36.12.

⁶ See IAS 28.33.

⁷ See IAS 36.10(b).

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Alternative 3 – Adopt the ECF approach

- 18. Under this alternative, the ECF approach would be used for additional impairment testing for investments in associates.
- 19. The ECF approach is designed to capture expectations of credit losses in the context of amortised cost measurement. In contrast, investments in associates are accounted for using the equity method, which is entirely different from amortised cost (eg regarding the link to interest revenue recognition). Therefore, the ECF approach is not an appropriate impairment test for investments in associates.
- 20. The staff does not recommend that the Board adopt this alternative.

Staff recommendation

- 21. For the reasons set out in the previous discussion of the different alternatives, the staff recommends that the Board adopt Alternative 2(a) and use the impairment indicators in IAS 36 to determine whether additional impairment testing is required for investments in associates.

Question 1 – Indicators of additional impairment loss for investments in associates

Does the Board agree with the staff recommendation to use the impairment indicators in IAS 36 to determine whether additional impairment testing is required for investment in associates, ie Alternative 2(a)?

If not, why and what other approach or approaches would the Board like to use and why?

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Impairment of reinsurance assets

22. IFRS 4 *Insurance Contracts* requires impairment testing of reinsurance assets if:
- (a) there is objective evidence of a loss event that occurred after initial recognition of the reinsurance asset;⁸ and
 - (b) the loss event has a reliably measurable impact on the amount due from the reinsurer.⁹
23. In its deliberations of IFRS 4 the Board concluded (as set out in the Basis of Conclusions of IFRS 4) that the most appropriate impairment test for reinsurance assets would be based on the incurred loss model in IAS 39 as the impairment test should focus on credit risk¹⁰.
24. A potential issue might result from the fact that IFRS 4 refers to objective evidence of loss events but provides no further guidance. Because the proposed ECF approach does not involve any loss events or triggers the guidance on loss events in IAS 39 would no longer exist. Prima facie, this might be perceived as indirectly affecting the interpretation of IFRS 4 because of the requirement to consider requirements of IFRSs dealing with similar and related issues when selecting accounting policies in accordance with IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors*.¹¹
25. Thus, the question for interpretation would then be whether the guidance on loss events existing in IAS 39 today would continue to be an appropriate analogy for the purpose of interpreting IFRS 4 even after it would have been eliminated as a result of the IAS 39 replacement project. The staff believes that eliminating the loss event guidance in IAS 39 would not result in a change in accounting policies for entities applying IFRS 4 to reinsurance assets. The reason is that the

⁸ This approach is based on the incurred loss model in IAS 39 (see IFRS 4.BC108).

⁹ See IFRS 4.20.

¹⁰ See IFRS 4.BC108.

¹¹ See IAS 8.11(a).

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requirement that stipulates that objective evidence of a loss event must exist as a prerequisite of impairment resides in IFRS 4 itself.¹² Thus, there is no dynamic link (ie incorporation by reference) to the impairment model of IAS 39 in the authoritative part of IFRS 4. Thus, for loss event identification regarding reinsurance assets the inferences from the loss event guidance existing in IAS 39 today would be as valid after replacement of IAS 39 as they are today.

26. The staff believes the Board has at least the following alternatives in dealing with this issue (each of which is discussed further below):
- (a) **Alternative 1:** adopt the ECF approach; and
 - (b) **Alternative 2:** retain the existing requirement.

Alternative 1 – Adopt the ECF approach

27. Prima facie, the same rationale that underpins the change from the incurred loss model to the ECF approach for financial assets in the scope of IAS 39 implies mandating a similar change for all other financial assets to which an incurred loss model applies.
28. However, the staff notes that the accounting for reinsurance assets has a very specific context. The impairment requirement for reinsurance assets in IFRS 4 is one of the five instances in which the implications of IAS 8 for selecting accounting policies still apply whereas otherwise IFRS 4 provides a temporary exemption from these implications of IAS 8. Therefore, while IAS 8 implications apply to the impairment aspect of the measurement of reinsurance assets the implications do not extend to the use of amortised cost as a measurement basis.
29. In fact, the nature of reinsurance assets means that they have a strong interaction with insurance liabilities and amortised cost measurement would be difficult to apply, if at all possible (and sensible).

¹² See IFRS 4.20(a).

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30. Therefore, the staff believes that applying the ECF approach to reinsurance assets would be prone to unintended consequences such as inconsistencies between the overall measurement and the impairment test used, and also accounting mismatches between the assets and liabilities of insurers.
31. Furthermore, the Board plans to issue a new IFRS on insurance contracts in 2011 with a possible effective date of 2013/14. Changing the accounting for reinsurance assets as part of the replacement of IAS 39 would therefore create a risk that the same issue would be addressed twice within a short period (and that the change made now would be overturned by the insurance contract project). This would create confusion for users and undue costs for insurance companies.
32. Therefore, the staff does not recommend adopting this approach.

Alternative 2 – Retain the existing requirement in IFRS 4

33. Alternative 2 has the advantages that
 - (a) the current requirement in IFRS 4 can be retained until the Board finalises its active project on insurance contracts.
 - (b) unintended consequences of changing (only) the impairment approach without revisiting the measurement basis for reinsurance assets in its entirety are avoided. This is based on the staff's view that eliminating the impairment guidance in IAS 39 will not create a knock-on effect from IAS 8.¹³

¹³ See paragraph 25.

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Staff recommendation

34. For the reasons set out in the previous discussion of the different alternatives, the staff recommends the Board adopts Alternative 2.

Question 2 – Impairment of reinsurance assets

Does the Board agree with:

- (i) the staff recommendation to retain the existing requirement for reinsurance assets in IFRS 4 (Alternative 2)?
- (ii) the staff's analysis in paragraph 25 that eliminating the impairment guidance in IAS 39 will not create a knock-on effect from IAS 8?

If not, why and what other approach or approaches would the Board like to develop and why?