Mr. Jean-Paul Gauzès
President of the EFRAG Board
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Submitted via website

Brussels, 24 May 2018

Subject: EFRAG Discussion Paper on Equity instruments – Impairment and recycling

Dear Mr. Gauzès,

We are pleased to respond to EFRAG's Discussion Paper concerning Equity instruments – Impairment and recycling.

EFRAG's findings from its assessment phase show that the majority of the respondents do not expect to modify their holding period for equities following the introduction of IFRS 9. In addition, less than half of the respondents expect to modify asset allocation decisions without giving an indication of direction or magnitude. The majority of those entities are insurance companies. Most insurance companies will defer the application of IFRS 9 until 2021 to align the effective date with that of IFRS 17 and are still assessing the interaction between those two standards, including any potential mitigating effects of applying the 'variable fee' approach. As such we think it is too early to conclude whether IFRS 9 (potentially in conjunction with the accounting model in IFRS 17) affects any asset allocation decisions to the disadvantage of long-term equity investments. We acknowledge that many of the arguments in favour of recycling have been considered by the IASB as part of the due process, but on balance have been dismissed by the Board.

Most entities have just completed their IFRS 9 implementation. Our recommendation would be to observe how practice evolves and to reconsider the potential issues as part of the IFRS 9 Post-Implementation Review (PIR). Given the concerns expressed primarily by the insurance industry, it would be desirable for the PIR to be performed before the effective date of IFRS 17 (2021).

We also do not believe that a 'carve-in' or 'carve-out' at EU level would be the appropriate instrument to tackle a potential issue. As mentioned in the previous paragraph, we recommend addressing potential problems as part of the IFRS 9 PIR executed by the IASB.

Having said this, we find it important to contribute to the discussion, which has been initiated by the European Commission. Hence, we include an overview of possible alternatives to the current FVTOCI approach for equity instruments, supplemented with their benefits/disadvantages, in an annex to our response (Annex 2). We trust this analysis will contribute to the discussion in a constructive manner.

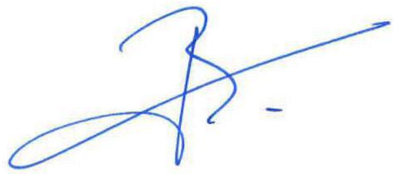
Some of our members believe that FVTPL is the appropriate approach for equity instruments. They acknowledge that the IASB included the FVTOCI option to cater for strategic investments as it was not able to agree on a sufficiently robust definition. To reflect the objective of such holdings, they deem it appropriate not to recycle any gains or losses in OCI as they do not form part of an entity's core performance. Furthermore, recycling would recognise gains or losses that do not relate to the accounting period, but also to prior reporting periods – which also seems not to be reflecting performance of the period appropriately. Having no recycling also mitigates the requirement to develop an impairment model for equity instruments, which would need an overhaul given the experience with the 'prolonged or significant decline' model in IAS 39. Not allowing for recycling also reduces the earnings management potential arising from a management decision to sell to arrive at a particular P&L impact. There is academic evidence[1] that shows that such potential is actually used by management and not only a theoretical possibility.

Other members believe that recycling provides a better reflection of an entity's performance and the underlying business model, especially in the insurance and utilities' industry. Their opinion is mainly based on the fact that realised and unrealised gain and losses are of different nature. They consider that this distinction is relevant information for users that shall be presented directly in the primary statements rather than simply in the disclosures. They also acknowledge the need for an impairment model under this approach and prefer to apply the revaluation model suggested in the DP for its simplicity and objectivity as it does not involve management discretion as when to recognise losses.

We also would like to highlight another issue that relates to the DP, namely the accounting treatment of fund investments from the perspective of the holder. Given the IFRIC agenda decision on 'financial assets eligible for the election to present changes in fair value in other comprehensive income' it is now clear that fund units (such as UCITs) don't qualify for the FVTOCI option. This is perceived by some to put indirect investments at disadvantage to direct investments from an accounting perspective. The investment industry is now proposing certain tailored solutions to avoid such disadvantages: mandates/consolidated funds with higher administrative burdens, increased costs, and loss of diversification from which only the large corporates will be able to benefit from. This topic may be considered within the FICE project but we would recommend that any PIR on the application of the FVTOCI option should also provide appropriate analysis of this issue.

Please do not hesitate to contact Ben Renier (Ben@accountancyeurope.eu) in case of any additional questions or remarks.

Sincerely,



Olivier Boutellis-Taft
Chief Executive

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[1] *See Barth et al., Bank earnings and regulatory capital management using available for sale securities, Review of Accounting Studies 22 (4), p. 1761-1792*

ANNEX 1 – DETAILED RESPONSE

(1) We are pleased to present below our detailed responses to the questions.

