EFRAG Equity Instruments – Impairment and Recycling – draft technical advice

Objective

1 The objective of this paper is to provide EFRAG TEG with a draft of the technical advice and ask them to approve it to be recommended to the EFRAG Board.

2 The discussion at the EFRAG TEG June meeting has suggested that some EFRAG TEG members would support a recommendation to modify the accounting requirements for equity instruments in IFRS 9 *Financial Instruments,* while others would not.

3 Since no formal vote was taken, the present draft has been developed to reflect both positions. Parts of the draft advice will need to be excluded from the final document according to the final recommendation of EFRAG TEG.

Background

4 In May 2017, the European Commission sent a request to investigate the potential effects on long-term investments of IFRS 9's requirements on the accounting for equity instruments. The request is enclosed as an appendix to this document.

5 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.

6 The IASB explained that gains and losses on instruments subject to the FVOCI election 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* had created application problems.

7 The European Commission requested EFRAG to:

(a) investigate the potential effects on long-term investment of IFRS 9's requirements on accounting for equity instruments;

(b) 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. The EC also requested EFRAG to consider if, 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.

8 EFRAG reported its findings of IFRS 9's requirements on the accounting for equity instruments on the potential effects on long-term investments in January 2018 in response to the first phase of the request.

9 EFRAG technical advice refers only to the questions specifically raised in the second phase of the request. EFRAG is not expressing an advice on other issues relating to IFRS 9, such as the use of fair value as a measurement basis for all equity instruments or whether the FVOCI election should be eliminated. However, EFRAG consulted its constituents on whether it would be appropriate to develop different accounting requirements for specific sub-sets of equity instruments.

10 In June 2018, the EC sent a second request to EFRAG related to IFRS 9's requirements. This recent request asks EFRAG to consider for equity instruments and equity-type instruments alternative accounting treatments to measurement at FVPL in the context of long-term business models. The EC asked for EFRAG's technical advice on this aspect of FRS 9 by the second quarter of 2019.

EFRAG recommendation

View A

The following section applies if EFRAG TEG concludes to recommend that no changes are made to IFRS 9 at this time.

11 EFRAG's advice to the European Commission is that no changes should be introduced to IFRS 9 in relation to the accounting requirements for equity instruments carried at FVOCI.

The conceptual arguments are finely balanced

12 EFRAG notes that IFRS 9 was widely debated, both in its development and during its endorsement in Europe. EFRAG concluded that the new Standard improves financial reporting over its predecessor IAS 39. Some concerns may exist about how well certain requirements apply to specific circumstances, but EFRAG notes that the Standard should be assessed in its entirety.

13 The general classification requirements in IFRS 9 are based on two fundamental concepts – the characteristics of the financial instrument and the business model of the investor. Recycling of disposal gains or losses for equity instruments carried at FVOCI may be seen as weakening the role of the first criterion and potentially creating a conflict within the Standard.

IFRS 9 allows a fair presentation of investment performance

14 While the majority of preparers from the consultation support the reintroduction of recycling, some constituents do not share the view that recycling gains are part of the performance in the period when the instrument is sold. In particular users mostly oppose this, and some would go as far as removing the FVOCI election altogether. While EFRAG does not support removal of the FVOCI election, the calls by some stakeholders for its removal are indicative of the overall lack of consensus.

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

The impairment solution is still elusive

16 There is a widespread agreement that, if recycling were to be allowed, an impairment solution would need to be implemented at the same time. However, constituents do not agree on how to reach an appropriate balance between relevance and consistent application. Our prior findings confirmed that there were diverging practices in the application of the IAS 39 impairment model. The majority of respondents acknowledged the need to for improvement, yet many propose to go back substantially to the same model.

17 EFRAG does not concur that the inclusion of a quantitative threshold is sufficient to achieve comparability; nor that allowing a reporting entity to reverse impairment losses would counteract management optimism.

18 Likewise, the consultation has not resulted in any progress in relation to the definition of long-term investment or long-term investor. Any attempt to define such terms has been discouraged by constituents, on the basis of conceptual or operational difficulties. EFRAG maintains that a degree of rigour in the use of the election or the impairment model would be essential to ensure comparability.

The evidence of behavioural changes is inconclusive

19 The data collection and consultation efforts have provided mixed results. The level of equity instruments held in the AFS category and the recycling gains are varied. Different views have been expressed about the expected impact of the new requirements on investment decisions and their timing. It would be difficult to isolate IFRS 9's impact from the impact of other factors such as tax or prudential regulations.

20 EFRAG concluded that any advice to promote changes to a Standard – especially one that became effective only recently, and was widely scrutinised – should be based on widespread agreement. Our work has not proved that this is the case at this stage. EFRAG instead advices to maintain IFRS 9 unchanged, and reassess it if clear evidence of the negative impact of the new requirements becomes available after the completion of the post-implementation review of the Standard.

View B

The following section applies if EFRAG TEG concludes to recommend that changes are made to IFRS 9

21 EFRAG advice to the European Commission is that the prohibition on 'recycling' for equity instruments carried at FVOCI in accordance with IFRS 9 should be reconsidered.

Recycling is conceptually justified

22 The prohibition on recycling means that gains or losses on equity instruments are never recognised in profit or loss. This does not seem consistent with the IASB's revised *Conceptual Framework for Financial Reporting*, which states that the statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. Consequently, in principle, all income and expenses are included in that statement.

