

Warsaw, 22 May 2018

Jean-Paul Gauzès  
EFRAG Board President  
35 Square de Meeûs  
B-1000 Brussels

**Equity instruments - impairment and recycling - EFRAG Discussion Paper March 2018**

Dear Mr. Gauzès

As the Polish Accounting Standards Committee (PASC) formally completed its two-year term of office on 12 May 2018, the Accounting and Auditing Department of the Ministry of Finance would like to provide EFRAG with the following documents attached:

- the PASC opinion on EFRAG's Discussion Paper „Equity Instruments – impairment and recycling” (Annex 1),
- the PASC answers to detailed questions put by EFRAG (Annex 2),
- remarks and additional general comments of the PZU Capital Group on IFRS 9 application obtained by the PASC (Annex 3).

Yours sincerely,

*Joanna Dadacz*



Director

Accounting and Auditing Department

Ministry of Finance

*e-mail: sekretarz.KSR@mf.gov.pl*

## **Annex 1**

PASC opinion on the Discussion Paper of EFRAG concerning the possible future amendments to IFRS 9 in the area of the accounting for equity instruments. The opinion is based mainly on the input provided by the Polish Financial Supervision Authority.

PASC generally welcomes the EFRAG's efforts in the area of accounting for equity instruments and is aware of a possible need for amendments stemming from the potential effects on long-term investments of the requirements of this standard. Nevertheless, having in mind that IFRS 9 application became effective just very recently (1 January 2018), the introduction of amendments to this standard seems to be premature. At this stage in Poland there are no financial statements yet available which would be prepared under the new IFRS 9 requirements, and there is a lack of reliable financial information on the market practice and factual quantitative data that would describe the impact of this new standard on the financial statements. In our opinion the introduction of amendments to the new standard in the nearest future is not an appropriate approach which would hinder the elaboration of more appropriate and reliable solutions in the area of equity instruments.

With regard to the proposed in the DP introduction of the possibility to recognize cumulative gain or loss on disposal in the profit or loss in case of equity instruments measured at fair value through other comprehensive income (FVOCI) – so called “recycling” – PASC would like to point out that it is not convinced that recycling of gain or loss on the disposal [similar to the previous Available-for-Sale (AFS) under IAS 39] would contribute to the maintenance of appropriate quality of the financial statements. Recycling of gain or loss on financial instruments (except for preserving such types of operations in the hedge accounting) provides broad possibilities of manipulating the profit or loss for the period, especially of creating interim profits.

Therefore it is difficult to assess currently the real need for introducing additional revaluation or impairment models, for extending the presentation or disclosure requirements, for adding quantitative presumptions or thresholds to the impairment models or for differentiating the impairment models as described in the EFRAG's DP.

In PASC's view a significant flaw of the so called “recycling” is the lack of unambiguous criteria of recycling application – it is a systemic / conceptual flaw causing the decrease of the reliability of financial statements, especially as the previous IASB's decisions in relation to particular assets seemed to be quite arbitrary. PASC is of the view that a general model should be elaborated – at the level of the Conceptual Framework – which would allow for a clear qualification of gain or loss items that should be subject to recycling. However, IASB is still avoiding this issue, similarly as the issue of providing reasonable criteria for recognizing gain or loss in profit or loss for a period or in other comprehensive income. PASC is of the opinion that EFRAG's potential could contribute to support the IASB in reaching solutions in those problematic areas.

PASC members expressed also an opinion that suggested changes in the hedge accounting (recognition of changes in the fair value of hedging instruments in OCI) and maintenance of measurement of equity instruments set out in the interim financial reports (half year financial statements) also for the balance sheet date are unjustified. The requirements in those areas

have been set out for many years, are well known to the market participants and ensure a stable reporting.

## **Annex 2**

**Q1.1 What are your views on the arguments presented in paragraphs 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.**

The existing provisions of IFRS 9 (the FVOCI option) allow for the elimination of volatility in profit or loss both during the holding period and for the period of disposal. It also removes the possibility of selective profit-taking at the end of the reporting period. Given that accumulated gain or loss on an instrument relates to performance over the entire holding period, in our view reintroduction of recycling would not reflect the entity's financial performance, or management's stewardship, for the period in which equity instruments were disposed of. We agree with the argument presented in par. 2.8 of the discussion paper.

