EFRAG
European Financial Reporting Advisory Group

# EFRAG SECRETARIAT BACKGROUND PAPER

## REQUEST FOR FEEDBACK AND WEB BASED QUESTIONNAIRE

# EQUITY INSTRUMENTS

# – RESEARCH ON MEASUREMENT

MAY 2019

© 2019 European Financial Reporting Advisory Group

# Table of Contents

**TABLE OF CONTENTS** .......... **2**
**THE PURPOSE OF THE BACKGROUND PAPER** .......... **3**
**CHAPTER 1: WHY IS EFRAG RESEARCHING THE TOPIC?** .......... **4**
*THE CONTEXT OF EFRAG'S RESEARCH* .......... *4*
*IFRS AND EQUITY INSTRUMENTS* .......... *5*
*WHAT IS THE INTERACTION BETWEEN IFRS 9 AND FINANCING FOR SUSTAINABLE ACTIVITIES?* .......... *8*
*STRUCTURE OF THE EFRAG SECRETARIAT BACKGROUND PAPER* .......... *9*
**CHAPTER 2: A LOOK AT HISTORICAL COST AND AVERAGE FAIR VALUE** .......... **11**
*HISTORICAL COST* .......... *11*
*AVERAGE FAIR VALUE* .......... *12*
**CHAPTER 3: OTHER ALTERNATIVES** .......... **15**
*APPROACHES BASED ON ADJUSTED COST* .......... *15*
*APPROACHES BASED ON ADJUSTED FAIR VALUE* .......... *16*
*ALLOCATION-BASED APPROACHES* .......... *16*
**CHAPTER 4: DEFINING A SCOPE OF APPLICATION** .......... **18**
*LONG-TERM INVESTMENT* .......... *18*
*EQUITY-TYPE INSTRUMENTS* .......... *21*
**CHAPTER 5: EXPLAINING LONG-TERM PERFORMANCE** .......... **24**
**APPENDIX 1: PRIOR EFRAG RESEARCH AND CONSULTATIONS** .......... **25**
**APPENDIX 2: REQUEST FROM THE EUROPEAN COMMISSION** .......... **27**
**APPENDIX 3: TRENDS IN INFRASTRUCTURE FUNDRAISING** .......... **29**

# The purpose of the Background Paper

ES1 In May 2019, EFRAG launched a public consultation ('the Consultation') to gather constituents' views on possible alternative approaches to the reporting of equity instruments to those in IFRS 9 *Financial Instruments.* The Consultation is available here.

ES2 This EFRAG Secretariat Background Paper provides context and background information to the Consultation. Constituents intending to respond to the Consultation are encouraged to read the EFRAG Secretariat Background Paper.

ES3 The Consultation is intended to complement previous EFRAG discussions and consultations on the accounting treatment for equity instruments. Prior Discussion Papers and feedback reports are available on EFRAG's project page[1] and include:

- a consultation to collect financial information on existing investment in equity instruments (July 2017) and the related report on the findings (January 2018);
- a Discussion Paper issued to obtain views on recycling and impairment for equity instruments carried at Fair Value through Other Comprehensive Income ('FVOCI') (March 2018) and the analysis of the responses (August 2018);
- an academic literature review on the potential effects of IFRS 9 on long-term investment (March 2018);
- following the completion of the prior investigation EFRAG issued in November 2018 a Technical Advice to the European Commission.

ES4 For this reason, the Consultation does not explicitly address the two measurement bases in IFRS 9, or the reintroduction of recycling which was the object of the prior consultation document. Constituents' input from previous consultations will be duly considered by EFRAG in developing its technical advice to the European Commission.

[1] https://www.efrag.org/Activities/1606201553344223/EFRAG-Research-Project-Equity-Instruments---Impairment-and-Recycling

# CHAPTER 1: WHY IS EFRAG RESEARCHING THE TOPIC?

## The context of EFRAG's research

1.1 In March 2018, the European Commission adopted its action plan on financing sustainable growth. One element of the action plan to achieve sustainable growth is to mobilise more private capital for sustainable projects, such as transport, energy and resource management infrastructure.

1.2 The European Investment Bank estimates the annual infrastructure investment gap for the EU27 (i.e. all Member States except the UK) until 2030 at roughly EUR 155 billion[2].

1.3 Several factors may have contributed to this gap, the major one being the substantial reduction in Government investing. Government infrastructure investment accounts for about 80% of the overall fall in infrastructure investment. The Government component of aggregate infrastructure investment declined by 0.45 percentage points (p.p.) of GDP between 2009 and 2016, compared to 0.1 p.p. for the nongovernment sector[3]. However, availability of private capital plays a key role to reach the objectives set out in the action plan.

1.4 Infrastructure is financed through multiple channels. The most common types of instrument, and their related characteristics, employed in the private sector can be classified along the lines of:

a) Type of instrument – equity, debt (loans and bonds), mezzanine;

b) Related characteristics:

(i) Publicly traded versus private (unlisted);

(ii) Direct holdings versus indirect holdings (via funds).

1.5 The following table summarises this classification[4]:

| | | Direct | Indirect |
|---|---|---|---|
| Equity | Public | Listed infrastructure, infrastructure corporate stocks | Listed infrastructure equity funds; index funds; ETFs |
| | Private | Direct equity investment in infrastructure corporate | Unlisted infrastructure equity funds |

[2] *Retooling Europe's economy,* EIB Investment Report 2018/2019

[3] *Retooling Europe's economy,* EIB Investment Report 2018/2019

[4] Inderst, G. (2013) *Private Infrastructure Finance and Investment in Europe,* Inderst, G., EIB Working Papers 2013/02

| | | | |
|---|---|---|---|
| Debt | Bonds | Corporate bonds; project bonds | Infrastructure bond funds |
| | Loans | Direct loans; asset-backed financing | Infrastructure loans, debt funds |

1.6 IFRS 9 has changed compared to IAS 39 the accounting treatment for some of these financing instruments. Some stakeholders have raised concerns that some of these changes may not be conducive to long-term investing in equity instruments. The changes and the related concerns are described briefly below.

## IFRS and equity instruments

### Accounting requirements before IFRS 9

#### *Direct holdings of equity instruments*

1.7 Under IAS 39, equity instruments, other than those held-for-trading, were classified as Available-for-Sale ('AFS'). These instruments were measured at fair value with changes in fair value presented in Other Comprehensive Income ('OCI').

1.8 An entity was required to assess at the end of each reporting period whether there was any objective evidence that an equity instrument classified as AFS was impaired. When an entity assessed that an instrument was impaired, the decrease in value below the original historical cost was reclassified to profit or loss as an impairment loss. Impairment losses could not be subsequently reversed through profit or loss but had to be recognised in OCI. The cumulative gain or loss in OCI was recycled to profit or loss on disposal.

#### *Indirect holdings of equity instruments*

1.9 Classification as AFS was available not only to direct holdings of equity instruments such as ordinary shares, but also to other types of financial instruments, that had not been classified as financial assets at fair value through profit or loss ('FVPL').

