

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of the EFRAG Board. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

EFRAG Equity Instruments – Impairment and Recycling – draft technical advice

Background

- 1 EFRAG is pleased to provide its reply to the request for technical advice sent by the European Commission in May 2017 on possible ways to improve the requirements of IFRS 9 *Financial Instruments* ('IFRS 9') on accounting for equity instruments from a long-term investing perspective ('the EC request'). The EC request is enclosed as Appendix 2 to this document.
- 2 The IASB issued IFRS 9 in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. Entities undertaking insurance activities are permitted to defer IFRS 9 until 1 January 2021. In accordance with IFRS 9, equity instruments are generally measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). However, as an alternative to FVPL, at initial recognition an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('the FVOCI election'). The FVOCI election is not available for equity instruments that are held for trading or contingent consideration recognised by an acquirer in a business combination. The entity may apply the FVOCI election on an instrument-by-instrument basis.
- 3 If an entity applies the FVOCI election to an instrument, changes in its fair value are presented in other comprehensive income ('OCI'). These changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess the instrument for impairment. However, dividends that are a return on investment from the instrument are recognised directly in profit or loss.
- 4 In its endorsement advice on IFRS 9, EFRAG expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling might not properly reflect their performance.
- 5 The Basis for Conclusions accompanying IFRS 9 explains the IASB's rationale for not permitting recycling for equity instruments designated in accordance with the FVOCI election. The IASB explained that, in its view, gains and losses on these instruments should be recognised only once in comprehensive income. Furthermore, the IASB noted that allowing recycling would create the need to assess these equity instruments for impairment and noted that the impairment requirements for available-for-sale ('AFS') equity instruments in IAS 39 *Financial Instruments: Classification and Measurement* ('the IAS 39 impairment model') had created application problems and was unduly subjective.
- 6 The EC request called on EFRAG to provide technical advice in two phases:

- (a) *Phase I ('problem definition phase')* - investigate the potential effects on long-term investment of IFRS 9's requirements on accounting for equity instruments. EFRAG reported its findings in January;
 - (b) *Phase II ('potential solutions phase')* - assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If an impairment model is deemed to be an important element in order to re-introduce recycling, then EFRAG should consider how the impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches. EFRAG should further consider whether, in the absence of a robust impairment model, alternative presentation or disclosure requirements that could enable users to form a view about the performance of the equity investments.
- 7 This letter reports EFRAG's technical advice in relation to Phase II. As part of its process to develop this advice, EFRAG published a Discussion Paper *Equity Instruments – Impairment and Recycling* in March ('the EFRAG DP'). The EFRAG DP closed for comment at the end of May and 53 comment letters were submitted. The summary of responses A feedback statement onto the consultation was issued on 29 August.
- 8 This advice only considers issues relating to recycling and impairment arising from the IFRS 9 FVOCI election for equity instruments. EFRAG has not reconsidered any other aspects of IFRS 9's requirements for equity instruments such as the use of fair value as a measurement basis or the types of instrument eligible for the FVOCI election.
- 9 In June 2018 the European Commission sent a second request to EFRAG related to IFRS 9's requirements. The second request asks EFRAG to consider alternative accounting treatments to measurement at FVPL for equity instruments and equity-type instruments in the context of long-term business models. The European Commission asked for EFRAG's technical advice on this aspect of IFRS 9 by the second quarter of 2019.

