EFRAG
European Financial Reporting Advisory Group

Alain Deckers
Head of Unit, Corporate reporting, audit and credit rating agencies,
European Commission
DG Financial Stability, Financial Services and Capital Markets Union
1049 Brussels

30 January 2020

Dear Mr Deckers,

Re: EC Request for technical advice on alternative accounting treatments for long-term equity investments

Following your request for advice sent on 1 June 2018 ('the EC request'), EFRAG is pleased to provide its advice on possible alternative accounting treatments to measurement at fair value through profit or loss ('FVPL') for equity instruments.

EFRAG has been requested by the European Commission ('EC') to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are much needed for achieving the *UN Sustainable Development Goals* and the goals of the *Paris Agreement on Climate Change*.

EFRAG advises, in particular, that the EC recommend to the IASB an expeditious review of the non-recycling treatment of equity instruments within IFRS 9 *Financial Instruments* ('IFRS 9'), testing whether the revised *Conceptual Framework for Financial Reporting* (March 2018) ('Conceptual Framework') would justify the transfer to profit or loss ('recycling') of fair value gains and losses accumulated in other comprehensive income ('FVOCI gains and losses') on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

The Annex illustrates the basis for this conclusion, together with EFRAG's recommendations with reference to the impairment model and the treatment of equity-type instruments.

In the course of developing its response to the EC request, EFRAG considered the outcome of a public consultation conducted to collect input to this advice '2019 public consultation' (presented in the *Feedback Statement* attached to this letter) and a technical assessment of the possible alternative accounting treatments (presented in the *Supporting Material* attached to this letter). This letter should be read in conjunction with these two documents.

On behalf of EFRAG, I am happy to discuss our reply with you, other officials of the EC or the Accounting Regulatory Committee, as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Attachments

- *Feedback Statement on Alternative Approaches for Equity Instruments*
- *Supporting Material – Alternative Approaches for Equity Instruments*

Annex: Basis for conclusion

IFRS 9 accounting treatment and the FVOCI option for equity instruments

1 EFRAG received 63 responses to its 2019 public consultation[1], aimed at collecting constituents' views on the EC request. The number of responses confirms that this is a topic that generates considerable interest in Europe, specifically, but not exclusively, for the financial sector. The European industry associations of Insurance, Saving Banks and Asset Managers, in their capacity as investors, responded to this consultation. EFRAG also received letters from the European associations of auditors and financial analysts. European Security and Markets Authority (ESMA), the European Central Bank (ECB), and 8 National Standard-Setters (NSS) also shared their positions while responding to the consultation.

2 Responding to the EC request is challenging, as there remains the need for definitions of long-term investment business model ('LTIBM') as well as for sustainable investments. At this stage, there are no accounting definitions to appropriately support the EC request. The following key messages emerged from the 2019 public consultation:

   a. there was no consensus on a definition for LTIBM. Seventeen percent (17%)[2] of respondents provided a definition close to their business model: for example 8%[2] of respondents suggested that the focus should be on effective asset-liability management, aimed at matching the investments with long-term insurance/savings liabilities. Thirty percent (30%)[2] of respondents considered it unnecessary to define LTIBM and preferred to rather focus on whether equity instruments are held for non-trading purposes; and

   b. on sustainable investment, there were no fully-fledged definitions proposed during the consultation that could be used in standard-setting. Twenty-two percent (22%)[2] of respondents considered that the 'sustainable' nature of the activities should not be a distinguishing feature in accounting. EFRAG notes that the ongoing work by the EC on its taxonomy for sustainable finance may provide a basis in this regard in the future.

3 EFRAG notes that the *EC Action Plan (March 2018)* ('Action Plan') to achieve sustainable growth aims at mobilising more private capital for sustainable projects (such as transport, energy and resource management infrastructure) and considers that availability of private capital plays a key role to reach the objectives set out in the Action Plan. Investments in infrastructure are financed through multiple channels. Direct and indirect equity holdings by institutional investors (including insurance entities and banks) play a relevant role in this context. IFRS 9 has changed the accounting treatment for equity instruments that were previously classified in the Available for Sale ('AFS') category under IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39'). Some stakeholders have raised concerns that these changes may not be conducive to long-term investing in equity instruments.

4 In a context where IFRS 9 has been recently implemented and is substantially still not applied by the insurance sector, its potential impact on long-term investment cannot be assessed based on actual data. Therefore, no compelling evidence has come to the attention of EFRAG that accounting is an impediment or not to long-term investment.

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[1] For a detailed illustration of the responses refer to the *Feedback Statement* attached to this letter.