#### *Equity instruments at cost*

1.10 Investments in equity instruments without a quoted market price and whose fair value could not be reliably measured were measured at cost and subject to a review for impairment.

### Accounting for equity instruments under IFRS 9

#### *Direct holdings of equity instruments*

1.11 IFRS 9 classifies debt-type financial assets on the basis of the business model within which they are held and their contractual cash flow characteristics. BC4.44 notes that, while a small number of constituents thought that the contractual terms of the instrument condition was unnecessary, the IASB concluded that determining classification solely on the basis of how the entity manages its financial instruments would result in misleading information that is not useful to understand the risks associated with complex or risky instruments.

1.12 In accordance with IFRS 9, equity instruments are measured at fair value which, in the IASB's view, provides the most useful information to users about such instruments. For those equity instruments that are not held for trading or contingent consideration recognised in a business combination, an entity may make an irrevocable election to present changes in the fair value in OCI ('FVOCI') instead of FVPL. The entity makes the election at initial recognition and may apply it on an instrument-by-instrument basis.

1.13 If the entity elects FVOCI, the changes in fair value are presented in OCI and are not reclassified into profit or loss ('recycled') on disposal. There is no requirement to assess these instruments for impairment. Dividends that are a return on investment from the instruments are recognised directly in profit or loss.

1.14 Accordingly, the impact of the change from IAS 39 to IFRS 9 in requirements for equity instruments previously classified as AFS is the following:

a) if these instruments are carried at FVPL under IFRS 9, all changes in fair value in each period are recognised in profit or loss of that period; or

b) if these instruments are designated in accordance with IFRS 9's FVOCI election, changes in fair value are never recognised in profit or loss.

1.15 In the Basis for Conclusions to IFRS 9, the IASB concluded that gains and losses on instruments subject to the FVOCI election should be recognised only once in comprehensive income, and noted that recycling would create the need to assess these equity instruments for impairment. The IASB explained that the impairment requirements for equity instruments classified as AFS under IAS 39 were very subjective and had created application problems.

1.16 The IASB noted this in the Basis for Conclusions of IFRS 9:

a) BC5.22 In the IASB's view, fair value provides the most useful information about investments in equity instruments to users of financial statements. 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. An example could be a requirement to hold such an investment if an entity sells its products in a particular country.

b) BC5.23 The IASB also noted that, in their valuation of an entity, users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading. Thus, the IASB believes that separate presentation in other comprehensive income of gains and losses for some investments could provide useful information to users of financial statements because it would allow them to identify easily, and value accordingly, the associated fair value changes.

### *Indirect holdings of equity instruments*

1.17 The FVOCI election is only available to equity instruments. The term 'equity instrument' is defined in IAS 32 *Financial Instruments: Presentation*. The IASB noted that IAS 32 allows preparers, in particular circumstances, to classify a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) as equity. However, these instruments meet the definition of a financial liability, and therefore they cannot be classified as an equity instrument.

1.18 Accordingly, instruments that are allowed to be presented, as an exception, as equity in the issuer's financial statements are not eligible for the FVOCI election in the holder's financial instruments. As a consequence, instruments such as units in investment funds shall be carried at FVPL by the holder. See paragraph 4.30 below for more details.

1.19 The use of FVPL for investments in direct and indirect holdings in equity instruments is expected to become more widespread with the introduction of IFRS 9. This is partly due to the fact that some instruments previously classified as AFS in accordance with IAS 39 will not be eligible for the FVOCI option in IFRS 9 as described in the previous paragraphs.

### *Removal of cost exception*

1.20 IFRS 9 does not retain the cost exception in IAS 39 for unquoted equity instruments whose fair value cannot be measured reliably. Paragraph 5.17 of the Basis for Conclusions to IFRS 9 argues that the introduction of IFRS 13 *Fair Value Measurement* has provided appropriate guidance and that valuation methods for equity instruments are well-developed.

## Concerns raised in relation to long-term investment business model

1.21 It has been argued that, given the nature of the business model of long-term investors, their reported performance should include both returns from dividends and gains or losses on disposal. FVPL has the effect that all such returns are included in profit or loss, while the FVOCI election has the effect that only dividends are included. However, FVPL has the effect that holding (i.e. unrealised) gains or losses are reported in profit or loss during the holding period.

1.22 It has therefore been argued that neither of the IFRS 9 accounting treatments is attractive to some long-term investors. If this creates a disincentive to hold equity instruments on a long-term basis, it may in turn curb financing for sustainable projects.

1.23 In its endorsement advice on IFRS 9, EFRAG expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. However, at the time, based on limited evidence, EFRAG assessed that it was unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9. Also refer to Appendix 1, for the summary of the previous work EFRAG has conducted on the topic.

1.24 IFRS 9 requirements apply to equity instruments regardless of whether they have been obtained on a primary market - i.e., subscribed when the instruments were originally issued - or a secondary market - i.e., purchased from a prior investor.

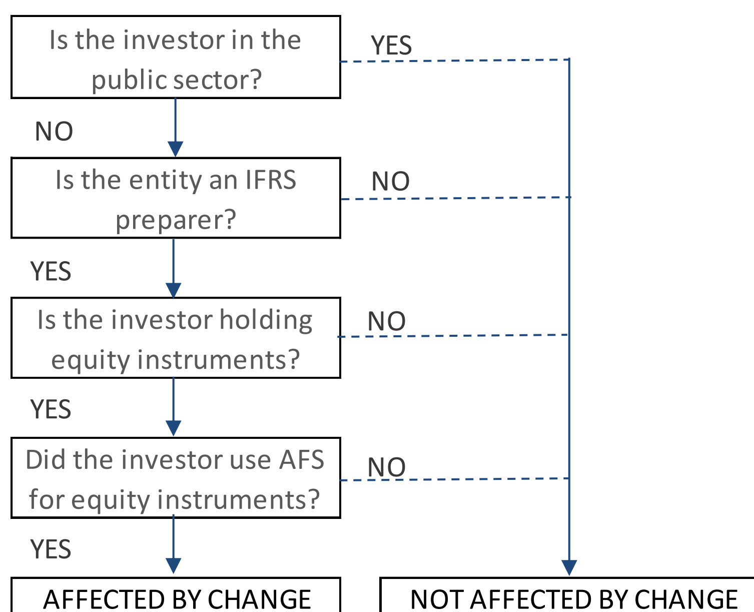
1.25 Transactions on the secondary market do not provide additional financing to the original issuer carrying out the sustainable project, so the scope of any investigation of the potential effects should address transactions on the primary market (although having deep secondary markets is more attractive to primary investors).

## What is the interaction between IFRS 9 and financing for sustainable activities?

1.26 The European Commission has committed to assess the impact of new or revised IFRSs on sustainable investments, with a view to ensure that the accounting standards do not directly or indirectly discourage sustainable and long-term investments.

1.27 It should be noted that according to the *IASB's Conceptual Framework for Financial Reporting*, the objective of general purpose of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The IASB concluded that providing transparent information is an important contribution to the promotion of investment, but that it is not the role of the Standards to encourage or discourage any type of investments.

