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Mr Jean-Paul GAUZES
Chairman – EFRAG Board
35 Square de Meeûs
1000 Brussels
Belgium

EFRAG Discussion Paper – March 2018 – Equity Instruments – Impairment and Recycling

Dear Mr Gauzès,

We, Société Générale, are pleased to provide EFRAG with our comments and answers on its Discussion Paper “Equity Instruments – Impairment and Recycling”.

We welcome this Discussion Paper and the valuable questions that it addresses as well as more broadly the European Commission initiative to reconsider the effects of IFRS 9 on long term equity investments.

Our detailed answers to the questions to constituents are provided in the appendix, and you will find hereafter our main messages.

As previously expressed in our answers to the various consultations on IFRS 9, we consider that relevance shall be the first criterion to measure the quality of an accounting treatment and that such relevance should be assessed according to the business model used to manage the financial instruments. Considering the business model helps to provide a better consistency between cash flows generated by equity investments and the performance recognised in the financial statements.

Outside trading activities (i.e. where financial assets that are held with the objective and evidence of short-term profit taking), the performance of long-term investments is recognised through realised gains and losses (either dividends received or capital gains and losses realised when the equity investment is sold). For such non-trading investments, unrealised gains and losses are not considered as components of the current performance for managing and conducting the activity as far as they remain uncertain; their presentation outside the income statement, in the OCI, is then appropriate to manage the discrepancy between a fair value measurement in the balance sheet and the recognition of their performance in the income statement based on the only realised gains and losses.

Prohibiting the recycling of OCI on long-term investments does not provide a clear distinction between unrealised and realised gains and losses. To provide users with a clear and understandable information, all components of the performance shall be presented in the same location, i.e. the income statement. We note that the Conceptual Framework recently issued by the IASB considers the income statement as the primary statement for reporting the entity's performance. Additionally, we do share views expressed by some stakeholders that consider the recycling as being complex.

We acknowledge with EFRAG that a robust accounting treatment for long-term equity investments shall then include a recycling mechanism but also an impairment model.

Such impairment mechanism currently exists in the IFRSs for assets that leads to an impact into profit or loss when they are derecognised and we do not see any conceptual reason to have an exception for equity investments.

Impairment shall be then assessed on a timely basis, consistently with the notion of prudence, ensuring the recognition of impairment losses where necessary and their reversal as soon as the impairment is no longer justified.

EFRAG has proposed two main impairment models in its discussion Paper:

Revaluation model

We do not support the revaluation model as it introduces in the income statement a volatility which is inconsistent with the underlying business model of such non-trading equity investments. The underlying objective of the revaluation model, which remains the comparability, shall not overshadow the relevance criteria.

Improvement of IAS 39 model

Regarding the improvements proposed to IAS 39 model (additional guidance and disclosures on methodology), we consider that it could not be furtherly explored without the introduction of an impairment reversal mechanism. We are convinced that the non-reversal feature of the former IAS 39 equity impairment model is the main reason of some misapplication of this impairment model and of the observed diversity of impairment criteria regarding the "significant or prolonged" decline in the fair value of the investment.

Having said that, we share EFRAG's view that the model should be improved. Firstly, we propose to clarify the underlying driver used to assess the objective evidence of impairment and to focus it on the only "prolonged" criterion as it is enough to assess the occurrence of a loss that has become highly probable or even quite-certain. The "significant" criterion is not consistent with medium or long-term investments as far as fair value can encounter successive decreases and recoveries over time.

Secondly, to avoid endless debates around thresholds, we propose to explore another approach for assessing the prolonged decline in the value of a long-term equity investment. We suggest applying the concept of "value in use" to assess the existence of an objective evidence of an impairment and consistently to measure the impairment loss as well.

Reversal of the impairment would follow a symmetrical approach to the impairment model, based on the measurement of the value in use to assess that the impairment loss no longer exists or has decreased.

