Accounting for equity instruments from a long-term investor perspective – status of the data collection

Objective

1 The objective of this session is to provide an update on the EFRAG activities on the request for technical advice from the European Commission.

Background

The relevant requirements of IAS 39 and IFRS 9

2 Under IAS 39 *Financial Instruments: Recognition and Measurement*, investments in equity instruments are generally classified as either held for trading and carried at fair value through profit or loss, or as available for sale ('AFS') instruments. Fair value changes in equity instruments classified as AFS are recognised in other comprehensive income ('OCI') and ultimately recycled to profit or loss upon derecognition.

3 Under IAS 39's AFS model, if there is objective evidence of impairment the cumulative loss recognised in OCI is reclassified to profit or loss. Impairment is assessed by evaluating whether there is a significant or prolonged decline in the fair value of the instrument below its cost.

4 Under IFRS 9 *Financial Instruments*, investments in equity instruments are generally recognised at fair value with changes in fair value recognised in profit or loss. However, an entity can make an irrevocable election at initial recognition for certain equity instruments within the scope of IFRS 9 to recognise subsequent changes in fair value through OCI (FVOCI).

5 Upon disposal, there is no recycling to profit or loss of gains or losses on any equity instrument accounted at FVOCI under IFRS 9. This is a key area of concern for long-term investors.

EFRAG's advice on the endorsement of IFRS 9

6 EFRAG's September 2015 endorsement advice letter to the EC stated:

"The default requirement to measure all equity investments at fair value through profit or loss may not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG observes that IFRS 9 provides an option to measure some equity instruments at fair value through other comprehensive income. However, it is not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance."

"While EFRAG acknowledges the difficulties that the IASB had to find a conceptually sound impairment model for equity instruments, we believe that a less conceptually sound model is better than no model. EFRAG also notes that, in commenting to the IASB, we suggested the lower of cost or market model be considered for the impairment of equity instruments held for the long term to enable users to distinguish those holdings from equity instruments held for trading. However, the IASB did not follow that suggestion."

7 With respect to recycling, EFRAG had previously stressed the importance of profit or loss as a main indicator of financial performance. In EFRAG's October 2013 letter to the European Commission *Reflecting long-term investment business models in financial reporting*, EFRAG stated:

"Users from almost all sectors incorporate profit or loss in their analysis, generally as a starting point for analysis. Profit or loss is also acknowledged generally as the main indicator of an entity's performance in financial communication. EFRAG believes therefore that profit or loss is an essential number that supports users' needs as it is the primary measure of an entity's performance. Given that the communication between preparers and users relies heavily on profit or loss, it is crucial that users have a good understanding of what this measure of performance depicts. Nevertheless, acknowledging that profit or loss plays a significant role in financial communication does not mean that it is the only information that should be used."

The request from the European Commission

8 The request from the European Commission has two distinct phases:

(a) Phase 1 – problem definition; and

(b) Phase 2 – possible solutions.

Status of the data collection

9 Phase 1 consists of two components – quantitative information about the significance of the equity portfolios for long-term investors under IAS 39 and the possible effects of the application of IFRS 9.

10 In relation to the collection of data, the EFRAG Secretariat has already:

(a) investigated the potential use of the FVOCI designation in its 2013 field test on classification and measurement of financial assets (37 participants, half of them from the banking sector and the other half from the insurance and other industries);

(b) received the same information on some additional entities from 4 members of the EFRAG FIWG;

(c) obtained some aggregated data on total equity instruments, total AFS instruments and related OCI balances held by European banks, by the European Banking Authority;

(d) reviewed publicly available sources, including:

(i) the 2016 Mercer asset allocation survey;

(ii) the Insurance Europe industry database;

(iii) the 2016 Pensions Europe statistical survey;

(e) on July 4th, launched a public consultation via a web-based questionnaire to all European constituents with an invitation to respond not later than September 30th;

(f) reviewed the financial statements of 34 major European public entities, 23 insurance companies and eleven industrial companies from the oil & gas, power generating and mining industries. Entities were selected based on the total assets.

11 The EFRAG Secretariat is summarising the results of the financial statements analysis. The extent to which the required information is available is varied , although in some cases information may not be available because the amounts were deemed to be immaterial.

12 Information is mostly available for the total amount of equity instruments, and the split between those that are carried at fair value through profit or loss and those in available-for-sale. Other information is frequently not available, such as the cumulated OCI credit and debit balances on AFS equity instruments, the amounts of securities disposed of in the period and the recycling gains/losses on disposals.

13 On average, equity instruments represent a small portion of total available-for-sale financial assets. The amount of equity instruments held by the industrial companies in the sample is substantially low. Most entities do not identify a 'long-term' portion of their equity portfolio.

14 The proportion of the split between equity instruments at FVPL and AFS varies across entities. There does not seem to be an explicit explanation for the reasons to use one category or the other, however for insurers it seems linked to how contract liabilities are measured. In some cases, unlisted securities are carried at cost less impairment losses.

15 The EFRAG Secretariat is planning to launch a call for an academic literature review to focus on two topics – the interaction between accounting requirements and asset allocation decisions (and holding periods), and the value-relevance of realised and unrealised gains on equity instruments. A preliminary research on the EBSCO electronic journal database has resulted in a very limited number of specific papers.

16 The topic will also be discussed with the Academic Panel in the inaugural September meeting.

Phase 2 – possible solutions

17 The request from the European Commission will require EFRAG to accelerate its research project that is looking into investments that European entities have in equity instruments that might be carried at FVOCI. Initial discussions with EFRAG TEG (and elsewhere) have shown significant consensus around the view that an impairment model is a prerequisite for the re-introduction of recycling.

18 In June, EFRAG TEG discussed a more articulated version of the 'lower of cost and fair value' approach for equity instruments. The approach was deemed to be simple to use, as it requires no judgment in assessing whether a decrease in fair value is an impairment loss or not. However, the approach may not be attractive to investors that do not want to be exposed to volatility in their profit or loss.

19 Following the concerns expressed by the User Panel about the fact that, if recycling of gains was allowed, entities may have an incentive to 'time' equity disposals, EFRAG TEG noted that it would be important to address these concerns and explain clearly why recycling of long-term gains provides useful information.

20 The next EFRAG TEG session will be in September. The EFRAG Secretariat plans to bring a draft paper to discuss the significance from a conceptual perspective of an impairment model to the removal of the recycling ban; and a revised version of an impairment model based on the existing IAS 39 requirements for available-for-sale assets.

Questions for EFRAG Board
21 Do EFRAG Board members have any preliminary comment on the proposed approach to providing the advice requested by the EC?