This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FR Board or EFRAG FR TEG-CFSS. 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 FR Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

IFRS 9 PIR *Classification and Measurement* – Equity OCI Election – PIR discussions
Issues Paper

Structure of this paper

1 This paper is structured as follows:

(a) EFRAG response to the RFI;

(b) IASB Staff preliminary views;

(c) IASB discussions;

(d) EFRAG working groups discussions;

(e) EFRAG FR TEG and FRB discussions; and

(f) Questions for EFRAG FR TEG-CFSS.

EFRAG response to the RFI

2 In January 2022, EFRAG issued its comment letter in response to the IASB Request for Information – *Post-implementation Review of IFRS 9 Classification and Measurement*.

3 EFRAG brought to the attention of the IASB the following points:

(a) The IASB should expeditiously review the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised.

(b) If recycling will be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

(c) With reference to the insurance industry, the need for recycling of gains or losses on realisation of equity instruments measures at FVOCI will increase when IFRS 17 is implemented. Since shadow accounting[1] is no longer permitted in IFRS 17, the lack of recycling will increase accounting mismatches for those insurance companies that have profit sharing features in their insurance liabilities.

(d) The current absence of recycling creates a disparity between equity and debt investments, which is inappropriate under particular business models, such as for banks and insurance companies that hold investments in equity

[1] Paragraph 30 of IFRS 4 stablishes that "*An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income.*"

instruments as well as in debt instruments as part of the same overall investment strategy.

(e) Users that responded to EFRAG consultation consider that if realised gains or losses are not reflected in profit and loss, the performance of the equity portfolio might remain undisclosed as equity. In their opinion, this makes difficult to understand how equity has evolved over the period despite the statement of changes in equity and does not contribute to a good financial reporting.

IASB Staff preliminary views

4 In the initial discussion on feedback received on equity instruments and other comprehensive income held in June 2022, the IASB Staff presented preliminary views (reported on the Agenda Paper 3A) on the following topics:

(a) **Consistent application of the OCI election**: the IASB staff considers that there is a need to clarify the scope of the equity instruments to which the OCI presentation election can be applied.

(b) **Request to broaden the scope of the OCI presentation election**: based on PIR feedback, the IASB Staff is of the view that those who believe the OCI presentation election should be available for a wider scope of instruments tend to strongly favour recycling of amounts presented in OCI. For this reason, the requests for OCI recycling should not be categorised as requests to amend the current OCI presentation election in IFRS 9, but as request for a new classification category for equity instruments that they think would better reflect a long-term business model or strategy.

(c) **Request to amend IFRS 9 to add a new classification category**: the IASB Staff is of the view that this would add complexity and would only be justified if there is evidence that there is a significant deficiency in the information that investors are being provided. The IASB Staff indicate that they do not think that this is the case since recycling would not result in users of financial statements receiving more or better information about "realised" gains and losses. Rather, recycling would change how that information is presented to users of financial statements.

(d) **Request to open the OCI presentation election to "equity-like" instruments**: the IASB Staff is of the view that it would not be appropriate to extend the OCI presentation option to "equity-like" instruments that do not meet the definition of an equity instrument in IAS 32. They observe that the rights and obligations of an entity as an investor in a fund that trades equities and other instruments is different to those of an entity's that directly purchases the shares of a company.

5 The IASB Staff also presented an update summary of the academic literature relevant to IFRS 9 – *Classification and Measurement* and a summary review of academic papers that provide US GAAP[2] evidence on available for sale securities and unrealised gains and losses (reported on Agenda Paper 3B).

6 In the context of this paper, the most relevant findings are the following:

(a) After the implementation of IFRS 9, for a sample of 87 European banks from 18 countries[3] the percentage of long-term investments in equity instruments did not decrease (38% in 2014 vs 40% in 2020), but the percentage of equity

[2] The evidence on the effect of Accounting Standard Update (ASU) 2016-01 is relevant to the PIR of IFRS 9 – Classification and Measurement because ASU 2016-01, similarly to IFRS 9, requires that equity investments be measured at fair value with changes in fair value recognised in net income. Previously changes in fair value were recognised on OCI until the gains or losses were realised.

[3] Löw, E., and Erkelenz, M. (2022). *Long and short-term investments by European banks– trends since the IASB published IFRS 9*, Working paper, Frankfurt School of Finance and Management.

instruments to which the OCI presentation election is applied in the year of initial application of IFRS 9 (29% in 2018) decreased in the two years after the implementation of IFRS 9 (18% in 2020).

(b) For a sample of FTSE 100 entities[4], the value relevance – association with share prices and returns and ability to explain variation in share price and returns – of earnings decreased and the value relevance of OCI increased after the implementation of IFRS 9. In the authors' view, investors rely more on the OCI when changes in fair value are not recycled, thereby reducing the value relevance of earnings.