1.28 As noted above, the changes in the accounting requirements resulting from IFRS 9 will impact those investors that meet the conditions illustrated in the following table.




1.29 Identifying which investors are affected by the change in the IFRS 9 requirements is only the first step in assessing the impact that the change may have on financing for sustainable activities. It would be necessary to obtain information on the size of their investment portfolio, and the relative size of equity financing compared to other funding sources (loans and debt).

1.30 It would be then necessary to estimate the elasticity of equity investment portfolios to the change in accounting requirements. This is complex, especially because asset allocation decisions are driven by a plurality of factors. It is difficult to disentangle the impact of accounting requirements from other factors such as expectation on future returns by class of assets or other regulations (tax, prudential).

1.31 It is also possible that any decrease in investment in equities would be offset by increases in other asset classes without an overall reduction of available financing. For instance, in the last few years European institutional investors have gradually, although marginally, increased their allocation in real assets, for which the return is expected to come largely from the yield on a physical asset with some degree of inflation exposure, such as real estate, infrastructure and natural resources[5].

1.32 Moreover, the quantitative assessment should be tailored to the specific characteristics of the infrastructure industry or sustainable activities.

1.33 Finally, it should be noted that IFRS 9 became effective for periods beginning or on after 1 January 2018, although entities that predominantly undertake insurance activities and entities with insurance activities within a financial conglomerate have the option to defer its application until 1 January 2021[6]. As a consequence, it is not yet possible to provide a comprehensive assessment of the impact of its initial application, for all entities – financial and non-financial - that hold equity instruments.

1.34 Due to all the above, it is highly complex to determine what impact the adoption of the new accounting requirements for equity instruments in IFRS 9 may have on the available financing for sustainable activities.

1.35 EFRAG has collected some quantitative information on existing investments in equity instruments and expected changes in asset allocation. EFRAG has also collected quantitative information on the current trends in infrastructure fundraising, that are disclosed in Appendix 3. However, EFRAG has not conducted a formal impact analysis and we are not aware of any available study.

## Structure of the EFRAG Secretariat Background Paper

1.36 **Chapter 2** discusses historical cost and average fair value as alternative accounting bases for equity instruments.

1.37 **Chapter 3** discusses other alternative accounting bases for equity instruments.

1.38 **Chapter 4** provides indications of how the concepts of ‘equity-type’ instruments and ‘long-term investment business model’ may be considered in the context of the scope of application of the possible changes to accounting requirements.

1.39 **Chapter 5** illustrates some examples of performance metrics currently used by investors to communicate long-term performance.

1.40 **Appendix 1** provides a summary of findings from prior EFRAG consultations.

---

[5] *European Asset Allocation Survey 2018,* Mercer LLC (2018).

[6] The IASB tentatively agreed at its November 2018 meeting to defer the effective date of IFRS 17 *Insurance Contracts* for one year with a consequential amendment to the mandatory effective date of IFRS 9 for insurers.

1.41 **Appendix 2** provides the EC request for technical advice.

1.42 **Appendix 3** provides an overview of the trends in global infrastructure fundraising.

# CHAPTER 2: A LOOK AT HISTORICAL COST AND AVERAGE FAIR VALUE

2.1 The basic measurement choices established in both IFRS Standards and most other accounting frameworks are historical cost and current value. Historical cost is not a fully defined measurement approach and IFRS Standards that use it typically provide guidance on matters such as components of cost, depreciation or amortisation (when applicable) and impairment. Fair value is one form of current value measurement.

2.2 IAS 27 *Separate Financial Statements* allows entities to measure investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 or using the equity method under IAS 28 *Investments in Associates and Joint Ventures* in their separate (i.e. non-consolidated) financial statements.

2.3 This Background Paper firstly explores historical cost and average fair value as possible alternatives. The EFRAG Secretariat has also considered some other approaches which are described in the next chapter:

a) approaches based on cost adjusted for the share of the profit or loss of the investee or for observable market transactions;

b) approaches based on adjusted fair value; and

c) allocation-based approaches that recognise price changes in profit or loss over the term that reflects the investment perspective.

## Historical cost

2.4 Accounting was founded on the concept of historical cost and it has been used for a long period also for equity instruments. IAS 39 allowed cost to be used in limited circumstance as discussed in Chapter 1. IFRS 9 does not permit the use of cost as the measurement objective but acknowledges that, in limited circumstances, cost could be an appropriate estimate of fair value, although not for quoted instruments.

2.5 Given the familiarity with the concept, this Background Paper explores whether historical cost as measurement basis could reflect the performance and risks in a long-term investment business model. Historical cost recognises the return on the investment (apart from impairment and dividends) once the investment is realised although the return has been generated over the whole holding period.

2.6 Historical cost is often viewed as simpler than other measurement bases such as fair value; but application issues do arise. For example, in open portfolios holdings in the same investee might be acquired at different points in time. On partial realisation of such holdings, cost needs to be allocated to the divested shares on some basis such as FIFO or weighted average. Another application issue is the determination of the occurrence and amount of impairment to be recognised in profit or loss.

2.7 The treatment of acquisition costs is not covered in this Background Paper. Furthermore, it is assumed that dividends will be recognised in profit or loss when receivable. The interaction between recognition of dividends and the measurement of the cost of the investment however needs further consideration - e.g. if some dividends are in substance a reimbursement of the initial investment, their recognition could trigger a corresponding reduction in the carrying amount of the investment.

2.8 If historical cost were to be used to report the performance of entities that hold long-term investment portfolios of equity instruments, the EFRAG Secretariat considers that it should be accompanied by an impairment model. As a matter of fact, any accounting alternative other than those in IFRS 9 (FVPL and FVOCI without recycling) would require entities to assess impairment losses.

### Historical cost and the statement of financial position

2.9 If historical cost is used to portray performance in profit or loss an entity would recognise in profit or loss dividends, impairment losses and gains/losses on disposals. Historical cost could be used to portray performance in profit or loss either in a single or in a dual measurement approach as follows:

a) in a single measurement approach, historical cost is also used as the measurement basis in the statement of financial position. During the holding period an entity would recognise impairment losses but not remeasurement gains or losses. It would recognise gains or losses when the equity instrument is derecognised;

b) a dual measurement approach, as the term is used in this Background Paper, involves measuring profit or loss in accordance with the specified alternative basis while retaining the use of period end fair value in the statement of financial position. To achieve this, an entity would recognise remeasurement gains or losses on the equity instrument in OCI during the holding period and would transfer amounts from OCI to profit or loss to recognise impairment losses. Finally, gains or losses would be recognised in profit or loss when the equity instrument is derecognised.

2.10 Paragraph 2.18 below illustrates the application of the two approaches.

2.11 The EFRAG Secretariat notes that the use of fair value on the statement of financial position to measure equity instruments is well established in IFRS Standards and it is generally agreed that it provides relevant information about the entity's financial position. Also, in case historical cost was used in a single measurement approach, the overall requirement in IFRS 7 *Financial Instruments: Disclosures* to disclose fair value of all financial assets would apply.

