EFRAG Equity Instruments – Impairment and Recycling – detailed analysis of feedback

Objective

1 The objective of this paper is to provide the EFRAG Board with a high level summary of the replies to EFRAG's Discussion Paper *Equity Instruments – Impairment and Recycling* (DP).

2 EFRAG published the DP as part of an effort to gather views and prepare a response to the European Commission (EC) that requested technical advice on recognition of equity instruments carried at FVOCI.

3 The DP's main focus was whether recycling gains and losses on the disposal of equity instruments carried at FVOCI would better reflect the performance of long-term investors and whether recycling should be accompanied by an impairment model.

4 The DP also included other impairment related issues and illustrated two alternative impairment models for equity instruments carried at FVOCI:

(a) a revaluation model, in which all declines in fair value below the acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI and recycled on disposal; and

(b) an impairment model similar to the model of IAS 39 *Financial Instruments: Recognition and Measurement* for equity instruments classified as available-for-sale ('AFS'), but with additional guidance to reduce subjectivity.

5 The comment period of the DP ended on 25 May and EFRAG received 51 replies. Appendix 1 includes the list of respondents.

6 EFRAG TEG discussed a high level summary of the replies at the June meeting and has been provided with a detailed analysis for the July discussion. This paper focuses on the main questions in the DP:

(a) Would the reintroduction of recycling improve the financial reporting of equity instruments in particular for long-term investors?

(b) How significant is an impairment model to the reintroduction of recycling?

(c) If an impairment model is considered to be important for the reintroduction of recycling, what should be the characteristics of an impairment solution?

7 In accordance with EFRAG procedures, a full feedback statement will be published in due course.

High-level summary

8 More than half of the total respondents to the DP suggested that it might be preferable to wait for the IASB's Post Implementation Review (PIR) of IFRS 9 before suggesting changes and/or that any change needs to be agreed with the IASB and not introduced at the European level. For some of these constituents, one or both of these suggestions substantively represented their complete response to the DP.

9 Nearly three-fourths of the 47 respondents who expressed a view on recycling agreed that its reintroduction would improve the depiction of financial performance of long-term investors. However, some National Standard Setters and users reject this view or would prefer to have fair value changes recognised immediately in profit or loss.

10 An overwhelming majority of respondents to the question as to whether recycling needed to be accompanied by an impairment model agreed that it did.

11 Approximately two thirds of the 31 respondents who expressed a preference about an impairment model, preferred a model similar to IAS 39, mainly because it attempted to make a distinction between temporary and other declines in fair value.

General comments on the project

12 32 respondents provided general comments on the timing of the request and process (10 respondents made both comments). The group included approximately half of the preparers, all the regulators and audit/accountant associations, one user organisation and seven National Standard Setters.

13 21 respondents noted that entities only just started applying IFRS 9 and therefore it was too early to draw conclusions on the impact of the Standard. Some of them mentioned that there was no clear evidence that the current requirements, which prohibit recycling, would have a negative impact on long-term investments, nor that the reintroduction of recycling would have a positive impact.

14 21 respondents noted that, regardless of the outcome of the technical discussion, it was necessary that any change would be discussed with the IASB. No change should be introduced at an European level.

15 It should be noted that the DP was not asking for views on these aspects; it is possible that some of the other respondents would also share the same view.

16 Two National Standard Setters mentioned that the FVOCI option for equity instruments in IFRS 9 should be eliminated. They considered the appropriate measurement criteria for all equity instruments was FVPL as this option allowed greater comparability between entities and they just accept FVOCI because it was introduced by the IASB. A user organisation (the one that had not commented on the timing of the request) also noted that FVPL would be their preferred option to represent investment performance.

17 Other respondents, mostly preparers (insurance companies) and some National Standard Setters, suggested to amend IFRS 9 to reintroduce recycling. Some of them noted that it would be the only solution to report all the components of the performance of equity instruments in profit and loss. This would also be more consistent with the accounting treatment of debt instruments carried at FVOCI.

18 Most of these respondents encouraged the EFRAG Board to advice the EC to urge the IASB to undertake a narrow-scope amendment to IFRS 9 on a timely basis so to have it in place when IFRS 17 *Insurance Contracts* becomes effective.