Question 1: Recycling gains or losses on disposal

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.

(2) The question of ‘recycling’ is actually raising a broader issue of how performance should be reflected in the financial statements. OCI is part of the statement of comprehensive income and as such contributes to the measurement of performance. On the other hand, many still measure performance solely based on P&L indicators, including net profit/loss and/or other aggregates. The appropriate accounting model could as such vary depending on how users believe that performance should be reflected.

(3) Some of our members believe that FVTPL is the appropriate approach for equity instruments. They acknowledge that the IASB included the FVTOCI option to cater for strategic investments as it was not able to agree on a sufficiently robust definition. To reflect the objective of such holdings, they deem it appropriate not to recycle any gains or losses in OCI as they do not form part of an entity’s core performance. Furthermore, recycling would recognise gains or losses that do not relate to the accounting period, but also to prior reporting periods – which also seems not to be reflecting performance of the period appropriately. Having no recycling also mitigates the requirement to develop an impairment model for equity instruments, which would need an overhaul given the experience with the ‘prolonged or significant decline’ model in IAS 39. Not allowing for recycling also reduces the earnings management potential arising from a management decision to sell to arrive at a particular P&L impact. There is academic evidence[2] that shows that such potential is actually used by management and not only a theoretical possibility.

(4) Other members believe that recycling provides a better reflection of an entity’s performance and the underlying business model, especially in the insurance and utilities’ industry. Their opinion is mainly based on the fact that realised and unrealised gain and losses are of different nature. They consider that this distinction is relevant information for users that shall be presented directly in the primary statements rather than simply in the disclosures. They also acknowledge the need for an impairment model under this approach and prefer to apply the revaluation model suggested in the DP for its simplicity and objectivity as it does not involve management discretion as when to recognise losses.

Question 2: Conceptual relationship between recycling and impairment

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.

(5) From a conceptual point of view, we agree that recycling, if re-introduced, should always be accompanied by some form of impairment (or equivalent) model.

[2] *See Barth et al., Bank earnings and regulatory capital management using available for sale securities, Review of Accounting Studies 22 (4), p. 1761-1792*

Question 3: Enhancing presentation and disclosure requirements

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?

(6) We agree that enhanced presentation and disclosure requirements would not be an adequate substitute for improving the depiction of performance in the primary financial statements. Some of the shortcomings of any impairment model, from an information perspective, could be mitigated by disclosures. But any aggregation within the disclosures, probably necessary to avoid disclosure overload, might limit the benefit of this.

Question 4: Two models

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.

(7) One might however consider introducing recycling combined with a revaluation model, an accounting model based on the holding objectives of equity investments, or an accounting model based on the IFRS 13 fair value hierarchy (see question 7) if there is compelling evidence that the FVTPL or the existing FVTOCI approach (without recycling) do have an impact on asset allocation.

(8) The impairment model would result in more relevant information (e.g. by applying thresholds consistent with the holding objectives and time horizon) compared to the revaluation model. But research revealed that a wide range of thresholds has been used to determine whether a decline in the investment's value was 'significant' or 'prolonged'. This has raised concerns on the effectiveness of the IAS 39 impairment model.

(9) Therefore, we have a preference for the revaluation model (i.e. 'lower of cost or market' approach) proposed by EFRAG to accompany FVTOCI measurement with recycling concerning equity instruments. The revaluation approach is simple to apply, provides a certain degree of objectivity and enhances comparability.

Question 5: Quantitative impairment triggers

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?

(10) In balance, we have a preference for the revaluation model to accompany recycling (see Question 4).

(11) Nevertheless, we recognise that this model does not allow to reflect the average holding period and the type of equity instruments held by reporting entities. To overcome this disadvantage, the use of quantitative triggers would remove subjectivity around the use of 'significant' or 'prolonged' from the previous IAS 39 impairment guidance. We think that management is in the best position to define quantitative thresholds but within certain limits that could be prescribed by the Standard (e.g. 20% decline in value at the reporting date or 10% in a certain period preceding the reporting date).

Question 6: Subsequent recovery in fair values

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?

(12) We have a preference for the revaluation model to accompany recycling (see Question 4). Nevertheless, we would like to make the following statement concerning the impairment model. The objective of an impairment model would be to reflect significant changes with an adverse effect on the issuer's perspectives. If these changes reverse and the conditions no longer apply, then recognising subsequent recoveries in P&L would be conceptually acceptable and consistent with the principles of other IFRS Standards (except for goodwill).

Question 7: Other considerations

Q7.1 Do you consider that the same model should apply to all equity instruments carried under the FVTOCI 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?