## Average fair value

2.12 One of the criticisms sometimes levelled at fair value for portraying performance is that changes in fair value can be volatile and that such volatility reflects 'market noise' that is not reflective of the underlying economic condition or prospects of the investee. In addition, it is sometimes suggested that year-end fair values are affected by behaviours such as portfolio rebalancing by market participants and lower levels of liquidity around year-end. It should be noted that the EFRAG Secretariat has not investigated such phenomena and expresses no view on their existence or significance for financial reporting purposes.

2.13 The use of some form of average (instead of period end) fair value could reduce the extent to which reported performance is impacted by 'artificial' price swings, while also providing information on the longer term trend in fair value.

2.14 Using an average fair value would require specifying a length – i.e. 90 days; and frequency of the values in the set – i.e. daily or weekly. For instance, accounting Standards and tax legislation in some European countries allow or used to allow the daily average of the last 30 days of the reporting period. The frequency could be based on daily, weekly or monthly prices.

2.15 The use of average fair values poses some practical issues. One is that entities may have to produce a higher number of estimates for those equity instruments that do not have a market price. For this reason this method could be more suitable for listed equity instruments. Another is that impairment should be still assessed when the average is higher than the closing price at the end of the period.

2.16 Using period averages may but does not necessarily reduce the volatility in the reported performance. The following table considers the Europe S&P 350 index for the periods ended 31 December 2018 and 2017 and shows:

a) the average and median change (for the whole sample) for year-end prices; and

b) the average and median change (for the whole sample) for the averages of daily prices in the last 90 days of the reporting period.

| | **Closing prices at year end** | **Average of daily prices in last 90 days** |
|---|---:|---:|
| Average change 2018-2017 | -13.1% | -5.2% |
| Average change 2017-2016 | 13.5% | 18.7% |
| Median change 2018-2017 | -13.8% | -7.2% |
| Median change 2017-2016 | 11.3% | 16.5% |
| Std deviation of average change 2018 | 0.192 | 0.213 |
| Std deviation of average change 2017 | 0.221 | 0.223 |

## Average fair value and the statement of financial position

2.17 Average fair value could be used to portray performance either in a single or in a dual measurement approach:

a) in a single measurement approach, average fair value is used as a measurement basis in the statement of financial position. An entity would report in its profit or loss holding gains or losses based on the change between the selected average for the reporting period and the comparative period;

b) in a dual measurement approach, period end fair value is still used as the measurement basis in the statement of financial position. An entity would report in its profit or loss holding gains or losses based on the change between the selected average for the reporting period and the comparative period. The difference between this amount and the total change between the fair values at the end of the reporting date would be reported in OCI.

### *Illustrative example of both measurement approaches for both alternatives*

2.18 To illustrate the impact of the two approaches using both measurement alternatives, assume an entity holding an instrument originally purchased for 100 LC as at 1 January 20x8. At 31 December 20x8, the closing price is 120 LC and the daily average of the last 90 days of the period is 108 LC. At the end of the following period, the closing price and the daily average of the last 90 days of the period are respectively 130 LC and 122 LC. An extract from the statement of financial position would look as follows:

| | ***Historical cost performance basis*** | | ***Average FV performance basis*** | |
|---|---|---|---|---|
| | **Single MA** | **Dual MA** | **Single MA** | **Dual MA** |
| ***As at 31 December 20x8* – in LC** | | | | |
| Investment held | 100 | 120 | 108 | 120 |
| Result for the year (P&L) | - | - | 8 | 8 |
| Retained earnings | - | - | - | - |
| Investment held reserve (OCI) | - | 20 | - | 12 |
| ***As at 31 December 20x9* – in LC** | | | | |
| Investment held | 100 | 130 | 122 | 130 |
| Result for the year (P&L) | - | - | 14 | 14 |
| Retained earnings | - | - | 8 | 8 |
| Investment held reserve (OCI) | - | 30 | - | 8 |

# CHAPTER 3: OTHER ALTERNATIVES

3.1 The EFRAG Secretariat also considered some other possible approaches. These approaches are less established than historical cost or fair value and raise some operational issues that would need to be further examined before they are considered for standard-setting activities.

## Approaches based on adjusted cost

3.2 One criticism of historical cost is that it does not provide timely information about changes in value, and therefore it may lack predictive value and not depict the full effect of the entity's exposure to risk arising from holding the asset. To mitigate this, historical cost could be adjusted to reflect events that have occurred since the purchase of the equity instrument.

### Adjusting for the share of profit or loss of the investee

3.3 The entity could be required to recognise its share of profit or loss of the investee. This adjustment would reflect the underlying performance of the investee and is similar to the equity method but without the need to apply all the consolidation procedures required in IAS 28.

3.4 This adjustment would reduce the incentive to make selective disposals, because gains would be recognised regardless of dividend distribution or disposal. Recognition of the share of loss would also mitigate the risk that impairment losses are not recognised timely.

3.5 An entity would need access to the financial information on the investee. This could be often possible, but there may be issues with the timing of the availability of the financial statements and the fact that the investees may not be reporting under IFRS Standards or a comparable GAAP. This approach would also not be practicable for large, open investment portfolios.

### Adjusting for observable market transactions

3.6 The entity could be required to incorporate observable price changes on the basis of orderly transactions for the identical or a similar instrument of the same issuer. A similar approach is used in US GAAP for unquoted instruments where the fair value is not readily determinable.

3.7 This adjustment would periodically align the historical cost to a current value, thus reducing the loss of relevance of historical cost over time. However, these adjustments would only be non-recurring and based on observable, external transactions that may happen at random.

3.8 An entity would be required to monitor if observable transactions are occurring on their investment. This would be burdensome for an entity with a large number of small investments.

3.9 The EFRAG Secretariat notes that the carrying amount of listed equity instruments is continuously adjusted based on observable market transaction. This alternative would result substantially in a FVPL measurement for listed equity instruments.

3.10 Compared to FVPL, the first adjustment could be more or less volatile. The second adjustment could result in less frequent but bigger changes, since market transactions on unquoted entities are not likely to occur frequently.

## Approaches based on adjusted fair value

3.11 Paragraph 15 of IFRS 13 indicates that a fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.

3.12 One criticism of fair value is that the holder of the instruments is exposed to the volatility caused by market changes that may not reflect positive or adverse changes to the issuer's prospects for future cash flows. Fair value measurement in the statement of financial position could be modified to reduce the reliance on current market conditions at the measurement date.

### Adjustments to the input

3.13 The entity could be required to maintain constant the original risk-free rate and update only the risk premium specific to the issuer. In this way, investment performance would not be affected by general market price changes. This would be similar to using the interest rate at inception for amortised cost irrespective of subsequent changes in market rates.

3.14 Compared to FVPL, this alternative would not incorporate in the measurement some of the fair value changes and may decrease volatility in profit or loss.

## Allocation-based approaches

3.15 The more known approaches affect the reporting of performance in the following way:

a) FVPL - immediate recognition of all price changes;

b) FVOCI election in IFRS 9 - no recognition in profit or loss of price changes;

c) Cost/ FVOCI with recycling - no recognition during holding period (except for dividends and impairment losses); full recognition in profit or loss in the period of disposal.