EFRAG's overall technical advice

- 10 EFRAG acknowledges the concerns of many stakeholders over IFRS 9's requirements for equity instruments from a long-term investing perspective, including long-term investing in infrastructure. However, as for the reasons explained in paragraphs 16 to 35 below, EFRAG has assessed that the arguments in favour and against the reintroduction of recycling are finely balanced and EFRAG has not yet reached a final position. The concerns raised could be potentially addressed otherwise than with the use of recycling and EFRAG does not recommend an immediate reintroduction of recycling for equity instruments designated in accordance with IFRS 9's FVOCI election. EFRAG will continue to research the accounting for equity and equity-type instruments in responding to the second request from the European Commission referred to in paragraph 9 above.
- 11 In addition to the explanations in paragraphs 16 to 35 below, EFRAG notes that our work has indicated a lack of consensus took the view that recommending changes to an endorsed IFRS Standard that was widely scrutinised and came into effect only very recently would be appropriate only if there is a strong consensus among European constituents that specific changes are necessary. Our work has indicated a lack of such a consensus. This is partially due to the fact that IFRS 9 has come into effect only very recently and there is not yet evidence of its impacts on the choices of preparers and users of financial statements.

- 12 The lack of consensus is also a reflection of the broader discussion on how IFRS Standards should portray performance, and the role and use of OCI at the Standard level. This discussion is still ongoing even after the publication of the revised *Conceptual Framework for Financial Reporting*, but it would not have been possible to address this broader discussion in the context of this specific investigation on the equity instruments carried at FVOCI.
- 13 ~~EFRAG further notes that a~~Additional experience in the application of IFRS 9, ongoing monitoring of its effects and the IASB's post-implementation review may in due course provide new evidence and arguments about the matters considered in the two phases of EFRAG's work. However, a comprehensive analysis and understanding of the impact cannot be completed until well beyond EFRAG's deadline to respond to the request for advice.
- 14 ~~EFRAG also acknowledges that, although there is no overall consensus, some stakeholders — mostly preparers and especially but not only from the insurance industry — strongly support an immediate reintroduction of recycling. Although EFRAG has not yet reached a final position on the reintroduction of recycling, Accordingly, despite our overall advice,~~ in Appendix 1 to this letter EFRAG has provided its comments on the significance of an impairment model to the re-introduction of recycling and what could be the characteristics of an impairment solution.

Summary of the arguments for and against recycling EFRAG's reasons for this advice

- 15 The following paragraphs explain illustrates how EFRAG has considered the different aspects of the issue and comments from respondents. explain the main reasons for EFRAG's advice in paragraph 10 above. EFRAG emphasises that the weighting of these arguments for and against recycling differs among stakeholders ~~that support the overall advice,~~ and that not all of the ese stakeholders holding a particular view would agree with all the arguments stated. ~~Similarly, arguments in favour of immediate reintroduction of recycling weigh differently for those constituents that support it.~~

Balance of the conceptual arguments

- ~~16 EFRAG assessed that the conceptual arguments for and against recycling are balanced. EFRAG also noted that IFRS 9 was widely debated, both in its development and during its endorsement in Europe. EFRAG concluded that, taken as a whole, IFRS 9 improves financial reporting over its predecessor IAS 39. In these circumstances and taking into consideration the lack of a strong overall consensus noted in paragraph 10 above, EFRAG concluded that the current requirements of the endorsed Standard should prevail.~~
- ~~17~~16 From the perspective of the IASB's *Conceptual Framework*, relevance and faithful representation determine the presentation of income and expenses in profit or loss. In principle all income and expenses are included in the profit or loss in the period when they occur, but in exceptional circumstances the IASB may decide instead to include some of these items in other comprehensive income, when doing so results in more relevant information. The Framework goes to state that, in principle, income and expenses included are reclassified into profit or loss (recycled) when doing so in results in more relevant information. The IASB's decision on recycling considers, for example, whether there is a clear basis to determine the period in which reclassification would enhance the relevance of profit or loss
- ~~18~~17 Therefore, based on the *Conceptual Framework*, both a FVOCI category with recycling and a FVOCI category without recycling are a departure from general principles. The merit of recycling depends on judgements about the effect on the relevance of profit or loss, on which constituents' views are mixed.

1918 EFRAG notes that the FVOCI election is also an exception to the general principle in IFRS 9 that equity instruments are carried at FVPL. The classification in the Standard is based on two fundamental concepts, the business model of the investor and the characteristics of the instruments, which result in different accounting treatments for debt instruments and equity instruments. Recycling disposal gains or losses for equity instruments carried at FVOCI may be seen as weakening the role of the second criterion and potentially creating a conflict within the Standard.