Additionally, we have observed that long-term equity investors may hold their equity investments directly or indirectly, for example through Undertakings for Collective Investments Transferable Securities (UCITS), Exchange Traded Funds (ETFs) or Authorized Investment Funds (AIF). We believe that such indirect investments should also be considered in the present study and that the issue could be addressed as well in the light of the current IASB's FICE projects ("Financial Instruments with Characteristics of Equity").

We hope you will find these comments useful. Please do not hesitate to contact us for any further information you might require.

Sincerely yours,

Pierre-Henri DAMOTTE

Head of Group Accounting Public Affairs

A handwritten signature in black ink, appearing to read 'P. Damotte', with several horizontal lines drawn over it for emphasis or as a signature flourish.

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Appendix

Q1.1. What are your view on the arguments presented in paragraph 2.3.-2.10? Do you consider that the reintroduction of recycling would improve the depiction of the financial performance of long-term investors?

Alternatively, do you consider that the existing requirements of IFRS 9 provide an adequate depiction? Please explain.

SG answer:

We consider that the reintroduction of recycling would improve the depiction of the financial performance of the investors. As mentioned in the Conceptual Framework recently issued by the IASB, the income statement remains the primary statement for reporting the entity's performance.

Outside trading activities where both realised and unrealised gains and losses are managed together (short-term profit taking is performed through either sales or repurchase of financial instruments or lockage of unrealised gains and losses by derivatives for instance), the performance of long-term investments is recognised through realised gains and losses either through dividends received or through capital gains and losses realised when the equity instrument is sold. For such non-trading investments, unrealised gains and losses are not considered as components of the current performance for managing and conducting the activity and their presentation outside the income statement, in the OCI, is consistent with the purpose of the income statement as reminded in the Conceptual Framework and as it is analysed by users.

Considering that variations of the fair value of an equity investments that is not derecognised are components of the investor's performance is inconsistent with non-trading business models. In such business models, the performance is primarily assessed based on realised gains and losses as they are certain, and fair value fluctuations are only seen as indicators of potential and reversible gains and losses that remain uncertain.

Prohibiting the recycling of OCI on long-term investments does not provide a clear distinction between unrealised and realised gains and losses and implies to provide additional information on the movements recorded in OCI during the period to distinguish which gains and losses recorded through OCI are now certain because realised and which ones remain uncertain as they are still unrealised and then subject to reversal according to fair value fluctuations.

We do not see any reason to split the presentation of performance between dividend income recognised in the income statement and realised gains and losses presented in OCI. All components of the performance shall be presented in the same location, i.e. the income statement to provide users with a clear and understandable information.

Additionally, we do share views expressed by some stakeholders that consider the recycling as being complex. Presenting unrealised gains and losses in OCI and realised gains and losses in the income statement provides users with a clear and much more understandable information and helps them to assess the timing and the amounts of the cash flows generated by equity investments. Furthermore, we note that recycling is a well understood mechanism that did not generate questions from users of our financial statements during all the last decade as we applied it to non-trading equity investments (previously classified as Available-for-Sale Financial Assets).

Moreover, the prohibition of recycling realised gains and losses into profit or loss, as currently existing in IFRS 9 leads in most cases to a default classification of non-trading equity investments in the accounting category of “Financial assets at fair value through profit or loss”. All equity investments are then presented together, both trading ones and non-trading-ones which may be confusing for users and does not clearly make the distinction between the different underlying business models. We question then the relevance of such similar presentation and we hope that it will not generate negative incentive for long-term investments decisions.

Q2.1. What are your views on the arguments presented in paragraph 2.11-2.17? Do you consider that, from a conceptual standpoint, recycling should be accompanied by some form of impairment model? Please explain.

SG answer:

From a conceptual standpoint, we support the application of an impairment model for non-trading equity investments as a supplement to a recycling mechanism. It will contribute to an adequate representation of the expected cash-flows of such financial assets.

Such impairment mechanism currently exists in the IFRSs for assets that leads to an impact into profit or loss when they are derecognised and we do not see any conceptual reason to grant an exception for equity investments.