3.16 An alternative approach would be to require recognition of price changes in a systemic way over the term that reflects the investment perspective. This would result in immediate recognition of a portion of price changes in the period, with the remaining portion being allocated in OCI.

3.17 This approach would be based on a systemic allocation mechanism, and would require to identify both a relevant period of time and allocation pattern. It is possible to envisage different variants.

3.18 A first variant is to estimate an holding period at initial recognition and apply an expected return rate over this period to compute the portion to allocate to profit or loss.

3.19 A second variant would be based on the expected duration of a designated (linked) liability – such as the duration of a loan payable or a long-term provision. The entity would need to designate the liabilities associated with its equity instruments. The portion of fair value change to allocate to profit or loss could be determined using the either the rate applied to the liability (assuming the liability is measured at amortised cost); or be determined to match exactly the expense included in profit or loss for the linked liability.

3.20 An allocation approach reduces exposure to short-term value changes that critics of a fair value based measurement approach do not consider part of a long-term investment performance. It also takes away the incentive to manage earnings by selectively selling specific instruments.

3.21 However, an allocation approach relies heavily on assumptions. The variant based on an expected return rate would raise the question on how the rate should be reassessed and how to adjust for any differences between the expected and actual rate; the variant based on a designated (linked) liability would raise issues about the eligibility criteria for designation and designation mechanism.

3.22 Moreover, it is possible that in one given year the fair value of the equity instruments decreases. In that case, could the entity still recognise a portion of income in profit or loss?

3.23 Formal documentation and designation are familiar to most reporting entities for hedge accounting treatment and doing the same would be simple for reporting entities with a limited number of liabilities. However, other reporting entities are likely to have numerous liabilities which may make it impracticable to designate an investment in an equity instrument to a specific liability on a 1:1 level. For these, the duration of the liabilities may form a basis for designation, but this is on the assumption of a static portfolio. The issue as to whether the pool or portfolio could be subsequently modified over time would need to be addressed.

3.24 Finally, an allocation based on a designated (linked) liability would raise issues on the implications of the underlying liability being settled early or transferred.

# CHAPTER 4: DEFINING A SCOPE OF APPLICATION

4.1 Under IFRS 9, equity instruments can be measured either at FVPL or FVOCI. The FVOCI election is not available for assets that are either held for trading or contingent consideration recognised in a business combination. Although the FVOCI election was initially designed with 'strategic' investments in mind, the Standard does not require to meet any qualifying criteria.

4.2 If changes were introduced to the reporting requirements, the EFRAG Secretariat has considered if those changes should be applied only to specific sets of instruments based on certain qualifying criteria. This Background Paper illustrates how the scope of application could be defined in relation to long-term investment and equity-type instruments.

## Long-term investment

4.3 The EC request refers to 'long-term investment portfolios' and the High-Level Expert Group to 'balance sheets of long-term investors such as non-financial corporations, insurance companies and banks'. There is however no definition of 'long-term investment', 'long-term investor' or equivalent in IFRS Standards.

4.4 IAS 1 *Presentation of Financial Statements* requires entities to classify assets and liabilities as current or non-current for presentation purposes in their statement of financial position. An asset is classified as current when:

a) the entity expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

b) the entity holds the asset primarily for the purpose of trading;

c) the entity expects to realise the asset within twelve months after the reporting period; or

d) the asset is cash or cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

4.5 IFRS 9 does not refer to short-term or long-term. IFRS 9 does not allow entities to use the FVOCI election for equity instruments that are held for trading. A financial asset is held for trading when:

a) it is acquired principally for the purpose of selling or repurchasing it in the near term;

b) on initial recognition, is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or

c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

4.6 IFRS 9 refers to a business model whose objective is to hold assets in order to collect contractual cash flows; a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and other business models. Paragraph B4.1.5 of IFRS 9 notes that a business model that results in measurement at FVPL is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets.

4.7 It is clear that the notions of 'held for trading' and 'short-term' overlap at least in part, but it cannot be concluded that any instrument not held for trading should automatically be considered as 'long-term'.

4.8 There is no indication that the IASB intended to differentiate the treatment of equity instruments based on a notion of 'long-term holding'. In an article published on the IFRS website[7], an IASB Board member explained that the FVOCI election was originally designed with 'strategic' investments in mind. The argument is that when capital appreciation is not the main reason to hold an investment the presentation of fair value changes in profit or loss may not be indicative of the investor's performance. This implies that the IASB's intention is that all equity investments that are held to generate an investment return should be reported at FVPL.

4.9 Despite the IASB's intention regarding how the FVOCI election should be used, in finalising IFRS 9 the IASB decided not to restrict its use to 'strategic' investments. This was mostly due to the challenges of defining 'strategic' investments.

4.10 In general, measurement requirements under IFRS Standards are not dependent on a notion of expected duration. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* may go close to it, by changing the measurement requirements for non-current assets held for sale when the sale is highly probable. One, but not the only condition to quality the sale as highly probable, is that it is expected to occur within 12 months from the reporting date.

4.11 Measurement requirements based on a notion of expected duration can be traced back to before 2001. IAS 39 superseded the portions of IAS 25 *Accounting for Investments* that dealt with debt and equity instruments. Previously, IAS 25 required the measurement of marketable equity instruments classified as long-term assets at the lower of cost and market value determined on a portfolio basis.

4.12 The EFRAG Secretariat considered whether a definition of 'long-term' investments is needed for the purpose of considering alternative measurement bases for equity instruments, but did not reach a conclusion. The EFRAG Secretariat notes that EFRAG had previously debated how such a definition could be developed, but no consensus emerged as to what this would include.

4.13 If a definition was deemed necessary, the following characteristics could be used individually or in combination to develop it:

a) the expected or actual holding period – this would tie-in to the notion of long-term investment (rather than investor);

b) the characteristics/ business model of the investor – this would tie-in to the notion of long-term investor; or

[7] https://www.ifrs.org/news-and-events/2018/04/ifrs-9-and-equity-investments/

c) the long-term nature of the (underlying) liabilities - some constituents claimed that equities may be held with the view to meeting obligations under long-term liabilities, and this linkage should be reflected in the way the investments are accounted for.

## The characteristics/ business model of the investor

4.14 The EC in its Green Paper Long-term financing of the European Economy issued in 2013 described the capacity of financial institutions to channel long-term finance as a business model in its investment portfolio.

4.15 The EC paper also described the financing process as a central issue to support structural economic reform and the return to the long-run trend of economic growth. Long-term financing is also needed throughout the whole lifecycle of a company, helping to start a business, allowing it to grow and then sustaining its growth. Long-term financing would support the transition of companies as they progress through this life cycle.

4.16 In July 2015, EFRAG issued a Bulletin *Profit or loss versus OCI,* which identified four groups of business models, one of which was the long-term investment business model. The business models used, for example, by banks and insurance entities would generally belong to this group, although banks may also undertake short-term trading activities.

4.17 In a long-term investment business model, entities acquire assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar 'condition' as when it was bought. Cash flows are generated by holding the asset (e.g. in the form of dividends, or income from letting others use the asset) and from sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective.

