EUROPEAN COMMISSION
Directorate General Financial Stability, Financial Services and Capital Market Union

INVESTMENT AND COMPANY REPORTING
Accounting and financial reporting
Head of Unit

Brussels,
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Jean-Paul Gauzes
President
EFRAG
Square de Meeûs 35
B-1000 Brussels

Subject: Request for technical advice on the accounting treatment of equity instruments under IFRS 9 from a long term investment perspective

Dear Mr Gauzes,

The Commission completed the endorsement process of IFRS 9 with the adoption of Commission Regulation (EU) No 2016/2067 on 22 November 2016.

The effect of IFRS 9 on long-term investors was widely debated during the endorsement process. In particular, the Commission asked EFRAG to consider long-term investment in developing its endorsement advice to the Commission on the standard. EFRAG concluded that it is unlikely that long-term investors would change their investment strategy because of the accounting changes brought by IFRS 9. The Commission subsequently conducted its own fact-finding exercise and came to the same conclusion. These assessments were qualitative rather than quantitative because they were largely based on behavioural expectations.

Notwithstanding these findings, the Commission has noted that EFRAG commented in its endorsement advice that the accounting treatment of equity instruments under IFRS 9 may not reflect the business model of long-term investors. Accordingly, the Commission considers it important to closely monitor the impact of IFRS 9 on long-term investors in order to avoid any unintended effects. Furthermore, during the standard's endorsement process, the EP[1] and some Member States have also called for close monitoring of the impact of IFRS 9 to ensure that it serves the EU long-term investment strategy.

As part of this monitoring exercise, the Commission would like to:

- obtain quantitative information about long-term equity investments and evaluate the possible impact of IFRS 9 on long-term investments ("phase 1") by the end of 2017 and;
- identify whether and how IFRS 9 could be improved with respect to the accounting treatment of equity instruments held for long-term investments ("phase 2") by mid-2018.

[1] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0381+0+DOC+PDF+V0//EN

Equity instruments are by default measured at fair value through Profit or Loss. To avoid fluctuations from unrealised gains and losses from changes in fair values being recognised in Profit or Loss, long-term investors can choose to recognise fair value changes in Other Comprehensive Income. However, EFRAG believes that long-term investors are unlikely to use this option because of the prohibition on presenting realised gains on sales of equity as profits (the so-called "ban on recycling")[2].

Against this background, the Commission would like to request EFRAG to conduct some fact-finding and research in this area. This work should address the areas set out below.

<u>Phase 1 problem definition</u>

1. Quantitative information about the significance of the equity portfolios for long-term investors before the entry into application of IFRS 9

This information could include the following for the years 2016 and 2015 (to the extent data is available):

- The size of the equity instruments' portfolios held by insurance companies and other long-term investors and the proportion that is considered to be held for the long term;

- The criteria used by long-term investors to classify their equity portfolios as long term and what information is disclosed about their long-term business model and the long-term portfolios in the financial statements;

- The accounting classification under IAS 39 of their equity portfolios and the amount of fair value changes recognised in Other Comprehensive Income in relation to the part of the equity portfolio that is considered long term;

- The amounts (in gross and net amounts) of realised gains and losses recycled through the profit and loss and the amount of the underlying equity portfolio sold to give rise to these gains and losses; the factors leading long-term investors to realise part of their long term equity portfolios;

- The magnitude of the fair value changes, and realised gains and losses in terms of annual profit.

- What impairment charges were recognised on the equity portfolios accounted for at fair value through Other Comprehensive Income and what criteria were applied?

2. Assessing the possible effects of the application of IFRS 9 on the equity portfolios of long term investors

As long-term investors will be further ahead in their implementation plans or have had more time to develop their thinking than during the endorsement process for IFRS 9, it would be helpful if EFRAG could provide information on the following points:

- Will long-term investors use the option to measure their long-term equity investments at fair value through other comprehensive income (FVOCI); what factors will influence their

[2] See EFRAG endorsement advice on IFRS 9, page 75: http://www.efrag.org/News/Project-181/EFRAG-Endorsement-Advice-on-IFRS-9-Financial-Instruments-

choice; what will be the size of the equity portfolio measured at FVOCI compared to the overall equity portfolio?

- Would long-term investors envisage that the application of IFRS 9 would affect their holding of and financial reporting (including investor relations) for their long-term equity portfolios? There should be an explanation of these effects together with, where possible, quantification. Any other information relevant to an assessment of their significance such as any mitigating actions likely to be taken should be included.

Phase 2 possible solutions

3. How to improve the new IFRS 9 accounting framework: How significant is an impairment model to the removal of the ban on recycling from a conceptual perspective?

The IASB initially sought to simplify IFRS 9 by requiring all changes in fair values to be recognised in Profit or Loss. However, the Board accepted that long-term investors preferred to report volatility on their investments in Other Comprehensive Income rather than in Profit or Loss. The IASB introduced the ban on recycling because it wanted to avoid earnings management by companies which could hold onto loss-making investments while realising gains on others. The impairment model for equities reported as available-for-sale under IAS 39 was open to judgement and had led to significant diversity in practice. According to the IASB, a robust impairment model would be needed to prevent companies to manage their earnings. Lacking such a model, IFRS 9 prohibits recycling.

We would invite EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling and also consider possible alternatives. For example, could fair value changes over time in Other Comprehensive Income be analysed between positive and negative changes on equity instruments so that investors could form a view about the performance of the equity investments? Alternatively, could the fair value changes on equity investments measured at Fair Value through Profit and Loss be disclosed with an analysis between realised and unrealised changes?

4. If an impairment model is considered to be an important element of a "recycling" approach, what features would characterise a robust impairment model and could these feasibly be made operational?

In the context of the EFRAG's ongoing research project, we would like to ask EFRAG to identify how the existing impairment model under IAS 39 for equity investments could be improved or if another impairment model could be developed, possibly by looking at other national or third-country GAAPs. The availability of a practicable and robust impairment model could be a significant factor to influence the IASB to reconsider the ban on non-recycling in IFRS 9.

Also in the light of the EP resolution calling on the Commission to report on whether IFRS 9 could be detrimental to long-term investment, we would be grateful if EFRAG could provide us with the preliminary outcome of its work on phase 1 by the end of 2017.

In order to provide appropriate qualitative and quantitative evidence of the need, if relevant, for a change to IFRS 9 or additional further disclosure around this area, we would ask EFRAG to consult publicly to the maximum extent possible within the given timeframe.

We thank you in advance for your cooperation and would be happy to provide any clarification required on this letter to EFRAG representatives.

Should you have any questions, please contact Erik van der Plaats or Dawn Robey (Telephone: +32 2 29 55565 or +32 2 29 52282).

Yours sincerely,

Alain DECKERS

cc.: A. Watchman, (EFRAG TEG Chairman), V. Ledure (FISMA)