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## **EFRAG Equity Instruments - Impairment and Recycling**

### **Cover Note**

#### **Objective of the session**

- 1 In May 2017 EFRAG received a request for technical advice from the European Commission in relation to the accounting treatment of equity instruments carried at fair value through OCI under IFRS 9.
- 2 The original deadline to submit the EFRAG's advice was the end of the second quarter. EFRAG has agreed an extension of the deadline until the end of September. To meet this new deadline, the EFRAG Board will need to approve the technical advice either at this meeting or in September. The objective of this session is to submit the EFRAG TEG's recommendation for technical advice to the EFRAG Board.

#### **Background of the project**

- 3 The IASB issued IFRS 9 *Financial Instruments* in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI election'). This FVOCI election is not available for equity instruments that are held for trading or are contingent consideration recognised in a business combination. The entity may apply the FVOCI election on an instrument-by-instrument basis.
- 4 If the entity applies the FVOCI election, changes in 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 these instruments for impairments. Dividends from the instruments are however recognised directly in profit or loss.
- 5 In the Basis for Conclusions of IFRS 9, the IASB notes that one of the primary reasons for not allowing recycling is that it would create the need to assess these equity instruments for impairment. The IASB also noted that the application of impairment requirements of available for sale ('AFS') equity instruments in IAS 39 *Financial Instruments: Recognition and Measurement* were very subjective.
- 6 In its Endorsement Advice on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL may 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 gains and losses may not properly reflect their performance.

- 7 EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9. However, EFRAG acknowledged that its assessment was based on the limited evidence available at that time.

**The request for technical advice**

- 8 In May 2017, the European Commission sent a request for technical advice to EFRAG. The request had two distinct phases: an assessment phase and a possible solutions phase:
- (a) in the assessment phase, the EC asked EFRAG to collect quantitative information about current holdings of equity instruments and their accounting treatment. The EC also requested EFRAG to obtain information of the entities' expectations in relation to:
    - (i) the extent to which they plan to use the FVOCI election and the factors that will influence their choices; and
    - (ii) the anticipated effects of the new requirements in IFRS 9 on their decisions to invest in equity instruments or other categories of financial assets and their holding periods (including quantification where possible).
- 9 In the possible solutions phase, the EC asked EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is a precondition to re-introduce recycling, then EFRAG is asked to consider how the existing impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches, possibly by looking at other national or third-country Generally Accepted Accounting Principles. EFRAG is also asked to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could be used to provide users with the necessary information to make the adjustments deemed necessary to the reported profit or loss.

**Scope of EFRAG project**

- 10 During the development of the project, the following topics were addressed:
- (a) Whether the reintroduction of recycling of disposal gains or losses would improve the reporting, in particular for long-term investors;
  - (b) The significance of an impairment model to the re-introduction of recycling of disposal gains or losses of equity instruments; and
  - (c) What would be a robust impairment solution.
- 11 The following aspects of IFRS 9 on accounting for investments in equity instruments were not addressed in the project:
- (a) Equity instruments are carried at fair value in the statement of financial position;
  - (b) Entities are allowed (but not required) to designate equity instruments to be carried at FVOCI;
  - (c) The election is voluntary and is open to all instruments that are not held for trading;
  - (d) The election is available on an instrument-by-instrument basis and is irrevocable.
- 12 EFRAG also did not address the definition of equity instruments and what instruments qualify as such.

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- 13 In June, the European Commission sent a second request for technical advice. The EC asks EFRAG to explore alternative accounting treatments to fair value measurements for long-term investment portfolios of equity and equity-type instruments. The alternative treatments should properly portray the performance and long-term risks of long-term investment business models, in particular for those equity and equity-type investments needed to sustain the United Nations Sustainable Development Goals and the goals of the Paris Agreement on climate change.

### **EFRAG TEG recommendation**

- 14 At its 5 July meeting, EFRAG TEG voted on the overall advice. EFRAG TEG voted with 10 votes in favour, 5 against and one abstention, to recommend that recycling should not be reintroduced at this stage.
- 15 Considering that mixed views were expressed both by EFRAG TEG members and respondents to the Discussion Paper, it was agreed that the technical advice would:
- (a) reflect also the arguments of those recommending changes to the requirements; and
  - (b) address the questions asked in the EC request concerning the relevance of an impairment solution for the reintroduction of recycling and what characteristics an acceptable impairment solution would have.
- 16 In relation to (b) above, EFRAG TEG at its 25 July meeting decided that it would not express a preference on the impairment solution. Therefore, the technical advice illustrates the two solutions presented in the EFRAG DP and the comments from respondents, but does include an EFRAG TEG recommendation.

### **Agenda papers**

- 17 In addition to this cover note, the following papers have been provided for the session:
- (a) **Paper 05-02** – draft technical advice revised to reflect the decisions and comments from EFRAG TEG;
  - (b) **Paper 05-03** – draft working plan to address the second request for technical advice;
  - (c) **Paper 05-04** – detailed summary of replies to the EFRAG DP (for background only).