4.18 Several frameworks have been proposed to categorise business models and could be used to refine the content of the EC paper and EFRAG bulletin mentioned above. However, a differentiation based on the nature of the business model would be inherently judgmental, especially for complex entities/group structures.

## The expected or actual holding period

4.19 The expected or actual holding period would be more practical than a qualitative definition if it was defined using a numerical threshold. That would enhance comparability among companies when they categorise their investment portfolios.

4.20 There is an unavoidable trade-off in a threshold-based approach of this kind. A single quantitative threshold in a Standard enhances comparability and reduces the risk of bias, but moves away from a principles-based approach and may limit relevance. For example, a numerical threshold would not differentiate an investor with a 10-year average holding period from an investor with a 3-year average period.

## The long-term nature of the (underlying) liabilities

4.21 Some IFRS Standards allow the use of accounting mechanisms to reflect a linkage between assets and liabilities. Paragraph 6.58 of the *IASB's Conceptual Framework for Financial Reporting* recognises that, in some circumstances, when assets and liabilities are related in some way, using the same measurement basis for the related assets and liabilities contributes to the usefulness of information.

4.22 During the prior EFRAG consultation, some constituents claimed that equities may be held with the view to meeting obligations under long-term liabilities, and this linkage should be reflected in the way the investments are accounted for.

4.23 For instance, insurance companies invest in equities and other assets to generate cash inflows used to settle their insurance liabilities. Energy companies may invest in equity or equity-type instruments to generate cash inflows to settle their obligations in relation to decommissioning of nuclear plants.

4.24 However, a differentiation based on this criterion gives rise to a number of conceptual and operational challenges. Firstly, there would be a need to determine if simply entering into long-term liabilities would be sufficient to qualify for long-term investing or whether a more stringent link between the long-term liabilities and the respective investments would be needed.

4.25 Secondly, and subject to the above, the range of qualifying liabilities could include items that are measured differently (amortised cost, fulfilment cost, current fulfilment value, best estimate of the settlement amount). In that case, the accounting mechanism would need to be articulated differently based on the measurement feature of the liability, or the measurement of the qualifying liabilities would have to be modified.

4.26 Specific questions on the scope of application and definition of long-term are included in the Consultation.

### Other qualifying criteria

4.27 Given the concerns mentioned in the EC request, another relevant characteristic could be the nature of the investee and its activities. The regulation on European long-term investment funds[8] (ELTIF) has been developed with the objective to raise and channel capital towards European long-term investments in the real economy, in line with the EU objective of smart, sustainable and inclusive growth.

4.28 The regulation does not define 'long-term' but instead provides stringent criteria around the eligible investments in terms of both the nature of the direct assets (infrastructure, public buildings, social infrastructure, transport, sustainable energy and communications infrastructure) and the issuers whose instruments ELTIF are allowed to hold (unlisted entities and listed entities with a market capitalisation below a specified threshold).

4.29 The EFRAG Secretariat acknowledges that it might be challenging to develop a conceptually sound and operational qualifying criteria for an accounting treatment on the basis of the nature of the investee and its activities.

## Equity-type instruments

4.30 Equity instruments are defined in paragraph 11 of IAS 32 as contracts that evidence a residual interest in the assets of an entity after deducting all of its liabilities.

---

[8] Regulation (EU) 2015/760 of 29 April 2015, on European Long-term Investment Funds. The full text is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32015R0760.

4.31 Neither the EC request, nor the High-Level Expert Group on Sustainable Finance final report to the EC on 31 January 2018 defines the term ‘equity-type investments’. Based on information received from EFRAG Working Groups[9] and responses to our previous consultations on this topic, the EFRAG Secretariat understands that these relate to puttable instruments from the holder’s perspective such as units in investment funds.

4.32 The last part of the March 2018 consultation included a question about other aspects of IFRS 9’s requirements, which could be relevant to the reporting of performance of entities that hold long-term investment portfolios of equity instruments.

4.33 Some of the respondents to this question mentioned that long-term investment in equities is not limited to holding instruments defined as equity in IAS 32 directly. Long-term investment can also be through indirect holdings in equity in the form, for example, of interests in Undertakings for Collective Investment Transferable Securities (UCITS), Exchange Traded Funds (ETFs), Authorised Investments Funds (AIFs). Some respondents argue that a comprehensive analysis of the long term investment business model needs to consider both direct and indirect holdings.

4.34 Under IFRS 9, interests in UCITS, ETFs and AIFs are neither eligible for amortised cost nor for the FVOCI election and must therefore be carried at FVPL. This is a significant change in accounting treatment compared to IAS 39 under which such holdings, other than those held for trading, were classified as AFS.

4.35 These instruments are not eligible for amortised cost because their contractual terms do not give rise to cash flows that are solely payments of principal and interest – in other words, they fail the ‘SPPI test’. In relation to the FVOCI election, the IFRS Interpretations Committee concluded in September 2017 that a financial instrument that meets the puttable requirements[10] does not meet the definition of an equity instrument and is therefore not eligible for the FVOCI election.

4.36 If an alternative accounting treatment was also to be applied to ‘equity-type’ instruments, then ‘equity-type’ would need to be defined. The definition could address one or more questions. The first question could be: *what type of financial assets would be included, other than direct holding of equity instruments?* One answer would be to include in the scope all instruments that qualify for each of the puttable exceptions under IAS 32. However, applying the IAS 32 puttable requirements may be difficult from a holder’s perspective due to incomplete information. For example it may be hard to determine whether the relevant instrument is the most subordinate and whether the instrument entitles the holder to a pro rata share of the fund’s net assets.

[9] Including the 2018 Case Study on IFRS 17 *Insurance Contracts.*

[10] IAS 32 allows an issuer to classify as equity certain instruments that either include an obligation for the issuer to repurchase or redeem the instrument on exercise of the put; or to deliver a pro rata share of the net assets on liquidation that is at the option of the instrument holder – provided that the instruments satisfy certain conditions specified in paragraphs 16A to 16D of IAS 32.

4.37 A second question could be: *would equity-type instruments be defined in relation to the type of underlying assets that they invest in?* If the alternative treatment (for instance, cost) was to be extended to all instruments that would qualify as for the puttable exception, an investor would be able to apply it to units in funds whose portfolio include not only equity instruments but other assets, such as material open positions in derivatives for trading purposes or debt instruments that may suffer credit losses. This would introduce inconsistency in the accounting treatment of directly and indirectly held financial instruments.

4.38 A way to address this would be to consider extending the alternative treatment to instruments that would qualify for the puttable exception, but with the additional requirement that the assets held by the fund do not include material items that under IFRS 9 need to be carried at FVPL or could be subject to significant credit losses. Alternatively, it could apply only to those instruments that would qualify for the puttable instrument exception but where the fund only holds equity instruments and derivatives for hedging purposes. Either of these requirements would increase the complexity already noted in paragraph 4.36 above.

