EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

EFRAG Research project Equity Instruments – Impairment and Recycling

1 The objective of this session is to provide an update on the status of the Research project on Equity Instruments – Impairment and Recycling.

Background of the project

2 IFRS 9 *Financial Instruments* was issued by the IASB in July 2014 and is effective for annual periods beginning on or after 1 January 2018. For equity instruments, other than those held for trading and contingent consideration recognised in a business combination, the IASB has introduced an irrevocable option at inception on an instrument-by-instrument basis that permits those instruments to be accounted for at fair value through other comprehensive income (‘FVOCI’) with no impairment losses recognised in profit or loss and no reclassification in profit or loss of gains or losses upon derecognition.

3 In the Basis for Conclusions of IFRS 9, the IASB notes that one of the primary reasons for not allowing recycling is that it would create the need to assess these equity instruments for impairment. The IASB also noted that the application of impairment requirements of available for sale (‘AFS’) in IAS 39 *Financial Instruments: Recognition and Measurement* was very subjective.

4 In its Endorsement Advice, EFRAG noted that 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 observed that the FVOCI option was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance.

5 However, based on limited evidence, EFRAG assessed it was unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9.

Objective of the project

6 In May 2017, EFRAG received a request for advice (‘RfA’) from the European Commission (‘EC’) for technical advice on the issue. The request has two distinct phases:

(a) Phase 1, which is due by the end of 2017, consists of information about the significance of the equity portfolio for long-term investors and whether the new requirements in IFRS 9 is expected to affect asset allocation decisions;

(b) In Phase 2, which is due by the end of the first half of 2018, the EC wants EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If an impairment model is considered to be a precondition for recycling, then EFRAG should define what would be the characteristics of the robust impairment model for equity instruments. The EC has also asked EFRAG to consider possible alternatives based on presentation.

Phase 1 – collecting the data

7 EFRAG launched a public consultation before the summer and received 19 responses with quantitative information for years 2014-2016 and 6 responses with general information only. Respondents came from the following industries and countries:

Industry	**Nr. of respondents**	**Country**	**Nr. of respondents**
Insurance	11	France	8
Financial Institutions	9	Germany	7
Non-financials	5	Belgium	4
Other	-	Other	6
Total	***25***	***Total***	***25***

8 The EFRAG Secretariat has presented a summary of the input to EFRAG TEG at the October meeting. We will follow up with some individual interviews and finalise the report for publication. However, when using the data, it is important to consider that:

(a) The sample of respondents is limited and therefore not statistically representative;

(b) The completeness and accuracy of the data provided by the respondents have not been verified;

(c) The data refer to the period between 2014 and 2016 and may not be fully representative of the situation as of the date IFRS 9 will be applied;

(d) Asset allocation decisions are driven by multiple factors, such as expected returns of asset classes, liability matching, risk appetite, tax regimes and other regulations; and

(e) The European Commission in its RfA refers to the impact of IFRS 9 on long-term investors, and the data collection request repeatedly mentions 'long-term portfolios' or 'the proportion of equity instruments considered to be held for the long-term'. However, the long-term notion is not defined in IFRS Standards that make a distinction only between current and non-current assets and liabilities, based on the entities' operating cycle.

9 Besides the public consultation, the EFRAG Secretariat has also:

(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) obtained some aggregated data on total equity instruments, total AFS instruments and related OCI balances held by approximately 150 financial institutions from 28 member states of the European Union and one country of the European Economic Area for the period 30 September 2014 to 30 September 2016, by the European Banking Authority ('EBA');

(c) reviewed the financial statements of 2015 of 45 public entities in Europe to collect the relevant data and investigate how these entities apply the IAS 39 impairment requirements, and in particular how they articulate the 'significant or prolonged' criterion;

(d) reviewed other publicly available reports, including:

(i) the ESMA report *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe* on the 2012; financial statements of 39 major European financial institutions;

(ii) the Mercer 2017 asset allocation survey, that includes data from 1,240 institutional investors across 13 countries in Europe and reports information on asset allocation by class of assets;

(iii) the 2015 Pensions Europe statistics on pension funds in the private sector in 21 European countries.

10 EFRAG has also commissioned an academic literature review to investigate the available evidence on how accounting requirements may affect asset allocation decisions, and how the presentation of recycling gains in profit or loss or OCI is relevant for long-term investors. The preliminary report will made available at the end of January.

Phase 2 – analysis of the issue and possible solutions

11 EFRAG TEG has already had some discussions on the different topics in the RfA. In the development of the alternatives, the following premises have been retained:

(a) equity instruments shall be measured at fair value in the statement of financial position;

(b) the FVOCI designation shall neither be removed nor made obligatory; and

(c) recycling of gains and losses on disposal enhances the relevance of information.

12 EFRAG TEG has also concluded that any approach should apply without distinction to all equity instruments (other than held-for-trading). In other words, the project will not try to define sub-sets of equity instruments – such as strategic investments or long-term investments – and develop specific requirements for these.

13 EFRAG TEG has tentatively agreed that the publication will include at least two approaches:

(i) a 'dual measurement' approach, under which all changes in fair value above the original cost are recognised in OCI, and all changes below are recognised in profit or loss;

(ii) an approach based on the impairment model for available-for-sale financial assets under IAS 39, with a discussion of some alternative features such as the use of automatic impairment triggers. The approach would allow for a reversal of previous impairment losses.