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

As described in par. 2.15 and 2.16, the reintroduction of recycling for equity instruments measured at FVOCI may lead to the hazard of maintaining loss-making investments, which in turn requires the burdensome implementation of an impairment model which would result in an asymmetric treatment of gains and losses. In our view, the prospect of these cascading difficulties is an additional argument against the reintroduction of recycling. We would also like to point out that the default FVPL measurement requirement for equity instruments provides the incentive to dispose of loss-making investments and leads to symmetric treatment of the changes in value of the investment.

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

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

We do not support the idea of introducing any new disclosure regarding the performance for long-term investments. We believe the proper application of the current requirements of IFRS 7 and IFRS 13 should result in ample disclosures without the risk of overloading the financial statements.

In our opinion the entities should use the current IFRS 9 requirements for FVOCI election and no changes should be introduced in such a short period of time.

**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.**

We don't support the idea of reintroducing recycling and impairment for equity instruments measured at FVOCI. Nevertheless, if the hypothetical reintroduction is considered, we would prefer the revaluation model with changes in a fair value below and above the original acquisition cost recognised respectively in profit or loss and in OCI. This method eliminates the lack of objectivity and comparability and does not require defining quantitative thresholds that are not in line with a principles-based approach.

In our view, the general objective and main feature of a robust model for equity instruments should follow IAS 1 par. 15 principle (fair presentation). It should also be relevant, reliable, ensure comparability and reflect adverse changes in the economic situation of an entity.

**Q5.1 Do you support the inclusion of quantitative impairment 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?**

Q5.1 With regard to our opinions above, we do not support inclusion of quantitative triggers in impairment models at the present moment.

Q5.2 In our opinion, relevant standard setting bodies shall wait for the actual outcome of IFRS 9 implementation in order to get knowledge about impact and comparability of the new requirements among entities.

**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?**

Q6.1 Subsequent recoveries in fair values for equity instruments at FVOCI election should be accounted for in OCI, according to the current principles – until relevant changes are justified, taking into account the impact of IFRS 9.

Q6.2 We do not support recognition of fair values in profit and loss for equity instruments at FVOCI election.

**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?**

Q7.1 In our opinion, relevant standard setting bodies shall wait for the actual outcome of IFRS 9 implementation in order to get knowledge about the necessity of changes in impairment models.

Q7.2 We are against the changes proposed in regard to hedging accounting (par. 5.32 of the document) and any changes in regard to annual reporting principles (par. 5.37-5.40). In our opinion, the annual reporting should reflect the value of equity instruments at the reporting date. In regard to hedging – the same valuation and presentation principles that are familiar to market participants are obligatory for a long period of time. These principles ensure stable reporting.

Q7.3 We do not have any additional suggestions.

**Q8.1 Are there other aspects of IFRS 9'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.**

Q8.1 We are providing the comments made by the PZU Capital Group regarding general problems in the IFRS 9 application resulting in particular from a very specific group structure, in which the ultimate parent entity is an insurer and among its subsidiaries there are two big banks (a usual situation is when the bank is the ultimate parent) – Annex 3.

## Annex 3

### Comments provided by PZU Capital Group

Re: EFRAG Discussion Paper on Equity Instruments – Impairment and Recycling

With reference to your query of 17 April 2018 regarding the EFRAG consultation materials regarding recognition of measurement and impairment of equity instruments, please find below the position of the PZU Group.

Equity instruments measured at fair value through other comprehensive income do not constitute a major part of the investment portfolio of PZU Group companies. As a result of implementation of IFRS 9 as at 1 January 2018, pursuant to paragraph 5.7.5, for certain equity instruments, PZU Group companies made an irrevocable election regarding the presentation of their subsequent fair value changes in other comprehensive income. This is justified especially in the case of long-term investments of strategic nature, in order to ensure that market fluctuations, the geopolitical situation, market cycles, perception of emerging markets by global investors etc., resulting in potential significant fluctuations of the market valuations of the investments in question do not impact on the Group's financial result reported on an ongoing basis.