(c) Based on a sample of 254 entities listed on the Australian stock exchange (ASX)[5], it was found that entities' profitability ratios – earning before interest and taxes and return on equity – based on reported amounts, restated amounts as if the OCI presentation election was applied to all equity instruments and restated amounts as if all equity instruments were presented in FVPL did not differ. In the authors' view, entities do not select their presentation choices to influence profitability ratios.

(d) Some US academic papers[6] examined the value relevance of available for sale securities and the issue of recycling before ASU 2016-01 were implemented. The findings of these academic papers do not support the theoretical prediction that unrealised gains and losses should be value relevant and that recycled gains and losses should not be relevant, as investors do not react to unrealised gains and losses consistently nor do they react as predicted. In particular, investors do not pay adequate attention to the amount or change in unrealised gains or losses that are reported in OCI and treat the recycled gains or losses as news.

IASB discussions

7 During its June 2022 meeting, the IASB had an initial discussion on feedback received on equity instruments and OCI and received the IASB Staff preliminary views. The IASB was not asked for any decisions.

8 IASB members were overall supportive to the IASB Staff preliminary views and welcomed the feedback that in general the option to present FV changes on investments in equity instruments in OCI works as the IASB intended.

9 Several IASB members noted that reintroduction of recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. If recycling will be permitted or required, a robust impairment model would be needed, which would add complexity and be difficult to develop.

10 Some IASB members considered that the feedback provided by stakeholders highlighted that the scope for the OCI presentation election that the IASB had in mind when the Standard was published is not applied consistently. Particular considerations should be discussed in relation to the insurance companies and the connection with the IFRS 17 requirements.

[4] Pinto, I., and de Carvalho Morais, A., (2022). *Equity instruments classification under IFRS 9: Determinants and consequences*, Working paper, Lisbon School of Economics and Management.
[5] Zang, Z., Scott, T., and H. Kabir. (2022). *Does OCI presentation election for equity financial assets matter?* Working paper, Auckland University of Technology.
[6] The evidence is based on Barth (1994), Ahmed and Takeda (1995), Dong, Ryan and Zhang (2014), Boulland, Lobo and Paugam (2019), Badertscher, Burks and Easton (2014), Barth, Gomez-Biscarri, Kasznik and Lopez Espinosa (2017), Easton and Zhang (2017).

11 One IASB member noted that a possible way forward could be to clarify in the Standard the scope of the OCI presentation election by referring to the indications described on the Basis of Conclusions of IFRS 9.

12 Another IASB member considered valuable to expand the perimeters of the OCI presentation election to include a narrow scope of puttable instruments and funds that invest in equity instruments. He noted that, from the holder perspective, these types of instruments have equity risks, and it seems to be reasonable to consider them in the scope of the OCI presentation election.

13 Some IASB members asked IASB Staff to conduct further analyses on information users' needs and how to improve consistently the impairment test.

14 One IASB member was in favour of further discussion on the potential inconsistency in IFRS 9 between the requirements in paragraph B5.1.2A[7] (i.e., day 1 gain or loss) and the requirements in paragraph 5.7.1(b)[8] for the presentation of fair value changes. He was also noted that in practice there are several issues regarding the estimation of the fair value of unquoted instruments, therefore the reintroduction of the IAS 39 exemption to fair value measurement could be reconsidered.

EFRAG working groups discussions

EFRAG FIWG discussion

15 EFRAG FIWG had on 21 June 2022 an initial brief discussion of the IASB Staff paper to the IASB meeting on 21 June 2022.

16 The following comments where provided:

(a) One member noted that in Spain the IASB staff proposals will have significant impact on the banks, where almost all equity portfolio was measured at FVOCI, and on the financial conglomerates which were now in process of implementing IFRS 9. It will create a lot of uncertainty for insurers. This member also noted that the mandatory recycling was asked for the whole FVOCI category and there was no question of creating an additional category.

(b) Another member mentioned the recent study providing evidence for the importance of recycling and agreed to forward the study.

(c) One member noted that equity and FVOCI election were hardly used in practice and that only around 0.25% of financial instruments were allocated to the FVOCI option. He questioned if abolishing of these categories was considered by the IASB to reduce complexity. He suggested that special rules might be incorporated in IFRS 17 for insurers.

(d) Another member noted that financial and mixed conglomerates in Bulgaria will face challenges and that the IASB staff proposals do not reflect the complexity of the real businesses.

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[7] IFRS 9 B5.1.2A states: "*The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also IFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:*

a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

b) *in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.*"

[8] IFRS 9 5.7.1(b) states: "*A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless: …*

b) *it is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5…*"

EFRAG IAWG discussion

17 EFRAG IAWG had on 23 June 2022 an initial brief discussion of the IASB Staff paper to the IASB meeting on 21 June 2022.