4.39 A third question could be: *would equity-type instruments be defined in relation to the sustainable nature of the activities they invest in*? If the objective is to incentivise investments in sustainable activities, access to the new accounting requirements could be limited only to mutual funds with an environmental or ethical focus. Most asset managers offer green and ethical funds, and non-governmental organisations and rating agencies have developed their own definitions and methodologies. However, there is no common standard or definition and, as noted above in paragraph 4.29, it might be challenging to base the application of accounting requirements on such a notion.

# CHAPTER 5: EXPLAINING LONG-TERM PERFORMANCE

5.1 While the objective of the Consultation is to explore alternative measurement bases, communication of long-term investment strategy and performance to stakeholders may be enhanced by disclosure of different metrics. In this chapter, the Background Paper illustrates some performance metrics that may be looked at as complementary tools to assist entities to communicate long-term performance.

5.2 3i (an investment company with Private Equity and Infrastructure business lines in northern Europe and North America) uses the following metrics:

| Metric | Purpose | Calculation |
|---|---|---|
| Gross investment return as a percentage of opening portfolio value | Performance measure of proprietary investment portfolio | Realised and unrealised gains along with dividends, fees and interest as well as related foreign exchange |
| Cash realisations | Provides information on the ability to make new investments | Cash proceeds from investments |
| Cash invested in the period | Primary driver of the group's ability to deliver attractive returns | Cash paid to acquire investments in the period |
| Total shareholder return | Provides a consolidated measure of shareholders' return | Both movement in share price as well as dividends paid |

5.3 Calpers (the Californian pension fund for state employees) focuses on the status of its funding but other KPIs include annualised rate of return, total fair value of investments as well as rate of return per asset class (public equity investments, private equity and real assets, that include infrastructure, real estate and forest land).

5.4 The Norwegian sovereign wealth fund, Government Pension Fund Global publishes a 70-page report on returns and risks. The report provides information on absolute and relative returns by class of assets, expected relative volatility, maximum deviation allowed from benchmarks (tracking error), relative volatility and relative return per unit of risk. This information is provided for the year, the last 3, 5 and 10 years as well as since inception of the fund.

# APPENDIX 1: PRIOR EFRAG RESEARCH AND CONSULTATIONS

A1.1 The Consultation is intended to complement previous EFRAG discussions and consultations on the accounting treatment for equity instruments. Prior Discussion Papers and feedback reports are available on EFRAG's project page and include:

a) a consultation to collect financial information on existing investment in equity instruments (July 2017) and the related report on the findings (January 2018);

b) a Discussion Paper issued to obtain views on recycling and impairment for equity instruments carried at Fair Value through Other Comprehensive Income ('FVOCI') (March 2018) and the analysis of the responses (August 2018);

c) an academic literature review on the potential effects of IFRS 9 on long-term investment (March 2018).

A1.2 EFRAG reported its findings from the assessment phase to the EC in January 2018[11]. The assessment phase has indicated that for some entities that consider themselves long-term investors, the aggregate amount/value of equity instruments classified as AFS under IAS 39 is substantial. On the other hand, some other entities that also consider themselves as long-term investors make little or no use of the AFS classification and as a result, they will not be affected by IFRS 9's requirements.

A1.3 In terms of the impact of IFRS 9 on asset allocation decisions, most respondents to the survey indicated that a variety of factors, including business, economic and regulatory factors, affect such decisions. However, almost half of the respondents (mainly insurance entities) reported that they expect to modify their asset allocation decisions as a result of IFRS 9's requirements, although most did not specify to what extent because they had not yet completed the analysis of the effects of IFRS 17 *Insurance Contracts*.

A1.4 IFRS 9 became effective for periods beginning or on after 1 January 2018, and entities that predominantly undertake insurance activities and entities with insurance activities within a financial conglomerate have the option to defer its application until 1 January 2021[12]. As a consequence, it is not yet possible to provide a comprehensive assessment of the impact of its initial application, for all entities – financial and non-financial - that hold equity instruments.

A1.5 Some partial information about the initial impact of IFRS 9 on classification and measurement is starting to be available. An initial report[13] published by the European Banking Authority has found that, on simple average, the initial impact of IFRS 9 on classification and measurement for banks is limited. EFRAG obtained similar findings from its prior consultation, although some individual respondents had a significantly higher percentage of their equity instruments classified as AFS.

[11] https://www.efrag.org/News/Project-303/EFRAGs-report-to-the-European-Commission-on-the-assessment-of-the-impact-of-IFRS-9-on-long-term-investments-in-equity-instruments

[12] As mentioned earlier, the IASB tentatively agreed at its November 2018 meeting to defer the effective date of IFRS 17 for one year with a consequential amendment to the mandatory effective date of IFRS 9 for insurers.

[13] *First observations on the impact and implementation of IFRS 9 by EU institutions,* EBA (2018)

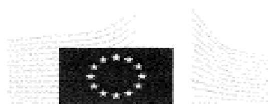
A1.6 EFRAG reported its technical advice for the second phase of the EC request in November 2018[14]. In EFRAG's view, a robust impairment model is a necessary complement to any reintroduction of recycling. This is due to several reasons including: a desire for consistency with other IFRS Standards and categories of assets; to provide information for users to evaluate stewardship; to achieve comparability among financial statements; to provide an assessment of future cash flow prospects; to eliminate or reduce any accounting-related incentive to maintain loss-making equity investments for an indefinite period; and to avoid recognition of losses only upon realisation which would not be consistent with the notion of prudence.

A1.7 EFRAG maintained that a degree of rigour in the use of the election or an impairment model would be essential to ensure comparability. It noted that the majority of respondents expressed a preference conceptually similar to the IAS 39 model but with improvements, however, there were different views on how else the model should be improved. The model should also allow to reverse previously recognised impairment losses.

A1.8 In the course of developing its response to the EC request, EFRAG also considered the arguments in favour of and against the reintroduction of recycling and assessed the arguments to be finely balanced. EFRAG noted that, at this stage, it did not have sufficient evidence to recommend the reintroduction of recycling.

[14] https://www.efrag.org/News/Project-340/EFRAG-publishes-its-technical-advice-to-the-European-Commission

# APPENDIX 2: REQUEST FROM THE EUROPEAN COMMISSION



EUROPEAN COMMISSION
Directorate General Financial Stability, Financial Services and Capital Markets Union

INVESTMENT AND COMPANY REPORTING
Accounting and financial reporting
Head of Unit

Brussels, 1 June 2018
FISMA B3/EVDP/fv/Ares(2018)3110211

Jean-Paul Gauzès
President
EFRAG
Square de Meeûs 35 B-1000 Brussels
jean-paul. gauzes@efrag. org

**Subject: Request for technical advice on possible alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity type instruments**

Dear Mr Gauzes,

As part of its Action Plan on Sustainable Finance[1], the Commission announced it would ask EFRAG to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.

Under IFRS 9 equity instruments can be measured either as fair value through profit or loss (FVPL) or, as an irrevocable choice at initial recognition, at fair value through other comprehensive income (FVOCI). However, in case of FVOCI measurement IFRS does not allow gains or losses realized upon the disposal of the financial asset to be recognized as profit or loss (no "recycling" through P&L).

