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EFRAG Research Project Equity Instruments - Impairment and Recycling
Issues Paper

Objective

1 The objective of this paper is to present to EFRAG TEG quantitative data related to the project to help in developing our discussions and future analysis.

Purpose of looking at quantitative data

2 During both the IASB Agenda consultation and the EFRAG Research projects' agenda consultation, constituents indicated that all accounting research needed to be evidence based at each step; identification of the issue, analysis and discussion of possible solutions.

3 Therefore, EFRAG uses evidence both to select its topics and develop its discussions and recommendations. The EFRAG Secretariat discussed with EFRAG TEG, the EFRAG User Panel and EFRAG FIWG in previous meetings what types of information would be useful to support the project.

4 The EFRAG Secretariat thinks that examining the amount of equity instruments currently treated as Available for Sale ('AFS') could provide helpful background to the analysis of the issue. In addition, a review of how entities apply current IAS 39 *Financial Instruments: Recognition and Measurement* accounting requirements related to AFS equity instruments, would help in assessing the extent of diversity in practice.

Sources of quantitative data

Previous data collected

5 In June 2013, EFRAG in collaboration with the ANC, ASCG, FRC and OIC, published a report including the results of the joint field test conducted to identify and describe how IFRS 9 would affect the current classification and measurement of financial assets. Thirty-seven companies participated in the field test, including companies from France, Germany, Italy, Spain and the UK. Nearly half of the participants were from the banking industry, with the remainder coming from the insurance industry and other industries. The majority of participants were European listed groups.

6 At that time, six participants from non-financial industries expected to apply the irrevocable designation to all or part of their equity securities, including non-quoted equities. Most of these investments were not held for trading and measuring them at FVPL would result in what is perceived to be unjustified volatility in profit or loss. Two of these participants commented that they intended to use cost as an approximation of fair value where this is appropriate. Four participants reported that these equities represented approximately 16% of their AFS investments or less than

1% of their total assets. Two participants indicated that they did not intend to apply the irrevocable designation.

7 Participants in the insurance industry indicated that equity securities they hold are usually listed instruments and held with other investments as part of their asset-liability management. They believe measuring equity securities at Fair Value through Other Comprehensive Income ('FVOCI') without recycling could lead to accounting mismatches. On the other hand, measuring these equity securities at Fair Value through Profit or Loss ('FVPL') would create volatility in profit or loss, thus not reflecting the long-term business model of insurers and distorting the performance reported.

8 Three participants in the insurance industry indicated that holdings in equity securities represented approximately 4% to 10% of the total financial investments (or the total assets); however, none of them could indicate whether some or all of these equity instruments would be measured at FVOCI.

9 Nine participants in the banking industry from various jurisdictions expected to apply the irrevocable designation to strategic investments not intended to be sold (e.g. investments held in entities that operate various exchanges and trading platforms to achieve commercial synergies). Some of these equity instruments had quoted prices, whereas others were non-quoted. These participants preferred to avoid the reported volatility in profit or loss by using the irrevocable designation.

10 Six of these nine participants indicated that they intended to measure at FVOCI without recycling, equity securities representing less than 3% of their total financial assets in the AFS category or less than 1% of the total assets.

11 Conversely, three other banks at the time did not expect to make significant use of the designation mainly due to its prohibition of recycling or because strategic investments are usually subsidiaries.

Current data collected

12 The EFRAG Secretariat used a data aggregator to extract a list with all European listed companies as of January 2017. The list included the name of the company, the country of incorporation, the primary industry and its market capitalisation as of 31 December 2015.

13 We sorted the companies into three industry groups:

(a) banking industry;

(b) insurance industry; and

(c) companies not in the banking or insurance industry (referred to as non-financial companies[1]).

14 At the time of the sampling, companies had not yet completed their 2016 financial statements. For purposes of the review, we selected the 15 companies from each industry group with the highest market capitalisation as of 31 December 2015. The 45 companies in the sample had a total market capitalisation of approximately 3 trillion Euros.

15 The EFRAG Secretariat reviewed the 2015 financial statements 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.

16 Within AFS equity instruments, the amount of an entity's holdings requiring Level 3 measurements was compared to the total AFS equity holdings. This comparison

[1] The category of non-financials includes companies from healthcare, consumer goods, energy and information technology sectors.

was made based on an assumption some entities might be more likely to consider the IFRS 9 irrevocable election for Level 3 equity instruments.