2019 One important difference between debt and equity instruments is that the latter do not have contractual cash flows. Since the impairment model for debt instruments under IFRS 9 is based on expected credit losses, which are defined as the difference between contractual cash flows and the cash flows that the entity expects to receive, this explains why the impairment model for debt instruments carried at FVOCI in IFRS 9 cannot be extended to equity instruments carried at FVOCI.

2120 ~~On the other side, those who support the immediate reintroduction of recycling put forward the following additional main. In arriving at its overall advice, EFRAG considered the balance of arguments for and against recommending changes to the FVOCI election at this time. Although EFRAG ultimately found the case for recommending changes at this time to be insufficiently persuasive, for the sake of completeness we set out below the other arguments brought forward by those who support of recycling arguments:~~

- (a) Investors hold an asset mix, of which equity instruments are one component. Since IFRS Standards allow to recognise disposal gains or losses in profit or loss on debt-type assets that are measured at FVOCI in accordance with IFRS 9, the same should be allowed for equity instruments;
- (b) The FVOCI election requires recognition of dividends in profit or loss. ~~Since some argue that~~ dividends represent a partial realisation of the value of the underlying investment, ~~and go on to argue that~~ the realisation of the entire investment on disposal should be reported consistently with dividends;
- (c) Cash realisation is an important event. Realised and unrealised gains or losses are different in nature and should be reported differently;
- (d) Realised gains or losses have confirmatory value and help users assess management's stewardship; and
- (e) Some commentators do not agree with the Framework's approach to OCI and recycling and argue that all income or expenses should be recognised in profit or loss at some point.

2221 Overall, EFRAG assessed that the conceptual arguments for and against recycling are finely balanced.

IFRS 9 and presentation of investment performance

2322 The majority of preparers that responded to the EFRAG DP supported the reintroduction of recycling, because they argue that cumulative gains or losses are part of an investor's performance. Others do not share this view, and in particular users mostly oppose FVOCI with recycling; some would even go as far as removing the FVOCI election altogether.

2423 While EFRAG does not recommend removing the FVOCI election, the calls by some stakeholders for its removal are indicative of the overall lack of consensus.

2524 Recycling has the effect that the cumulative gain or loss (i.e. the total change between the purchase cost and the selling price) is reported in profit or loss in the year when the investment is sold. Some argue that this reduces relevance because it does not reflect the performance in the reporting period (instead it reflects performance over the entire holding period).

2625 These constituents would argue that equity investments are inherently volatile and including fair value changes in the performance of the period is a fair presentation of the economic activity of the investor and provides relevant information to the users of the investor's financial statements. They also express concern that recycling creates an opportunity to management for selective profit-taking aimed at achieving a pre-determined particular accounting result in the period.

2726 EFRAG notes that the requirements in IFRS 7 *Financial Instruments: Disclosures* enable an assessment of the amount of cumulative gains or loss on disposal on these instruments, if a user considers the information to be relevant.

A generally accepted robust impairment solution is still elusive

2827 There is widespread agreement that, if recycling were to be re-introduced, an impairment solution would need to be implemented at the same time. In its DP, EFRAG presented two possible solutions, but each of them had some limitations.

2928 The majority of respondents that expressed a view on the possible solutions preferred a solution similar to the IAS 39 impairment model but acknowledged that the IAS 39 impairment model would need improvement. Our findings from Phase 1, and those of ESMA¹, confirmed that there were divergent practices in the application of the IAS 39 impairment model.

3029 However, there is no consensus on how to reach an appropriate balance between relevance and comparability. Some respondents stress the need to achieve sufficient comparability which could likely be achieved only if the Standard included general quantitative thresholds. Others oppose this because they believe that the impairment solution should prioritise relevance over comparability, and therefore that each entity should set its own thresholds. More work on this issue could possibly result in a shared solution, but this solution is not yet available.