The Commission has already asked EFRAG to assess the FVOCI treatment for equity instruments in an earlier call for advice[2]. The Commission asked to assess in two phases: 1) the significance of the equity instruments portfolios measured at FVOCI and the possible impact on long-term investments, and 2) to explore possible alternative accounting treatments. The Commission notes that EFRAG's work is well under way for this call for technical advice.

This request for technical advice asks EFRAG 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.

Alternative accounting treatments for long term equity investments should preferably enhance investors' insight in the long term performance of investments as opposed to recognizing point in time market based value changes in reported profit or loss during the duration of the equity investment.

[1] COM/2018/097 final : http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

[2] https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1606211130208837%2F06.02%20-%20Request%20from%20EC%20-%20Equity%20Instruments.pdf

We would be grateful if EFRAG could provide us with the outcome of its work by the second quarter of 2019.

We thank you in advance for your cooperation and would be happy to provide any clarification required on this letter to EFRAG representatives.

Should you have any questions, please contact Erik van der Plaats (Telephone: +32 2 29 55565).

Yours sincerely,

Alain DECKERS

cc.: A. Watchman, (EFRAG TEG Chairman)

# APPENDIX 3: TRENDS IN INFRASTRUCTURE FUNDRAISING

A3.1 Despite a perceived financing gap for infrastructure and sustainable investment at a global level, it seems that many investors are deploying private capital into investments that are connected in some way to infrastructure and sustainable development. The appetite for infrastructure investment may be driven by a search for yields that are not offered by more 'traditional' assets.

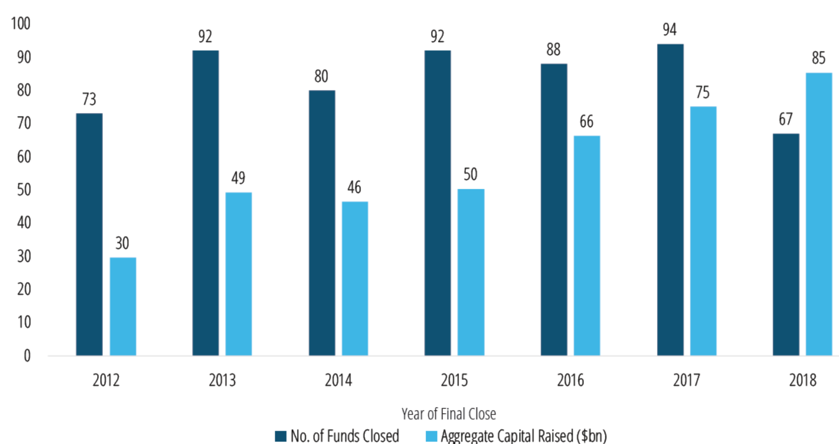
A3.2 Comprehensive data is difficult to find, also because different sources may use different categorisations by geographical area or industry, or inconsistent definitions. This appendix aims only to provide a high-level overview of the trend in recent years.

A3.3 The EFRAG Secretariat understands that most capital in the infrastructure area is raised through private funding, and the data reported below refer to unlisted infrastructure funds. The parties providing capital to these unlisted funds are not only corporates, but also institutional pension funds, sovereign wealth funds, private banking, retail investors and charitable endowments.

A3.4 A January 2019 report[15] observes that unlisted infrastructure fundraising marked an all-time high in 2018 - its second consecutive annual record - and is likely to do so again in 2019. Comparison of global capital raised by unlisted infrastructure funds and on a private basis for 2018 and 2017:

| | **2018** | **2017** |
|---|---:|---:|
| Unlisted infrastructure funds | $85bn | $75bn |
| Aggregate global private capital raised | $757bn | $925bn |

A3.5 The sixty-seven unlisted infrastructure funds raising funds in 2018 represents approximately 11% of the aggregate global private capital raised. Europe-focused infrastructure funds accounted for $35bn (41%) of the total raised in 2018. The table below illustrates the annual trend in global unlisted infrastructure fundraising.

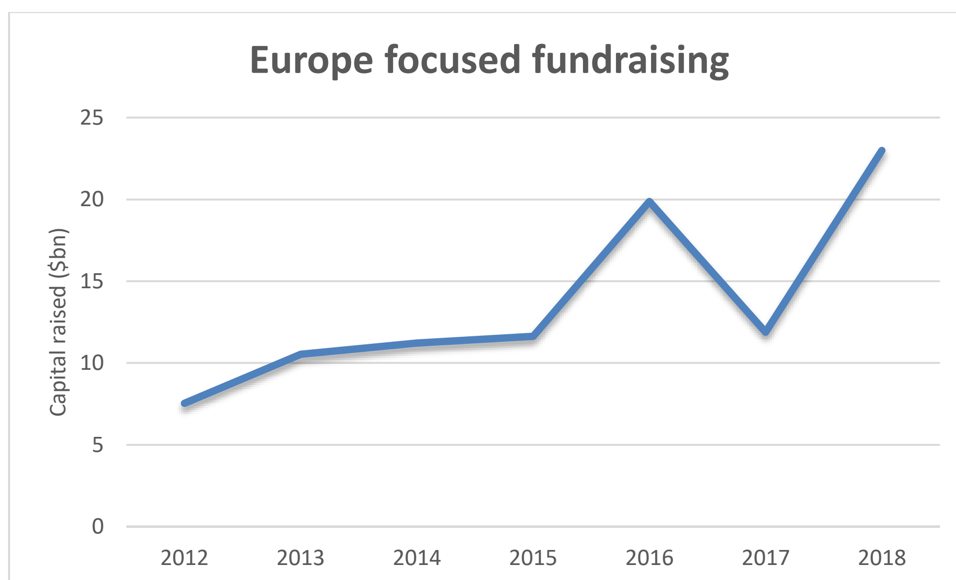



[15] *2018 Fundraising Update,* Preqin (2019)

A3.6 A third of all 2018 infrastructure fund closures did not have a specific focus on any one infrastructure sector, and these 'diversified infrastructure funds' collected the majority (approximately 86%) of capital from investors. The remaining capital come from sector specific funds such as energy, energy & renewables and telecoms.

A3.7 The recent trend is expected to continue, as the report states that *2018 saw the asset class secure almost twice as much capital as it did as recently as 2014, having set three consecutive annual fundraising records. It is testament to the appetite that investors have for infrastructure – its diversification, inflation-hedging and income stream potential are all key advantages, especially given the concerns many investors have about a prospective market downturn.*

A3.8 A similar trend can be observed in Europe. Another report[16] shows that Europe-focused infrastructure funds have significantly grown. The following table illustrates how fundraising has evolved between 2012 and 2018, with a 93% increase in the last year.




A3.8 More data collection and analysis is needed to assess what the interaction is, if any, of the accounting requirements and fundraising for these type of projects.

[16] *Fundraising Report 2018,* Infrastructure Investor (2019)

EFRAG receives financial support of the European Union - DG Financial Stability, Financial Services and Capital Markets Union. The content of this document is the sole responsibility of EFRAG and can under no circumstances be regarded as reflecting the position of the European Union.