The percentage of AFS equity instruments over total assets

17 On average, AFS equity instruments were 0.8% of total assets for non-financial entities, 2.4% for insurance companies and 0.6% for banks. The following table presents the distribution of the ratio:

	Number of companies		
% of AFS equity instruments over total assets	**Non-financials**	**Insurance**	**Banks**
AFS equity instruments not specified	1	2	1
0%-0.5%	7	4	9
Between 0.6% and 2%	5	2	4
Between 2.1% and 5%	2	7	1
Total	**15**	**15**	**15**

The percentage of level 3 AFS equity instruments over total AFS equity instruments

18 On average, AFS equity instruments whose fair value is measured using level 3 inputs were 54.4% of total AFS equity instruments for non-financial entities, 10.5% for insurance companies and 38.5% for banks. The following table presents the distribution of the ratio:

	Number of companies		
% of Level 3 AFS equity instruments over total AFS equity instruments	**Non-financials**	**Insurance**	**Banks**
Not specified	2	4	4
Less than or equal to 20%	2	9	4
Between 20% and 50%	5	2	3
Greater than 50%	6	0	4
Total	**15**	**15**	**15**

'Significant or prolonged' threshold

19 Almost all non-financial companies did not disclose their thresholds for assessing a significant or prolonged decline in the fair value of the instrument. For those which did provide a disclosure, we found that objective evidence of impairment ranged from 20% to 25% (significant) or from 6 to 9 months (prolonged) decline in the fair value of the equity instrument below its cost.

20 For insurance companies, 40% did not disclose their thresholds for assessing significant or prolonged decline in the fair value of the equity instruments. From those which did provide a disclosure, the majority disclosed that objective evidence of impairment was 20% (significant) or ranged from 6 to 12 months (prolonged) decline in the fair value of the equity instrument below its cost.

21 For banks, 40% did not disclose their thresholds for assessing significant and prolonged decline in the fair value of the equity instruments. From those which did provide a disclosure, the majority disclosed that objective evidence of impairment

ranged from 40 to 50% (significant) or from 18 to 36 months (prolonged) decline in the fair value of the equity instrument below its cost.

22 Some of the companies in our sample from the insurance and banking industry disclosed that these thresholds were only a general rule and were interpreted on a case-by-case basis for specific equity securities. There were also some companies who seemed to only use these thresholds as indicators, but not as automatic triggers to recognise or measure impairment. Moreover, many entities mentioned that the thresholds disclosed are used for quoted equity instruments, without mentioning what they use for the unquoted ones.

23 One insurance company did not disclose a specific threshold for assessing significant decline in the fair value of the equity instruments, but mentioned that this is determined by geographic market on a quarterly basis.

24 The following tables summarise the application of the two criteria:

	Number of companies		
Significant criterion % of decrease of the fair value below cost	**Non-financials**	**Insurance**	**Banks**
No AFS	0	1	0
Not disclosed[2]	13	6	6
20%	1	6	1
25%-30%	1	2	2
40%-50%	0	0	6
Total	**15**	**15**	**15**

	Number of companies		
Prolonged criterion (in months)	**Non-financials**	**Insurance**	**Banks**
No AFS	0	1	0
Not disclosed	13	5	6
6	1	4	2
9-12	1	4	0
18-20	0	0	3
24-36	0	1	4
Total	**15**	**15**	**15**

25 The partial disclosure and diverging practice are consistent with the findings in the ESMA report *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe*[3] on the 2012 financial statements of 39 major European financial institutions.

26 The report showed that a number of financial institutions did not disclose any accounting policy regarding the impairment assessment for a potentially material portfolio of equity instruments classified as AFS. Others disclosed how they applied

[2] For some of these companies (potentially for 4 banks and 4 non-financials), equity instruments classified as AFS seem to be immaterial.
[3] The full ESMA report can be found here.

the 'significant or prolonged criteria' in an ambiguous manner that suggested the use of a combination of significant and prolonged criteria.

27 More than half of the financial institutions quantitatively disclosed what they consider significant or prolonged. ESMA found that ranges from 6 to 36 months in relation to the period and from 20% up to 50% in relation to the decline in fair value were used.

Informal outreach of a sample of banks

28 In addition to the analysis of the 45 listed companies' financial statements, EFRAG Secretariat reached out to a sample of banks. We enquired what percentage of their AFS equity instruments they expect to designate to the FVOCI category of IFRS 9. The main findings are presented below:

(a) One bank expects to designate to the FVOCI category 8% of its AFS equity instruments. It expects to use the election principally for long-term investments, either strategic or necessary for the conduct of the banking business;

(b) Two banks do not expect to use the irrevocable designation;

(c) One bank expects to use the designation, but has not yet identified the investments to which it will be applied; and

(d) One bank has not yet taken a final decision.

29 The majority of respondents claimed that they manage their investments in equity instruments in separate portfolios, determined either on the basis of the activity of the investee or the business purpose of the investment. For example, separate portfolios can be identified for long-term strategic investments, private equity activities, or investments in entities that are necessary for the conduct of the banking business.