23 The Framework allows the Board to conclude that, in exceptional circumstances, excluding certain income or expenses items would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period. However, EFRAG is not persuaded that it is the case with respect to gains and losses on disposal of equity instruments, because:

(a) These items provide relevant information because they have confirmative value about the entity's ability to generate cash inflows;

(b) The sale establishes a clear basis to identify the period in which the amounts should be transferred to profit or loss, thus providing faithful representation.

The change would be effective and easy to achieve

24 Some concerns have been expressed that the respective role and interaction between profit or loss and OCI has not yet been fully explained. However, EFRAG concluded that the reintroduction of recycling would not pose particular issues in terms of understandability. Users are well familiar with recycling of disposal gains, since it was a requirement in IAS 39, and some academic studies confirm that realised and unrealised gains and losses have different value relevance.

25 Also, it would not impose any additional cost to preparers – IFRS 7 *Financial Instruments: Disclosures* already requires entities to disclose cumulative gains or loss on disposal on equity instruments carried at FVOCI and any transfers of cumulative gains or loss within equity on these instruments.

26 The FVOCI election represents an exception to the principles in IFRS 9 to recognise equity instruments at FVPL, as acknowledged in paragraph BC5.28 of the Basis for Conclusion of the Standard. As such, the characteristics of the election should be assessed more on whether it is conducive to a positive outcome rather than on purely conceptual grounds. EFRAG believes that a modification of the exception is justified if it improves its effectiveness, and would not call into question the general principles of the Standard..

An impairment solution is could be found

27 EFRAG believes that the reintroduction of recycling needs a robust impairment solution. While there are still some issues to further consider, our consultation shows that there is reasonable consensus about the objective of an impairment model and its general characteristics. There is a good basis to engage the IASB and other parties to come up with an acceptable solution.

Behavioural changes are a real possibility

28 Many respondents deemed it premature to propose amendments to the requirements in IFRS 9, since the Standard has been effective since 1 January 2018 (and will not be in use by entities with insurance undertakings until 1 January 2021). However, it cannot be ignored that a number of large investors from the financial industry have repeatedly signalled that they expect to modify their investment decisions. Further, many respondents supported the reintroduction of recycling for equity instruments carried at FVOCI.

Question for EFRAG TEG

29 Which recommendation do you support? Do you have comments on how that view is articulated and justified?

30 Do you think that the advice should only include the preferred view, or also illustrate, at least partially, the arguments supporting the opposite view?

31 If the EFRAG TEG recommendation is that the requirements in IFRS 9 should not be changed – would you still include a description of the changes supported by constituents?

How the requirements in IFRS 9 should be changed

To be considered whether this part could be included even if EFRAG TEG recommends 'no change'. Next paragraph proposes how the section could be introduced

32 While EFRAG does not recommend changes to the requirements in IFRS 9, it should be acknowledged that constituents have expressed mixed views and some of them, in particular preparers in the financial industry, have expressed support for the reintroduction of recycling. Assuming that the European Commission sees merits in further considering the issue, the following paragraphs 34 – 42 illustrate what changes these constituents would generally support.

33 Paragraphs 34 - 42 below illustrate how EFRAG would recommend to amend the requirements in the context of the reintroduction of recycling gains and losses on disposal of equity instruments carried at FVOCI.

The availability of the FVOCI election

34 EFRAG would not recommend to develop specific requirements, including the availability of the FVOCI election, applicable only to certain equity instruments. In our project, no specific characteristics of the instrument or the investor have been identified that would, either conceptually or operationally, justify a different accounting treatment. Therefore, EFRAG supports having the same requirements for all equity instruments other than those that are held-for-trading or as contingent consideration.

35 During the consultation process, several respondents to EFRAG's DP suggested that the FVOCI election be expanded to include fund units such as Undertakings for Collective Investment Transferable Securities (UCITS). EFRAG plans to reconsider the scope of the FVOCI election as part of its efforts to respond to the more recent EC request.

Recognition of impairment losses

36 There is inherent volatility in the fair value measurement of equity instruments. Therefore, an impairment model needs to make a distinction between temporary declines in fair value and declines that are likely to be more permanent. The IAS 39 impairment model attempted to make that distinction through the 'significant or prolonged' trigger but was criticised because it was perceived to have application problems.

37 EFRAG would recommend to retain the core principle of the IAS 39 impairment model, that is to assess whether a fair value decline in an individual investment in an equity instrument below its acquisition cost is 'significant or prolonged'. This model is well understood by both users and preparers. The perceived problems with this impairment model could be mitigated through improved application guidance including quantitative triggers.

38 Many respondents to the consultation favoured this impairment approach but several preferred that the quantitative triggers be determined by the reporting entity.

Question for EFRAG TEG (*this question does not apply if View A is chosen)*

39 Do you want to express a view on whether there should be triggers or rebuttable presumptions, and how they should be set?

40 EFRAG agrees that the assessment should be conducted by reference to the equity holdings in the individual issuer, and does not recommend to specify a cost formula.

Reversal of impairment losses

41 IFRS 9's predecessor Standard, IAS 39, did not allow for the reversal of an impairment loss. EFRAG believes that reversals of impairment losses should be allowed. This would, with the exception of goodwill, be consistent with the treatment of other impaired assets under IFRS Standards.

42 The reversal of impairments should be symmetrical with the impairment model. This would better differentiate recoveries in fair value that are temporary and unrelated to the impairment from those recoveries in fair value that may be more sustainable. Most respondents to the consultation agreed that reversals should be allowed, and that their prohibition may have discouraged entities from recognising impairment losses.