Comments to specific question

Question 1 Recycling gains or losses on disposal

Preparers and business associations

19 Comment letters from preparers and organisations of preparers from Austria, Belgium (two respondents), Greece, Poland and Singapore expressed the view that recycling would improve the depiction of the financial performance of long-term investors. This view was also expressed by some preparers and organisations from Germany (four respondents), France (five respondents), and European/international organisations of preparers (six respondents). The arguments provided in favour of recycling included in these comment letters were that:

(a) the FVPL category introduced undue volatility and failed to reflect the long-term investments business model as unrealised gains and losses could not be considered similar to realised gains and losses;

(b) due to the prohibition of recycling the equity instruments carried at FVOCI, the cash flows relating to gains on disposal from the sale of equity instruments, were not reported in profit and loss anymore. As a result, the general principle to show in a transparent way all realised gains and losses in profit or loss account had been left out under IFRS 9. This created the false impression that the cumulative gains and losses at the time of disposal of equity instruments were not relevant or economically insignificant, and therefore not a part of the financial performance;

(c) disposal gains or losses might not have predictive value but the recycling of accumulated OCI to profit and loss when equity instruments were sold would still be relevant;

(d) the *Conceptual Framework* established that the statement of profit or loss was the primary source of information about financial performance; and

(e) recycling was also fully consistent with paragraph 7.19 of the *Conceptual Framework* which included a general presumption that accumulated gains and losses in OCI should be transferred to profit or loss in a future period, when this results in the statement of profit or loss providing more relevant or more faithful representation of the entity’s financial performance for that future period and argued that was the case when the investments were sold, and the gains or losses were realised;

20 A Danish and a German organisation representing financial institutions regarded recycling as a possible approach. They noted that conceptually recycling could be appropriate for long-term investments, but this very complex issue could not be solved by a short-term change.

21 Two German preparers expressed that recycling could be a possible approach or had no preferences as it was considered that there were no differences between profit or loss and OCI.

22 One organisation representing some UK financial institutions was against recycling. It noted that the existing provisions for IFRS 9 provides the appropriate basis for depicting the performance of equity securities.

23 Three comment letters did not express a clear consensus or no view on the issue.

National Standard Setters

24 The standard setters from Austrian, France, Italy and Japan considered that recycling would be preferable. The arguments provided were:

(a) there were crucial differences between realised performance that should be recognised in P&L and unrealised performance that should be recognised in OCI;

(b) it also seemed appropriate to consider changes in value of investments within equity instruments in the financial performance. This certainly included the consideration of final profits or losses at disposal; and

(c) both dividends receipts (which were included in profit or loss) and gains on disposal from the sale of equity instruments represented a form of realisation of the fair value of the instruments. Therefore, both events should be presented in the same way.

25 On the other hand, the standard setters from Norway, Poland, Spain and the United Kingdom were against recycling. The arguments provided were:

(a) the timing of a sale of an equity instrument was entirely controlled by the entity and did not help reflect the entity's performance in the year;

(b) any re-measurement gains or losses pertained to holding period and not the period of disposal; and

(c) recycling could lead to manipulation of profit and loss and obscured the performance of an entity's portfolio.

26 The Danish standard setter had not seen any convincing evidence that IFRS 9 would affect long-term investors' behaviour. The respondent had "sympathy" for recycling should IFRS 9 be reopened.

27 The Dutch standard setter thought that it should first be understood what the issue was before a solution could be suggested. The respondent noted that recycling should be accompanied by some impairment solution.

28 The German standard setter had not yet formed a final view on the issue. It saw no clear evidence that the current requirements would negatively impact long-term investments, nor that the reintroduction of recycling would have a positive impact. Similarly, the Portuguese standard setter thought that any recommendations should be made after the post-implementation period.

Regulators

29 The two European regulators responding the to the consultation, were either against recycling or had no clear preference from a conceptual perspective as to whether recycling should be reintroduced. The regulator that was against recycling noted that the evidence collected by EFRAG did not demonstrate a need to introduce recycling to support long-term investments. On the contrary, the respondent noted, "recycling may introduce in some cases, and especially for financial institutions, short-term accounting incentives to put in place opportunistic profit-taking disposal policies, thus sustaining earnings management practices, which would be contrary to the objective of encouraging long-term investments".