In the case of instruments which have been classified in the Group companies into the category of fair value measurement through other comprehensive income, the designation has been made on the basis of an assumption of irrevocable recognition of fair value changes in other comprehensive income. However, the valuations of the investments in question are difficult to predict in the long run (in particular if it exceeds 10 years). In this context, for this type of investments, in our opinion it would make sense to consider special optional conditions making it possible to recognize some or all of the results of measurement of such investments in the profit and loss account, especially at the time of realization of such investments. Such a solution would make it possible, among others, to share realized profits with the shareholders, and reduce future dividends by realized losses.

Taking advantage of the opportunity, we would like to share certain issues which we identified during the work on implementation of IFRS 9 in the PZU Group, in particular on the consolidation level, with a request to convey them together with other comments to EFRAG.

The PZU Group comprises two big banks subject to consolidation: Alior Bank SA and Bank Pekao SA, for which, due to the type of their activity, the implementation of IFRS 9 was a strategic challenge, requiring many months of preparations and significant investments in IT systems.

The new rules for recognizing expected credit risk losses make the method and amount of the losses dependent on change of the credit risk from the moment of initial recognition of the financial instrument. From the perspective of the banks' financial statements, the moment of initial recognition of the financial instrument is its creation or acquisition. However, from the perspective of the PZU Group's consolidated financial statements, the initial recognition takes place at the time of obtaining control over each of the banks. As a consequence, the level of change of the credit risk for the bank may be completely different from the changes from the

perspective of the PZU Group, which causes significant differences in the amount of the required expected credit risk losses (12 months vs. lifetime credit losses).

Additionally, the loans for which there was an impairment identified in the banks at the time of obtaining control, in subsequent periods may be subject to the so-called curing as a result of reduction of the credit risk. However in accordance with prevailing regulations, for the PZU Group, impaired instruments purchased as a result of a business combination transaction will be the so-called POCI and will be subject to losses throughout their lifetime without the possibility of curing them and reducing to the 12-month expected credit losses. In our opinion, this does not reflect the economic nature of these loans in the long run.

Another issue is the overlap of two standards in the consolidation: IFRS 9 and IFRS 3 pertaining to business combinations. As at the date of obtaining control, the banks' financial assets were measured for consolidation purposes at fair value and the credit risk was taken into account in their valuation as a result of purchase price allocation (PPA). At the time of transition to IFRS 9, the banks calculated the expected credit losses, as a result of which, for instruments which were in the portfolios at the time of obtaining control, the credit risk was included in the measurement once again. As a consequence, it is necessary to make additional consolidation adjustments to eliminate the double recognition of the credit risk and correctly settle them in subsequent periods, as a result of which net interest income and the losses shown by the banks may significantly differ from those shown on the consolidated level.

In our opinion, the above issues significantly hinder the analysis of the consolidated financial statements and interpretation of the consolidated financial results of the PZU Group, which may materially differ from the results presented by the banks on the level of their consolidated financial statements. PZU, Alior Bank SA and Bank Pekao SA are listed on a single capital market (WSE) and report on similar dates, in an identical regulatory regime and according to identical accounting standards (IFRS). Such discrepancies cause a permanent dualism of results, which is difficult to explain, unpredictable and causing confusion among the users of financial statements (including investors and analysts) as regards issues of key importance for financial results (net interest income, bank credit losses).

The hindered forecasting of the PZU Group's financial results involving increased uncertainty and unpredictability will in the long run have negative impact also on the valuation of PZU's shares.

It should be noted that the loan portfolios of the banks are managed on their level (rather than on the PZU level, which results, among others, from the banking law). As a consequence, adoption of a different approach for the needs of PZU Group's consolidated reporting, where the parent company is an insurance undertaking, seems to be a questionable paradox.

The banks' records required to settle and report the differences between the banks' financial statements and the consolidation packages for the needs of the PZU Group correctly and in full compliance with the current provisions of IFRS 9 requires, in practice, implementation of separate systems dedicated only to consolidation, which will generate additional costs (IT and HR) and delays in reporting.

An alternative is to apply significant simplifications, which is not a perfect solution either.