3130 Likewise, EFRAG's work did not result in any progress in relation to the definition of long-term investment. Any attempt to define this term, or other defining criteria to identify specific sub-sets of equity investments, have not found support.

3231 It has been noted that it would be difficult to develop a clear principle that would not result in excessive judgement and complexity. Some would also disagree that long-term investors are inherently different, or that specific accounting requirements are needed to depict their performance. EFRAG maintains that a degree of rigour in the use of the election or the impairment model would be essential to ensure comparability.

Is there evidence of behavioural changes?

3332 EFRAG's Phase I data collection and consultation efforts yielded mixed results. The materiality of equity instruments held in the IAS 39 AFS category and the recycling of cumulative gains or losses varied among financial institutions. For some, recycled gains and losses represent a significant proportion of net profits in the years examined. However, others make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL.

¹ See *Review of Accounting Practices – Comparability of IFRS Financial Statements of Financial Institutions in Europe*, ESMA (2013).

- 3433 Different views have been expressed about the expected impact of IFRS 9 on asset allocation decisions and holding periods. Most respondents indicated that a variety of non-accounting factors, including business, economic and regulatory factors, affect their decisions to invest and hold equity instruments or other classes of assets.
- 3534 Some respondents to the phase I data collection consultation indicated that they expect to modify their asset allocation decisions as result of IFRS 9, but almost none provided a quantitative estimate. Some indicated that they could move their investments between different classes of equities, e.g. from listed to unlisted entities, which EFRAG notes would have no impact on total equity investing.
- 35 While some respondents to the phase I data collection consultation indicated that IFRS 9's requirements could affect their decisions, other commentators argue that recycling of gains and losses might also affect behaviours in a way that is not conducive to long-term investing. This is because recycling could create incentives to dispose of investments in order to recognise the cumulative gain in profit or loss, i.e. for accounting-related rather than for solely economic reasons.
- 36 Based on the arguments above, EFRAG is not yet in a position to reach a conclusion on the reintroduction of recycling but is committed to continue its work on the accounting for equity instruments in the context of long-term investing.

Appendix 1 - EFRAG replies to the detailed questions in the EC request

- 37 While EFRAG has not reached a final position ~~concluded on~~ ~~does not recommend~~ the reintroduction of recycling for equity instruments designated in accordance with IFRS 9's FVOCI election at this time, ~~we~~ address the specific questions raised in the request below.

How significant is an impairment model to the removal of the ban on recycling from a conceptual perspective?

- 38 In EFRAG's view an impairment model would be a necessary accompaniment to any reintroduction of ~~removal of the ban on~~ recycling for equity instruments carried at FVOCI in accordance with IFRS 9. EFRAG's reasons for this view are explained in the following paragraphs.
- 39 One of the main arguments in favour of some form of impairment model is consistency with other IFRS Standards and categories of assets. IFRS Standards generally have some form of impairment (or equivalent) requirement for assets, other than those measured at FVPL. This is the case for both for assets carried at cost, such as inventory, property, plant and equipment, intangible assets and amortised cost debt instruments, and for assets accounted for at FVOCI, including revalued property, plant and equipment and intangible assets accounted for in accordance with other applicable IFRS Standards and for FVOCI-debt instruments accounted for in accordance with IFRS 9.
- 40 It can be argued that an impairment model enhances the relevance of profit or loss for stewardship purposes. In principle, an impairment loss on an equity instrument is an incurred loss and is therefore economically similar to a loss on disposal. EFRAG considers that inclusion of incurred losses enhances the relevance of profit or loss as the primary source of information about an entity's financial performance, including from a stewardship perspective.
- 41 An impairment model also provides information that is relevant for the assessment of future cash flow prospects. The returns generated in a long-term business model are linked to the ultimate cash flows from the sale of assets. In principle, an impairment model results in declines in fair value being recognised in profit or loss prior to ultimate disposal when those declines relate to identifiable adverse changes in the issuer's economic condition. An impairment model would provide

relevant information to users of financial statements if it provides insight into whether a decline in fair value is more or less likely to reverse in the future. It can even be argued that the informational value of impairment with respect to assessing future cash flows would be important enough regardless of whether or not recycling occurs.