Auditors and accountants

30 An association of auditors from the UK was against recycling. Firstly, the comment letter noted that the FVOCI category was intended for strategic investments only for which changes in fair value were not of primary relevance. Secondly, if FVOCI would also be used for non-strategic investments, recycling in one period would not reflect the investor's periodic performance. Other five audit firms or associations of auditors did not have a (consensus) view on the issue.

Users

31 The two users organisations had the following views:

(a) one group believed that FVPL was the better approach to depict performance. However, it noted that users focus on the statement of profit or loss to assess an entity's performance, so fair-value fluctuations in OCI were accordingly not regarded as performance. Recycling could therefore be recommendable to gauge the performance of an investor over the entire holding period. The group considers that recycling was more suitable to assess stewardship, particularly when determining how an entity realises capital gains or losses and how successful the entity was in managing its investment portfolio; and

(b) the other group of users believed that the act of realisation of a gain or a loss does not change the economic reality of the performance of the business. The gain or loss has accrued over the holding period and if management had elected to use OCI, realised gains were not part of the performance of the period. They thought that the election should only be available for strategic investments. Volatility in fair values of long-term investments was "normal" and accordingly, this group of users do not see any need to "smooth earnings". Instead the management should explain the reasons for the movements.

32 An individual user responding to the consultation was in favour of recycling as he thought realised gains and losses should be reported in profit or loss.

Question 2 Conceptual relationship between recycling and impairment

33 Of the preparers that were in favour of recycling or did not have a view on this, two German preparers responding to the consultation did not think it was necessary to introduce an impairment model. The other 15 preparers and organisations representing preparers either supported an impairment model, or did not oppose to it.

34 Nine national standard setters were in favour of an impairment model if recycling should be introduced, and two had not formed a view. However, one of these noted that from a conceptual point of view, testing assets for impairment was a fundamental stand-alone concept irrespective of recycling that, at least theoretically, should apply to any class of assets held.

35 The Polish standard setter, which was not in favour of recycling (and did not provide a view on impairment) noted that the issues related to impairment was another argument for not introducing recycling.

36 The UK association of auditors that was against recycling noted that a form of impairment model would be a pre-requisite. Otherwise the timing of recognition of losses was entirely within the control of the investing entity. Other three auditors and associations of auditors/accountants also shared this position and two did not provide a view.

37 Both regulators and user organisations supported the need for an impairment model to reduce incentives for earnings management, it was needed for prudence and transparency reasons, as well as to enhance the relevance of profit or loss for stewardship purposes and assess prospects for future cash flows.

38 Most of respondents acknowledge that some of the negative fair value changes could be permanent. Most of them also agreed that a robust impairment model increased the relevance of the profit and loss statement as primary source of information of the performance of the company.

Question 3 Enhancing presentation and disclosure requirements

39 Almost all the respondents who replied agreed that presentation and disclosure solutions could not adequately replace recognition and measurement in the primary financial statements and referred to IAS 1 *Presentation of Financial Statements*. For that reason, it was generally agreed that information recognised in the financial statements was more valuable that information disclosed in the notes.

40 Most of those respondents also did not support additional disclosure requirements, beyond those already in IFRS 7 *Financial Instruments: Disclosure* paragraph 11A and 11B. However; many acknowledged that if recycling with impairment were introduced there would be a need to disclose information on both the impairment policy and amounts.

Question 4 Two models

41 Several constituents agreed that a robust impairment model needed to provide relevant and reliable information and allow comparability. Some constituents suggested relevance should take precedence if there was a conflict between features.

Preparers and business associations

42 The 14 preparers who expressed a view favoured a solution similar to IAS 39. Some mentioned that they supported modifications that reduced subjectivity.

43 The argument provided in favour of an IAS 39 model were:

(a) it would distinguish between permanent declines in the fair value of the underlying equities versus their short-term market-driven fair value changes for three respondents;

(b) it would avoid the unintended volatility in profit or loss, when the current fair value was below the original cost for three respondents;

(c) it would allow the application of an impairment approach for equity instruments that was consistent with the one for debt instruments measured at FVOCI for two respondents;

(d) it was consistent with statutory reporting for one respondent;

(e) entities would be familiar with the model from IAS 39 for one respondent; and

(f) it would enhance transparency for one respondent.