Impairment shall be then assessed on a timely basis, consistently with the notion of prudence, and the related impairment losses shall be recognised in the income statement when necessary and reversed when the impairment conditions are no longer met.

Q3.1. What are your views on the arguments and analysis presented in Chapter 3 of the DP?

Q3.2. Are there other improvements in presentation and disclosure that you would support?

SG answer:

We believe that disclosing information in the notes to financial statements can be useful when they provide explanations that help to understand the financial situation and the performance of the entity. These information's are then supplementing the figures provided in the primary financial statements but they cannot be an alternative to them.

We share EFRAG's view that enhancing disclosure is not sufficient to provide an adequate information. Above all else, gains and losses must be accounted for in the primary financial statement and more precisely in the income statement to provide users with a useful and understandable information.

Moreover, expecting so granular additional information could be disproportionate to the current need and inconsistent with the objectives of disclosure effectiveness, notably given the size of the different underlying equity portfolios that can exist in a group.

Q4.1. What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?

Q4.2. Which if either, of the two models do you prefer? Please explain.

Q4.3. Do you have suggestions for a model other than those presented in the DP? if so, please describe it and explain why it would meet characteristics such as relevance, reliability and comparability.

SG answer:

Objective of a robust model

We believe that a robust model for equity instruments shall permit to provide users with relevant and reliable information on the performance of the underlying business. Accordingly, as far as trading portfolios are not concerned, the model should not introduce short-term volatility in the recognition of performance that would then become inconsistent with the objectives of the business model. Therefore, measurement at fair value through OCI with unrealised gains and losses recycled through income on disposal would be more relevant for such instruments. The recycling should be complemented with an impairment mechanism ensuring the recognition of impairment losses where necessary and their reversal as soon as the impairment is no longer justified.

Relevance shall remain the first criteria to be considered, and we do not believe that the approach briefly described above would add any complexity to accounting treatments.

Assessment of the two proposed impairment models

The EFRAG has proposed two main impairment models that could be introduced as part of the fair value through OCI with recycling model. We do not support the revaluation model as it introduces in the income statement a volatility when fair value is below the original acquisition cost. As far as this volatility is inconsistent with the underlying business model of such non-trading equity investments, we do not consider that it would provide users with a relevant and consistent information. The underlying objective of the revaluation model, which remains the comparability, shall not overshadow the relevance criteria.

Nevertheless, should a revaluation model being adopted, the unit of account should be consistent with the management. It could then mitigate the drawback mentioned above when the underlying business model is conducted on a portfolio basis. A re-evaluation model based on a portfolio basis, consistently with the actual, documented and evidenced management of the entity, rather than on an asset by asset basis, would then provide users with much more relevant information.

Regarding the improvements proposed to IAS 39 model (additional guidance and disclosures on methodology), we consider that it could not be further explored without the introduction of an impairment reversal mechanism. We are convinced that the non-reversal feature of the former IAS 39 equity impairment model is the main reason of some misapplication of this impairment model and of the observed diversity of impairment criteria regarding the “significant or prolonged” decline in the fair value of the investment. Indeed, preparers would probably have calibrated their impairment trigger differently (i.e. at an earlier stage of unrealised loss) had the reversal of the impairment been possible.

Suggestion to improve the IAS 39 model

Having said that, we share EFRAG’s view that the model should be improved. Firstly, we propose to clarify the underlying driver used to assess the objective evidence of impairment. The current proposition is still based on the two “significant or prolonged” criteria, and we consider

that the most important one is the “prolonged” one as it is enough to assess the occurrence of a loss that has become highly probable or even quite-certain. The “significant” criterion is not consistent with medium or long-term investments as far as fair value can encounter successive decreases and recoveries over time.

Secondly, to avoid endless debates around thresholds, we propose to explore another approach for assessing the prolonged decline in the value of a long-term equity investment. We suggest retaining the concept of “value in use” to assess the existence of an objective evidence of an impairment. The concept is already applied in IFRS standards – i.e. defined by IAS 36 - and commonly understood by preparers and users. It could be then extended to financial assets when the business model applied is to hold these assets for a long period

The value-in-use measure is an entity specific measure determined in accordance with “future cash flows that the entity expects to derive from the assets” (IAS 36.6). It considers internal and external factors and notably, the intended holding horizon of the assets.