18 The following comments where provided:

(a) One member noted that the preliminary views described in the IASB Staff Agenda Paper are quite different than the EFRAG suggestions reported in its Final Comment Letter. In particular, EFRAG considered the IASB should reintroduce an amendment to allow the recycling of FVOCI gains and losses on equity instruments when realised. Quite the opposite, the IASB Staff considered this request required a new classification category. It is not entirely clear why the IASB Staff came to this conclusion. Lastly, this member welcomed the opening of the IASB to extend the OCI presentation election also to equity-like instruments expressed during the last IASB meeting.

(b) Two members provided comments in writing. One member indicated that those who ask for recycling were not asking for a different category but for a limited amendment. Another member indicated that it was crucial to keep the current principle-based approach: many insurers have decided to apply the FVOCI without recycling election because, even if not perfect, it is a more meaningful treatment than FVPL. FVPL is not relevant for many preparers to provide a fair view of the performance of the entity in the context of their business model. This member did not agree with paragraph 58 of the IASB staff paper that it is just a presentation matter. It would be important that the IASB considers the impairment model that was proposed by the CFO Forum / Insurance Europe as it could address some of the concerns.

EFRAG FR TEG and FRB discussions

EFRAG FR TEG discussions

19 EFRAG FR TEG discussed the topic in the meeting on 29 June 2022. Members generally were not supportive of the IASB Staff preliminary views.

20 The following comments were provided:

(a) It was noted that preliminary views described in the IASB Staff Agenda Paper were not in line with the EFRAG suggestions to review the recycling of gains and losses on equity instruments measured at FVOCI nor with the clear expectation of reintroducing recycling reported by the stakeholders of the European financial sector. Members questioned the IASB Staff conclusion that this request required a new classification category.

(b) Some members did not share IASB concern about the impairment model. In its advice to the European Commission and its Final Comment Letter, EFRAG provided an illustration of how the impairment model could be improved if recycling were to be reintroduced, clarifying the terms “prolonged” and “significant decline”. Other suggestions to improve the impairment test were provided during the PIR process. Members noted that in the absence of further research, it is not possible to conclude that the application problems connected to the available-for-sale category in IAS 39 cannot be overcome with an improved impairment model.

(c) The time elapsed since the application of the Standard was considered not sufficient to support the conclusion of the IASB Staff that there was no new evidence that OCI presentation election does not work as intended. In addition, there is a lack of evidence from the insurance sector that will apply IFRS 9 only starting from 2023.

(d) One member noted that, from a preparer's point of view, having the realised gains and losses in the statement of performance is different than having them in the notes of the financial statements. Furthermore, it does not provide faithful information when losses are reported in OCI and result in a reduction of equity without passing by the statement of profit and loss.

(e) It was noted that the statement of profit or loss and the OCI have different relevance to users. In addition, the Conceptual Framework for Financial Reporting require that the amounts recognised in the OCI should in principle always be recycled. In addition, it is unclear why the recycling is acceptable for bonds but not for equity instruments.

(f) One member considered that the current scope for the OCI presentation election needs to be clarified. The terminology used by the Standard is unclear and the example from the RFI does not help to understand what "strategic" or "long-term" investment means. Another member suggested that if the recycling is reintroduced more guidance on both impairment and derecognition should be developed.

(g) Lastly, the opening of the IASB to extend the OCI presentation election also to some equity-like instruments expressed during the last IASB meeting was welcomed.

EFRAG FRB discussions

21 EFRA FRB discussed the topic at its meeting on 14 July 2022. EFRAG FRB members made the following comments and suggestions:

(a) In general, EFRAG FRB members shared the comments and the concerns expressed by the EFRAG working groups and EFRAG FR TEG members in their previous meetings. Members questioned the IASB Staff conclusion that the request to reintroduce the recycling implied the need of a new classification category and expressed concern about the need to clarify the scope of the OCI presentation election identified by the IASB Staff. Redefining the scope of the OCI presentation election could lead to several application problems in the banking and insurance sectors.

(b) An EFRAG FRB member questioned the conclusion of the IASB Staff that there was no evidence that the OCI presentation election does not work as intended since there is a lack of evidence from the insurance sector that will apply IFRS 9 only starting from the 2023. He noted that, in this sector, there is an ongoing discussion on how to adjust (using an APM) the income features to show the realised gains and losses that are relevant for the distributions but are not visible from the income statement.

(c) The European Commission (EC) representative clarified that the reintroduction of the recycling for equity instruments measured at FVOCI is a very sensitive issue for the EC and should be addressed appropriately.

(d) Several EFRAG FRB members believed that the development of a robust impairment model is the key for finding a shared solution with the IASB and recommended that the EFRAG Secretariat proactively work on this.

Questions for EFRAG FR TEG-CFSS

22 Does EFRAG FR TEG-CFSS have any comments on the IASB and EFRAG discussions on equity instruments and OCI presentation election?