44 Arguments provided against the revaluation model proposed were:

(a) the approach would result in short-term value decreases being recognised in profit or loss, which would not result in relevant information for users for three respondents;

(b) the information would not be relevant as there would be no assessment of the factors causing the impairment or consideration of the characteristics of the equity portfolios for three respondents;

(c) it would a be source of volatility in the profit or loss for long term investors, in contradiction with their long-term investment strategies for eight respondents;

(d) it would result in an asymmetric treatment for two respondents; and

(e) it would not adequately portray the performance of a managed portfolio of equity investments (in which will be expected to show fair value gains and other losses) for one respondent.

45 Although the preparers favoured an IAS 39 approach, some also provided arguments in favour of the revaluation model:

(a) it would be simple for three respondents; and

(b) it would be less discretionary than an IAS 39 approach for one respondent.

46 13 preparers did not express a preference between the models in the DP. Two of these, in particular, suggested an impairment model based on value in use..

47 The preparer association that was against recycling did not express any preference.

National Standard Setters

48 The standard setters that did not express a view on recycling also did not express a preference on the impairment model.

49 The Danish standard setter thought that impairment should be evaluated with no reference to the criteria of 'significant' or 'prolonged' to be as close to the FVPL approach as possible and to be less subjective.

50 The Dutch standard setter noted that the triggers in any impairment model should be sufficiently clear to avoid subjectivity. In addition, any reversal of an impairment should be symmetrical to initial recognition of an impairment.

51 The standard setter of Germany thought that the models presented by EFRAG were a good starting point for further discussion but not sufficiently developed to enable a judgement of their merits.

52 The Portuguese standard setter did not favour one of the models, but impairment in accordance with IFRS 9.

53 The standard setters in favour of recycling also generally favoured an IAS 39 based impairment model.

54 The Austrian standard setter thus seemed to consider the IAS 39 to be better than the revaluation model as the latter would not reflect the business model of long-term investments.

55 The French standard setter similarly favoured the IAS 39 model of the two approaches but noted that it should include an impairment reversal mechanism.

56 The Italian standard setter also thought the IAS 39 model should be amended to allow for reversals of impairment losses. In addition, it should provide application guidance on the terms "significant" and "prolonged" to reduce the subjectivity around the interpretation of these terms. Quantitative thresholds might be included in this guidance.

57 The standard setter of Japan did not mention it directly, but it seemed to consider the IAS 39 model to be better than then revaluation model although a "significant or prolonged" decline in fair value might not necessarily depict the effects of identifiable adverse changes in the issuer's economic conditions.

58 The standard setters that did not support recycling were generally more in favour of the revaluation model.

59 The Norwegian standard setter saw some merits in the revaluation model as it would at least provide information about unrealised loss on an equity instrument with fair value below cost ("lower of cost and market"). The respondent thought that this could provide useful information, the model would increase comparability, reduce complexity (easily understandable), and provide information that would be transparent and less subjective then an "incurred loss" approach.

60 The Polish standard setter noted that if recycling would be introduced, it would favour the revaluation model as this was objective, result in comparable information and was principle-based.

61 The Spanish standard setter preferred the revaluation model as it did not involve the problem of identifying a bright line.

62 The UK standard setter thought that a wider debate was needed about when recycling provides more relevant information or a more faithful representation, and what conditions should apply before it could provide a view on impairment.

Auditors and accountants

63 The UK auditor/accounting association that was against recycling noted that any impairment model would involve complexity and create difficult questions of judgement.

64 Two auditors or associations of auditors favoured the revaluation model. The arguments provided were:

(a) it was simple;

(b) provided a certain degree of objectivity;

(c) enhanced comparability;

(d) more consistency with the treatment of the impairment of other assets; and

(e) less scope for earnings management.

65 One audit company favoured an IAS 39 approach but thought that the modifications which included the use of a backstop trigger and introduction of an impairment reversal process might result in the revaluation approach being an interesting alternative as it was simple and offered better comparability across entities.