- 42 A robust and operational impairment model also eliminates or reduces any accounting-related incentive to maintain loss-making equity investments for an indefinite period. Allocation decisions would therefore be less affected by accounting requirements and this would reduce the opportunity costs for shareholders that management does not pursue better investments.
- 43 Any impairment model has the effect that the accounting treatment of gains and losses is asymmetric. Gains would be recognised in profit or loss only upon sale if recycled, while some losses would be recognised in profit or loss earlier. If recycling was required without an impairment model, then both gains and losses would be recognised in profit or loss only upon sale. When EFRAG commented on the Exposure Draft *Conceptual Framework for Financial Reporting*, it advocated that prudence should be re-introduced in the Framework and should under some circumstances lead in accounting policies that treat income and expenses asymmetrically. Recognising impairment losses in profit or loss seems to be consistent with this notion of prudence.

Presentation and disclosure alternatives

- 44 EFRAG considered whether, in the absence of a robust impairment solution, additional or amended disclosure or presentation requirements could provide a suitable alternative. We concluded that this is not the case and respondents would support this view.
- 45 IFRS Standards already specify various general disclosures about financial assets and liabilities as well as disclosures specifically about equity instruments designated at FVOCI. Some of the general disclosures include:
- (a) the carrying amount of each of the categories of financial assets and liabilities be disclosed in either the statement of financial position or in the notes; and
 - (b) the net gain or loss in the statement of comprehensive income or in the notes.
- 46 *IFRS 7 Financial Instruments: Disclosures* also includes disclosure requirements specifically for investments in equity instruments designated at FVOCI:
- (a) which investments in equity instruments have been designated at FVOCI;
 - (b) the reasons for using this presentation;
 - (c) the fair value of each such investment at the end of the reporting period;
 - (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period;
 - (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers;
 - (f) the reasons for disposing any investment;
 - (g) the fair value of any investment disposed at the date of derecognition; and
 - (h) the cumulative gain or loss on disposal.

- 47 In the EFRAG DP, EFRAG assessed that, in every scenario considered, users would need additional information to adjust profit or loss as reported in order to depict profit or loss on the basis of FVOCI with both recycling and impairment.
- 48 EFRAG noted that it is generally supported that information recognised is more value-relevant than information disclosed in the notes. Some academic studies – not specific to this topic – found that while the notes to the accounts are important to professional equity investors, information recognised in the financial statements receives more attention than disclosures in the notes. Other literature suggests that recognised information is more reliable than disclosed information, or that investors have difficulty in understanding disclosed information.
- 49 Respondents to the consultation shared the view that presentation and disclosure solutions could not adequately replace recognition and measurement in the primary financial statements. In addition, most respondents did not support additional disclosure requirements beyond those already required by IFRS.

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 be feasibly made operational?

- 50 EFRAG considers that the underlying objective of a robust impairment model should be to distinguish declines in the fair value of an equity instrument below its purchase price that reflect objectively identifiable, adverse changes in the issuer’s economic condition from declines that reflect temporary market fluctuations. EFRAG notes that the first type of decline in fair value is less likely to reverse in the future than the second type.
- 51 However, EFRAG noted that putting this objective into practice is inherently challenging and subjective. The IAS 39 impairment model identified as possible indicators of impairment “information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered”, in addition to the “significant or prolonged” impairment trigger. However, as noted in paragraph 5 above, the IAS 39 impairment model was considered by the IASB to be unduly subjective, and EFRAG’s and ESMA’s findings confirmed that it was not applied consistently in practice.
- 52 For this reason, EFRAG focused on possible solutions that aimed to reduce subjectivity compared to the IAS 39 impairment model. The EFRAG DP explored two possible solutions:
- (a) a revaluation model; and
 - (b) an impairment model similar to the IAS 39 model but with additional guidance to reduce subjectivity.