[2] % of the respondents that addressed the relevant question. The survey allowed for multiple selection of answers. Not all the respondents addressed all the questions.

5 EFRAG notes that asset allocation decisions are driven by a plurality of factors and that it is difficult to disentangle the impact of accounting requirements from that of other factors, such as expectation on future returns by class of assets or other regulations, including taxes and prudential requirements. Furthermore, EFRAG notes the work already undertaken by ESMA, the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA) in response to the EC request on Sustainable Finance, where the European Supervisory Authorities are assessing potential sources of undue short-termism. EFRAG also notes the ongoing debate on how to enhance broader corporate reporting on the basis of the lessons learnt from the first year of the application of the Non-Financial Reporting Directive ('NFRD'), in order to enhance the consistency and comparability of non-financial information disclosed throughout the EU.

6 In the 2019 public consultation, respondents expressed mixed views on whether an alternative accounting treatment is needed to portray the risks and performance of equity and equity-type instruments held in a LTIBM. Seventy (70%) of respondents considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments. However, 30% of respondents did not consider that an alternative accounting treatment is needed.

7 Seventy-eight percent (78)% of those who supported an alternative treatment (corresponding to 52% of the total respondents) favoured a model based on fair value through other comprehensive income ('FVOCI') with recycling and impairment, with a scope that is similar to the FVOCI option under IFRS 9. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9.

8 Nearly all respondents from the insurance and asset management industry, together with a large majority of the banks and non-financial corporates, supported the need for an alternative accounting treatment. Users and NSS had split views. The users who supported an alternative treatment (half of the users who responded) mainly supported the FVPL model for all equity instruments. NSS who supported an alternative prefer FVOCI model with recycling; NSS who did not support an alternative, mainly believed that more evidence is needed before a change is proposed. Respondents from the accounting/audit profession and regulators did not consider that an alternative treatment is needed, mainly because at this stage there is no evidence to support such a need.

9 EFRAG considers that equity instruments should be measured at fair value on the face of the statement of financial position. The discussion of an alternative accounting treatment should focus on *when* fair value changes should be recognised and *where* they should be presented.

10 With reference to FVOCI without recycling, EFRAG is aware that this requirement in IFRS 9 is considered to be the result of a compromise, as explained in the Basis of Conclusions to IFRS 9. The IASB considered that:

(a) fair value provides the most useful information about equity investments to users. However, the IASB noted arguments that presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment [IFRS 9.BC5.22];

(b) a gain or loss on those investments should be recognised once only. Therefore, recognising a gain or loss in other comprehensive income ('OCI') and subsequently transferring it to profit or loss is inappropriate [IFRS 9.BC5.25] and

(c) recycling of gains and losses to profit or loss would create the requirement to assess the equity instrument for impairment, which had created application problems [IFRS 9.BC5.25].

11 EFRAG notes that the Conceptual Framework (§7.19), which was revised after the issuance of IFRS 9, sets that in principle income and expenses included in OCI in one period are reclassified from OCI to the statement of profit or loss in a future period, when doing so results in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that future period. If there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the IASB may, in developing Standards, decide that income and expense included in OCI are not to be subsequently reclassified.

12 EFRAG notes that, as illustrated above, the IFRS 9 non-recycling requirement has been justified by the IASB on the basis of the lack of an impairment approach that would have to accompany recycling and because, in the IASB's view, gains or losses for the equity instruments under the FVOCI option should be recognised once only. IFRS 9 does not offer a conceptual reason to exclude recycling on the basis of any of the reasons listed above.

13 Incidentally, beyond the EC request and EFRAG's 2019 public consultation, the December 2019 IASB Accounting Standard Advisory Forum meeting discussed inputs received on the topics to consider in the forthcoming public consultation on the IASB future Agenda, planned for the second half of 2020. The input collected shows that stakeholders recommend that the IASB should test whether the IFRS Standards that permit or require non-recycling are consistent with the Conceptual Framework. The need for such a test was highlighted both in general terms for IFRS Standards and with specific reference to equity instruments that are accounted for using the FVOCI option under IFRS 9.

14 The 2019 public consultation indicated that 70% of respondents supported a change to IFRS 9, noting that FVPL creates volatility in profit or loss that does not permit an appropriate reflection of the business model of long-term investors. However, it should be noted that many defined 'long-term' as other than held-for-trading. On the other hand, FVOCI without recycling has not been identified as a workable alternative. Those in support of this view argue that the reclassification of gains or losses from OCI to profit or loss, when realised, provides relevant information about the entity's performance. Finally, 25%[2] of respondents concluded that the requirements in IFRS 9 could discourage investment in equity instruments. Quantitative evidence is still lacking at this stage to determine if this view is correct or not.