(13) An alternative approach that EFRAG could consider would be to identify accounting models based on the holding objectives of equity investments. For example, for those investments that are held for purposes of funding liabilities (e.g. decommissioning liabilities), a model similar to IAS 19 (with potentially some adjustments) would achieve a better performance presentation of the asset and liability management performed by the entity.

(14) One might also consider introducing an accounting model based on the IFRS 13 fair value hierarchy, i.e. OCI without recycling for level 1 equity investments and OCI with recycling for level 2/3 equity investments. The accounting treatment would reflect the underlying liquidity/tradability of the equity instruments: The disposal of a level 1 investment (i.e. listed on a liquid market) followed by a re-purchase has no genuine economic substance, hence the recycling does not truly reflect the performance associated with the disposal itself but rather from the accumulation of results over the holding period (potentially accumulated over many years). Conversely, the disposal of an equity investment held in a private entity (i.e. level 2/3 equity investments) is more likely to have a genuine substance as it requires more efforts to find an acquirer and similarly entails more difficulties to re-purchase. This approach would allow to address the earnings management concern associated with the recycling of OCI.

(15) We support rebuttable presumptions for recognising impairment losses instead of automatic triggers (see also question 5).

(16) The ineffective portion of hedging should always be recognised in the P&L.

(17) Translation should be allowed to occur at the reporting date's exchange rate and booked in P&L unless hedged, since investments in equity instruments may be seen more similar to monetary items than non-monetary items, especially if embedded in a comprehensive management of other monetary assets and liabilities.

(18) Impairment tests should be executed at each reporting date.

Question 8: Other aspects of IFRS 9's requirements on holdings of equity in**struments**

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.

(19) We do not have any other accounting issues concerning equity instruments to bring to your attention at this stage.

ANNEX 2 – EQUITY INSTRUMENTS: OVERVIEW OF ALTERNATIVES TO THE CURRENT FVTOCI APPROACH

__Important remark:__ This annex should be read in conjunction with our letter (Annex 1) and not as a separate document.

Proposed alternatives	Benefits	Disadvantages
1. All equity at FVTPL (i.e. removing the FVTOCI election option)	• Disposal results are reflected in the P&L (as opposed to the current FVTOCI approach) • Avoid earnings management	• Showing all the volatility in the P&L (during the holding period) • Not reflecting the holding objectives of LT investors • No difference between realized and unrealized results
2. FVTOCI + recycling on disposal + revaluation model (LCM approach) (EFRAG DP)	• Recycling: o Perception that, upon disposal, the P&L better reflects the performance of LT investors[3] o Allows to make a difference between realized (P&L) and unrealized results (OCI) • Revaluation model: o Easy to apply (removes all judgement) o More objectivity	• Recycling: o Periodic performance versus cumulative performance o Earnings management opportunities for listed equities • Revaluation model: o Less relevance o Shows volatility in the P&L (as long as FV is lower than the original cost)
3. FVTOCI + recycling on disposal + impairment model similar to AFS equities[4] (IAS 39) (EFRAG DP)	• Recycling: o Perception that, upon disposal, the P&L better reflects the performance of LT investors[3] o Allows to make a difference between realized (P&L) and unrealized results (OCI) • AFS inspired impairment model: o More relevant (allows to take into account the holding horizon) o Lower P&L volatility than revaluation model	• Recycling: o Periodic performance versus cumulative performance o Earnings management opportunities for listed equities • AFS inspired impairment model: o Perception that there could be less comparability when thresholds are determined by management o How to determine thresholds? o How to deal with subsequent recoveries in value?

[3] *Please refer to paragraph 2 in Annex 1 for appropriate context*
[4] *But with thresholds for 'significant' or 'prolonged'*

4. An accounting model based on the holding objective[5], e.g.: • Assets linked to decommissioning liabilities in the utilities' industry • Assets held to fund insurance obligations • Assets held by capital risk entities	• P&L would better reflect performance • Avoid mismatches in the P&L • Avoid earnings management opportunities	• Would imply more fundamental changes to IFRS 9 and potentially other Standards
5. Accounting model based on the IFRS 13 fair value hierarchy[6]	• Avoid earnings management opportunities	• Would imply more fundamental changes to IFRS 9 and potentially other Standards • Would further add to the complexity of IFRS 9 • Would not solve the potential issue of the insurance industry unless if combined with option 4 • Interaction with existing anti abuse provisions on wash sale to be assessed • The fair value hierarchy might not systematically reflect the liquidity of the market

[5] *Please refer to paragraph 13 in Annex 1*
[6] *Please refer to paragraph 14 in Annex 1*