Consistently, impairment losses would be accounted for using the value in use of the equity instruments. It would then better approximate what is a “realised” loss in the context of a long-term investment.

Reversal of the impairment would follow a symmetrical approach to the impairment model, based on the measurement of the value in use to assess that the impairment loss no longer exists or has decreased.

Q5.1. Do you support the inclusion of quantitative triggers in an impairment model? If so, should an IFRS Standard specify the triggers, or should management determine them?

Q5.2. If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

SG answer:

We do not support the inclusion of quantitative triggers or thresholds within an impairment model.

Relevance shall remain the main driver of an impairment model like for any other accounting treatment. Comparability should be assessed as a secondary criterion to be applied when comparable underlying situations are contemplated. Comparability cannot be used a uniformization tool that would ignore the diversity of the underlying situations or business models as far as financial instruments are concerned.

We believe that the debate around the diversity of thresholds used under IAS 39 to assess the prolonged or significant decline in the value of an AFS equity investments has been merely caused by the prohibition of impairment reversal. Allowing reversal of impairments will aim at better apply the underlying objective of impairment, at enhancing relevance of gains and losses reported in the income statement and will contribute to a more consistent and relevant application of the so-improved standard.

Q6.1. How should subsequent recoveries in fair values be accounted for? Please explain.

Q6.2. If subsequent recoveries in fair values are recognised in profit or loss, which of the approaches in paragraphs 5.2.-5.10 do you support and why?

SG answer:

Based on an improved IAS 39 model which would use the concept of value in use to assess and to measure the impairment loss, the reversal would follow a symmetrical approach to the impairment model, based on the measurement of the value in use to assess that the impairment loss no longer exists or has decreased.

Q7.1. Do you consider that the same model should apply to all equity instruments carried under the FVOCI election? If not, why not and how would you objectively identify different portfolios?

Q7.2. Do you have comments on these other considerations?

Q7.3. Are there other aspects that EFRAG should consider?

SG answer:

Relevance shall remain the main driver of an impairment model like for any other accounting treatment. Comparability should be assessed as a secondary criterion to be applied when comparable underlying situations are contemplated. Comparability cannot be used as a uniformization tool that would ignore the diversity of the underlying situations or business models as far as financial instruments are concerned.

That is why we do not support the introduction of quantitative triggers (see our answer to question 5) and we favour an impairment model that takes into account the holding perspective of a non-trading equity financial asset by considering its value in use when assessing an impairment situation.

Other considerations - Unit of Account - Cost formula

As far as equity financial assets can be acquired in multiple steps, we consider that when amending IFRS 9 for equity investments, it will also be necessary to develop a cost formula and to specify then how to account for impairments gains and losses.

Others application issues (*Interactions with hedging requirements, Interactions with changes in Foreign exchange rates, Timing of impairment tests & interaction with interim reporting*)

The additional questions raised by the EFRAG are relevant but we believe that further analysis and developments will be then necessary. But we also believe that such further works should be performed only once the underlying accounting model will have been built.

Q8.1. Are there other aspects of IFRS9's requirements on accounting for holdings of equity instruments, in addition to those considered in the DP, which in your view are relevant to the depiction of the financial performance of long-term investors? Please explain.

SG answer:

Long-term equity investors may hold their equity investments directly or indirectly, for example through Undertakings for Collective Investments Transferable Securities (UCITS), Exchange Traded Funds (ETFs) or Authorized Investment Funds (AIF). Excluding these investments, because of their debt classification under IAS 32, leads to a non-comprehensive analysis of the long-term investment business model.

We believe that such indirect investments should also be considered in the present study and that the issue could be addressed as well in the light of the current IASB's FICE projects ("Financial Instruments with Characteristics of Equity").