15 The feedback from 2019 public consultation summarised above, shows an expectation from the financial sector, including the insurance sector, that the applicable accounting treatment is relevant to the objective of reducing or preventing detrimental effects on long-term investment. In addition, the feedback has shown that there is a strong view from insurance entities, banks, asset managers and self-defined long-term investors, but also from non-financial corporates, that an alternative accounting treatment is needed for equity instruments under IFRS 9 to properly portray the performance and risks of equity instruments held in a LTIBM. As mentioned above, the views of users of financial statements and NSS were split.

16 Actual impact data do not exist at this point in time to confirm whether the views reported above are correct or not, in particular as European entities from the insurance sector, which are also institutional investors, do not apply IFRS 9 yet. However, most respondents are justifying their views on the basis of conceptual, managerial and strategic reasons.

17 In conclusion, EFRAG advises that the EC recommend to the IASB an expeditious review of 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. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

Impairment model (including the EFRAG advice to the EC of November 2018)

18 In the 2019 public consultation, approximately 28%[2] of respondents considered that an improved version of the IAS 39 impairment model could be used as a way forward. These respondents considered that a robust impairment model can be developed without undue costs by using the IAS 39 impairment model as a starting point, with additional guidance to reduce subjectivity in its application. However, respondents who did not support an alternative accounting treatment noted that additional impairment requirements have proven to be difficult to agree upon and would introduce additional complexity into financial reporting which is unlikely to benefit users of the information.

19 In its November 2018 advice to the EC, EFRAG noted that the reintroduction of recycling for equity instruments carried at FVOCI would require a robust impairment model.

20 In the 2019 public consultation, 52%[2] and 78% of those who supported the need for an alternative accounting treatment to the current IFRS 9 treatment for equity instruments proposed the introduction of recycling using the impairment model in IAS 39 as a basis for a new model, with improvements. EFRAG supports such an approach in principle.

21 In 2018, EFRAG noted also that the IASB concluded that the IAS 39 impairment model was unduly subjective, and ESMA 's findings confirmed that it was not applied consistently in practice.

22 As a result, EFRAG suggests improvements to the IAS 39 impairment approach, such as clarifying the terms ‘prolonged’ and ‘significant decline’. Feedback to the previous EFRAG survey[3], highlighted that there was no consensus on how to reach an appropriate balance between relevance of the resulting financial information and comparability of accounting policies among preparers. Some respondents stressed the need to achieve a sufficient level of comparability which could likely be achieved only if the Standard included general quantitative thresholds or rebuttable presumptions.

23 Some respondents to the 2019 public consultation proposed thresholds for the decline in fair value, such as longer than six months and more than 20%, below cost for longer than 12 months or more than a specified quantitative trigger. Others opposed this because they consider that the impairment solution should prioritise relevance over comparability, and therefore that each entity should set its own thresholds.

24 EFRAG considers that a degree of rigour in the use of the election or the impairment model would be essential to ensure comparability and therefore suggests combining quantitative indicators and the exercise of judgement within appropriate limits and with appropriate disclosures in the notes.

25 EFRAG also concluded[3] that, contrary to the IAS 39 model, the new impairment model should allow reversal of impairment losses. If a decline in the value of an equity instrument is recognised in profit or loss because it results from an adverse change in the economic condition of the issuer, subsequent recoveries in value that

[3] EFRAG’s response to the European Commission dated 28 November 2018.

result from a reversal of that adverse change should similarly be recognised in profit or loss. This was confirmed in the current consultation as mentioned above.

Treatment of equity type instruments

26 In relation to accounting for investments in units of funds under IFRS 9, EFRAG is sympathetic to the concerns on the accounting at FVPL, as opposed to FVOCI. EFRAG supports that similar fact patterns should be treated similarly, and notes that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32 *Financial Instruments - Presentation*.

27 EFRAG considers that any changes to the accounting for these instruments, aimed at allowing for direct and indirect equity instruments to be treated similarly for accounting purposes, would require careful consideration. It would be necessary to evaluate the challenges of developing an appropriate standard setting solution and considering knock-on effects on the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and the ability to assess the nature of the underlying assets and business model at the level of the fund itself.

28 In the 2019 public consultation, suggestions of relevant criteria have been made by stakeholders, in order to select units of funds that could become eligible to the equity accounting treatment and prevent unintended consequences. As a working assumption, EFRAG has considered that the definition of equity-type instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.