66 Two associations of auditors/accountants did not provide a view.

Regulators

67 One of the regulators did not think that any of the models proposed would improve financial reporting as they did not strike the right balance between relevance and comparability. For example, the revaluation model could result in comparable information, but as the information would not take the different sources of fair value changes into account the information would not be relevant. The other regulator favoured the revaluation approach, as the IAS 39 approach would not result in timely and comparable recognition of impairment losses.

Users

68 The two organisations of users replying to the consultation did not express any preference about the two impairment models suggested in the consultation document. One of the organisations thought, however, that the concepts of "significant and prolonged" should remain as a principle-based approach introducing qualitative guidance and some quantitative thresholds.

69 The individual replying to the consultation did not favour any of the models and suggested an approach aligned to the expected loss model. The trigger event should be whether there was a dividend cut.

Other suggestions

70 A few constituents suggested alternative impairment models to the two models illustrated in the DP. The suggested different options included:

(a) an impairment model applied at the level of a long-term investment portfolio;

(b) a value-in-use method based on the future cash flows the entity expects from the asset; and

(c) an impairment model where the trigger was the reduction of the dividend.

Question for the EFRAG Board

71 Do you have comments or questions on the high level summary of replies?

APPENDIX I – List of respondents

Respondent	***Country***	***Type***
ACCA - Association of Chartered Certified Accountants	International	Auditing Association
Accountancy Europe	International	Business Association
ACTEO – Association pour la participation des entreprises françaises à l'harmonisation comptable internationale AFEP – Association française des entreprises privées MEDEF – Mouvement des entreprises de France	France	Business Association
AFME - Association for Financial Markets in Europe	International	Business Association
AFRAC - Austrian Financial Reporting and Auditing Committee	Austria	National Standard Setter
Allianz	Germany	Preparer
ANC - Autorité des Normes Comptables	France	National Standard Setter
ASBJ – Accounting Standards Board of Japan	Japan	National Standard Setter
ASCG - Accounting Standards Committee of Germany	Germany	National Standard Setter
Assuralia	Belgium	Business Association
BNP Paribas	France	Preparer
BusinessEurope	International	Business Association
Carsten Zielke	Germany	Individual
CFO Forum – European Insurance CFO Forum	International	Business Association
CNC – Comissao de Normalizacao Contabilistica	Portugal	National Standard Setter
CRUF – The Corporate Reporting Users Forum	International	Professional Organisation of Users
Commerzbank	Germany	Preparer
DASB - Dutch Accounting Standards Board	Netherlands	National Standard Setter

DASC - Danish Accounting Standards Committee	Denmark	National Standard Setter
Deloitte	International	Auditing
Deutsche Telekom AG	Germany	Preparer
ECB – European Central Bank	International	Regulator
EFAMA – European Fund and Asset Management Association	International	Business Association
EFFAS - European Federation of Financial Analysts Societies	International	Professional Organisation of Users
ESBG - European Savings and Retail Banking Group	International	Business Association
ESMA - European Securities and Markets Authority	International	Regulator
Evonik Industries AG	Germany	Preparer
FBF - French Banking Federation	France	Business Association
FFA - Fédération Française de l'Assurance	France	Business Association
Finance Denmark	Denmark	Business Association
FRC - Financial Reporting Council	UK	National Standard Setter
GBIC – German Banking Industry Committee	German	Business Association
GDV – German Insurance Association	Germany	Business Association
HBA - Hellenic Bank Association	Greece	Business Association
ICAC – Instituto de Contabilidad y Auditoría de Cuentas	Spain	National Standard Setter
ICAEW - Institute of Chartered Accountants in England and Wales	UK	Auditing Association
ICAS – Institute of Chartered Accountants of Scotland	UK	Auditing Association
Insurance Europe	International	Business Association
Invest Europe	International	Business Association
ISDA - International Swaps and Derivatives Association	International	Business Association
KBC	Belgium	Preparer

Mazars	International	Auditing
NASB - Norwegian Accounting Standards	Norway	National Standard Setter
OIC – Organismo Italiano di Contabilita	Italy	National Standard Setter
PASC - Polish Accounting Standards Committee	Poland	National Standard Setter
ProSiebenSat.1 Media SE	Germany	Preparer
Siemens AG	Germany	Preparer
Société Générale	France	Preparer
Temasek Holdings	Singapore	Preparer
UK Finance	UK	Business Association
Anonymous	Austria	Preparer