Revaluation model

- 53 Under the revaluation model, the equity instrument is carried at fair value in the statement of financial position and:
- (a) changes in fair value below the original acquisition cost (both declines in value and subsequent recoveries) are recognised in profit or loss; and
 - (b) changes in fair value above the original acquisition cost are recognised in OCI.
- 54 Under this model, the amount recognised in profit or loss in a period is simply the (negative) difference between the fair value at reporting date and the original cost; and the cumulative difference recognised in profit or loss in prior periods.

- 55 The revaluation model would completely eliminate the inherent subjectivity in the assessment of impairment losses and does not rely on indicators, unlike the IAS 39 impairment model. It is more consistent with other Standards such as IAS 2 *Inventories* where all declines below cost are recognised in profit or loss in the period they occur.
- 56 In developing IAS 39, the IASB considered a model along those lines. The IASB Board noted at the time that this would ‘significantly change the notion of ‘available for sale’ in practice’ and believed such a change was not appropriate at that time. However, the AFS notion is no longer an issue, as it is not contained in IFRS 9.

Impairment model similar to the IAS 39 model with less subjectivity

- 57 The IAS 39 impairment model, despite including various more principle-based criteria, was largely dependent in practice on its ‘significant or prolonged’ trigger. Initially EFRAG considered whether ‘significant’ or ‘prolonged’ should be replaced with other terms, but these also included some element of subjectivity.
- 58 EFRAG concluded that a model similar to the IAS 39 model should allow the possibility to reverse impairment losses. If a decline in the value of an equity instrument is recognised in profit or loss because it results an adverse change in the economic condition of the issuer, subsequent recoveries in value that result from a reversal of the adverse change should similarly be recognised.
- 59 Respondents commenting on this aspect generally agreed, Allowing recognition of reversals in impairment losses would be consistent with the treatment of other impaired assets under IFRSs Standards, with the exception of goodwill. Some constituents also expressed the view that this would ease the pressure on the entities and be conducive to a more balanced impairment assessment.
- 60 To reduce the subjectivity of the assessment, the IFRS Standard could be more prescriptive and leave less room for judgement. One of the challenges in applying judgement is that the IAS 39 impairment model was not based on any specific likelihood that the original acquisition cost will not be recovered. Further, the relationship between the general guidance on objective evidence and the ‘significant’ or ‘prolonged’ triggers was not explained. While EFRAG supports the use of reasoned judgement in a principle-based system, these challenges lead to a risk that a reporting entity's judgement on ‘significant or prolonged’ becomes arbitrary.
- 61 The IAS 39 model could be made less subjective if thresholds for ‘significant or prolonged’ were defined or other more specific guidance was provided. A ‘significant’ decline could be defined as a specific percentage decline from the acquisition cost and ‘prolonged’ as a specific time period where the fair value has been below the acquisition cost. This could be done in one of three ways:
- (a) the IFRS Standard could specifically define quantitative thresholds;
 - (b) the IFRS Standard could require reporting entities to define quantitative thresholds for both ‘significant’ and ‘prolonged’ as part of their accounting policy, explain and disclose them; or
 - (c) a combined approach, under which the IFRS Standard could set an upper limit for both terms, and reporting entities could select a threshold within the limit.
- 62 Many respondents to the consultation agreed that the objective of an impairment solution should be to reflect in profit or loss only those declines in fair value that are the effect of objectively identifiable, adverse changes in the issuer’s economic condition. EFRAG notes that the impairment model similar to IAS 39 is better suited to achieve this objective, because in the revaluation model all declines in

fair value below the purchase cost are treated in the same way and charged to profit or loss.

- 63 The majority of respondents that expressed a view were in fact more supportive of an impairment model similar to IAS 39. Also, the majority would not support prescriptive quantitative thresholds, but only thresholds set by the reporting entity and/or rebuttable presumptions.