Accounting for equity instruments from a long-term investor perspective Cover Note

Objective

1 The objective of this session is to consider the approach to the request for technical advice from the European Commission (attached as Agenda Paper 06-02).

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.

Phase 1 – problem definition

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 To meet the specific request from the EC, the EFRAG Secretariat envisages the need to collect information to help define and scale the problem. This will include, but not be limited to, information on:

(a) the proportion of equity investments held by insurance companies and other long-term investors that is considered to be held for the long-term;

(b) how the term "long-term" is interpreted in this context;

(c) the volume/value of equity instruments classified as AFS under IAS 39 by long-term investors and the extent to which those investments are likely to be designated at FVOCI under IFRS 9;

(d) reasons why long-term investors dispose of equity instruments;

(e) historical data on recycled amounts under IAS 39; and

(f) the basis for recognising impairment losses on equity instruments under IAS 39 and the amounts recognised.

11 The EFRAG Secretariat has considered the information available in the commercial database. Our initial assessment is that the database does not provide a sufficient level of detail – for instance, the balance for AFS instruments is not further disaggregated between equity instruments and other AFS instruments. Further, qualitative information such as that envisaged under paragraph 10(b) and (d) is not provided in the commercial database.

12 The EFRAG Secretariat therefore envisages launching a public consultation before the summer break to seek relevant information. Given that part of the data collection concerns possible changes in behaviours by long-term investors, the EFRAG Secretariat considers that it would be helpful to include some structured interviews (similar to those conducted in the outreach for the Dynamic Risk Management project).

13 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; and

(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.

Phase 2 – possible solutions

14 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.

15 Therefore, the project is considering possible impairment models that could support recycling of gains and losses of equity instruments measure at FVOCI. A relevant past accounting research project that dealt with recycling was EFRAG's PAAinE project on Performance Reporting. The EFRAG Secretariat will use that project as a resource and also build on the prior work of EFRAG's financial instruments efforts, particularly the work done examining impairment models for assets other than debt securities.

Timeline for the project

16 The EC has requested that the EFRAG response on Phase of the project be provided by the end of 2017 and the information on Phase 2 by mid-2018. Given the other high priority projects, including the expected request for endorsement advice on IFRS 17 *Insurance Contracts,* it may be necessary to delay other EFRAG research projects. We will revise the research work plan for the July meeting of the EFRAG Board.

Questions for EFRAG Board

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

Agenda Papers

18 In addition to this cover note, the agenda paper for this session is Agenda Paper 06-02 – Letter from the European Commission.