30 Also, banks use various models to measure the fair value of Level 2 and Level 3 equity instruments, as follows:

(a) Models based on recent transactions involving the issuer or entities in the same industry;

(b) Discounted cash flow methods;

(c) The share of net assets, either based on reported figures or on an adjusted basis, when market-based or income-based models are not available; or

(d) a multi-criteria approach.

31 These banks use the following information to assess whether their investments in equity instruments are impaired:

(a) Qualitative factors such as:

(i) The generation of losses or a significant negative variance with respect to the budgeted targets;

(ii) The announcement or start-up of insolvency proceedings or restructuring plans;

(iii) The downgrading of the company by more than two rating tiers.

(b) Quantitative indicators deriving from the market values of the company, such as the significant or prolonged decrease in fair value below the initial acquisition cost.

Other sources

32 In addition to the quantitative evidence summarised above, the EFRAG Secretariat gathered additional evidence from other sources.

European Banking Authority ('EBA')

33 The EBA launched an impact assessment of IFRS 9 on a sample of 58 institutions across the European Economic Area in January 2016[4]. According to this survey, the equity instruments currently classified in the AFS category represent, on average, 2% of the total financial assets of these institutions.

34 Moreover, 19% of banks said they intended to reclassify equity instruments that are currently classified in the AFS category under IAS 39 to the FVPL category under IFRS 9. Some have mentioned that this is because of the IFRS 9 prohibition on recycling gains and losses in profit of loss.

35 EBA provided us with aggregated data for 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. The key findings are on average:

(a) More than 90% of the companies reporting AFS instruments had equity instruments in AFS;

(b) AFS equity instruments represented 18.2% of total equity instruments and 4.4% of total AFS instruments;

(c) The net accumulated AFS OCI reserve represented 1.2% of total AFS instruments; and

(d) The gain on derecognition of total AFS instruments represented 0.5% of the value of AFS instruments per quarter.

Some remarks on the data

Asset comparisons

36 Based on the EBA data, more than 80% of equity instruments are carried at FVPL and equity instruments are not a notable portion of the total AFS instruments, although their absolute amounts are significant.

37 However, at this stage we do not dispose of the information on the total cumulated debit amount in OCI related to ASFS equity instruments, which would provide an indication of the potential loss in value.

Question for EFRAG TEG

38 In view of the above, would EFRAG TEG consider for exposure an approach where entities recycle gains on disposal, are not required to assess equity instruments for impairment, but disclose separately the movements in the debit and credit balance of OCI?

39 Insurance companies generally utilise the AFS classification for equity instruments more than other industries as their AFS equity holdings are more material representing a higher percentage of total assets. Non-financials and banks seem to have significant amounts of Level 3 AFS equity instruments.

40 The EFRAG Secretariat has only gathered data for 7 quarters and therefore cannot make any observations about long-term trends. Considering that IFRS 9 is not yet effective, and that asset allocation decisions are impacted by other factors, we think that it is premature to try to assess the impact of the recycling prohibition on long-term investments.

Current practices

[4] The full EBA report can be found here.

Determination of different portfolios

41 As noted above, banks manage their investments in equity instruments on the basis of separate portfolios. To reflect this management model, the EFRAG Secretariat believes that it may be helpful to consider an approach where different portfolios with similar characteristics provide basis for:

(a) a different measurement of impairment losses; or

(b) different disclosures.

Question for EFRAG TEG

42 In view of the input received, would EFRAG TEG reconsider its prior indication that the impairment model should be common to all equity instruments, and support investigating an alternative approach linked to the characteristics of commonly used portfolios?

'Significant' or 'prolonged' thresholds

43 At least 40% of the companies reviewed do not disclose any policy for assessing their AFS equity instruments for impairment, including the significant or prolonged criterion, although in some cases the lack of disclosure could be due to materiality considerations.

44 Between those companies that do disclose their thresholds, there are differences in the quantitative thresholds selected. Moreover, sometimes different thresholds were used for different equity instruments by the same company and thresholds were used as indicators, rather as automatic triggers to recognise or measure impairment.

45 This could mean that some companies are more prudent than others in assessing what they consider objective evidence of impairment for their equity instruments. This could in turn mean that in a future impairment model for equity instruments, some judgment may need to be removed, for example by making use of rebuttable presumptions at which moment an impairment amount should be recognised and increased.

46 On the other hand, it may be normal to have these differences between different entities, as different types of equity instruments have different characteristics. This could justify a different approach on impairment for different types of equity instruments.

Questions for EFRAG TEG

47 Based on the information in paragraphs 43 - 46 above, would EFRAG TEG advise to launch a public consultation on how entities currently apply the 'significant' or 'prolonged' test in IAS 39?

48 Are there other ways in which the data presented can help in developing an impairment approach?