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EFRAG Equity Instruments – Research on Measurement

Moving towards a consultation document

Objective of the session

- 1 Following a new request for technical advice from the European Commission, EFRAG has started a project to explore possible alternatives to the use of fair value measurement for equity and equity-like instruments.
- 2 The objective of the session is to discuss the process to issue a consultation document, taking into account the deadline set in the request.

Background of the project

- 3 In June 2018 EFRAG received a new request for technical advice from the European Commission to consider alternatives to fair value as the measurement basis for equity long-term investment portfolios of equity and equity-like instruments.
- 4 In the words of the request, the alternative treatments should properly portray the performance and long-term risks of long-term investment business models, in particular for those equity and equity-type investments needed to sustain the United Nations Sustainable Development Goals and the goals of the Paris Agreement on climate change. When referring to equity-like instruments, EFRAG understands that the Commission has in mind units in investment funds such as (but not limited to) the European Long-Term Investment Funds (ELTIF) established under Regulation 2015/760 of April 2015.

The project so far

- 5 The current project should be discussed in the broader context of the overall work of EFRAG on equity instruments. EFRAG has already conducted two consultations in the last 18 months and the EFRAG Secretariat is persuaded that it would not be helpful to ask constituents exactly the same questions in the immediate future. In the following paragraphs we summarise the activities already accomplished.

Activities completed in the earlier phase

- 6 EFRAG has already consulted constituents on:
 - (a) The size and accounting treatment of their equity portfolios in their pre-IFRS 9 financial statements;
 - (b) Their expectation in terms of the possible impact of IFRS 9 on their asset allocation decisions;
 - (c) Their views about the reintroduction of recycling;
 - (d) Their views about the interaction between recycling and impairment; and

- (e) Their preference in relation to an impairment model for equity instruments.
- 7 In relation to point (a), it could be possible to update the quantitative data collected in 2017. There are some new reports available, such as the 2018 Mercer European Asset Allocation survey. However, the EFRAG Secretariat notes that the EFRAG Board was reluctant to draw any conclusion from the data presented in relation to the potential impact of IFRS 9. Moreover, the data would still only be based on a one-year period and would still exclude insurance entities.
- 8 The EFRAG Secretariat sees no benefit in re-engaging constituents on points (b) – (e). There has been no development since the completion of the earlier consultation. No new arguments in favour or against recycling were provided during the consultation; these arguments have been repeatedly debated at the EFRAG TEG and Board level, and only weeks ago EFRAG has publicly reported its view that at this stage there is insufficient evidence to reach a conclusion on a reintroduction of recycling.
- 9 In relation to point (e), EFRAG's first technical advice could be integrated by a more specific description of how to improve an impairment model similar to IAS 39. However, EFRAG TEG has not expressed a formal preference on an impairment model and the EFRAG Board declined to re-engage with EFRAG TEG on this aspect.

EFRAG TEG discussions in the new phase

- 10 The European Commission request refers to long-term investment. There is no definition of long-term investment in IFRS Standards and the Commission has indicated that they will not provide a definition; however, EFRAG has been encouraged to develop its own definition if this is helpful to complete our task.
- 11 In September, EFRAG TEG discussed whether it should develop its own definition and the majority of members was not supportive. Concerns were raised both on the conceptual merit of differentiating the accounting treatment for long-term investments in equity and on the operational difficulties of developing a definition.
- 12 In November, EFRAG TEG had an initial discussion about measurement bases alternative to fair value. The EFRAG Secretariat proposals – which have been circulated also to the EFRAG Board – included
- (a) modified historical cost (less impairment);
 - (b) value in use;
 - (c) a long-term expected value approach;
 - (d) modified fair value, including the use of averages; and
 - (e) a 'linked' approach, i.e. an approach where the amount of the change in value of the equity instruments recognised in profit or loss is determined in a manner that reflects the measurement of the expense included in profit or loss for a liability economically linked to the equity instruments.
- 13 None of the alternatives were clearly supported by EFRAG TEG and none were rejected, with the possible exception of the long-term expected value approach and value in use - which some noted would be practically indistinguishable from fair value for instruments without a quoted price. It was also noted that most of the alternatives could be difficult and complex to apply. A revised paper is being brought back to the December EFRAG TEG meeting.
- 14 Finally, at the January EFRAG TEG meeting, the EFRAG Secretariat will present a paper to discuss how the notion of equity-like instruments could be defined better.

Areas of difficulty

- 15 During the project, there have been areas of difficulty that are summarised below:

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- (a) Significance of quantitative data – this is a discussion that goes beyond the specific topic. In recent years, the EFRAG Board in particular has requested the EFRAG Secretariat to provide quantitative ‘background’ data, which are collected either via public consultation, or publicly available reports and data aggregators. Both these activities require time to collect, summarise, analyse and report the data. However, at the end of the process often EFRAG Board members or EFRAG TEG members have criticised the data, for being not ‘statistically significant’ (due to the small size, geographical distribution or self-selection bias). Others have considered that the data could not be used to prove any causation.
- (b) Scope definition – contrary to EFRAG’s own research project, where EFRAG has full responsibility and control on the problem definition, this project originates from an external request. The request provides a background by referring to the work of the High-Level Expert Group and the European Parliament resolution that requires the Commission to monitor the effects of IFRS 9. However, some EFRAG TEG members have repeatedly requested clarification of the Commission’s view of the problem with existing requirements and the basis on which alternative accounting models could be appraised.

Content of future consultation document

- 16 Although the European Commission request does not ask EFRAG to consult constituents on its proposals for alternative measurement bases, the EFRAG Board has indicated that there should a public consultation.
- 17 The European Commission is asking that EFRAG provides its reply by the second quarter of 2019. Assuming that the consultation document is issued in February with a 2-months consultation period, it could be possible to discuss the feedback at the EFRAG TEG May meeting and report the conclusions at the EFRAG Board June meeting.
- 18 Considering the tight timetable and the fact that the input from the new consultation is likely to overlap partially with the prior discussion (including comments on the timing and process to potential changes to IFRS 9), the EFRAG Secretariat suggests planning an initial discussion on the content of the recommendation for a technical advice at the EFRAG TEG April meeting
- 19 The proposed outline of the Discussion Paper (the ‘DP’) is as follows:
Objective of the DP
- 20 In the first part, the DP will describe the context of the consultation. Reference will be made to the background in the request from the European Commission and the prior EFRAG Research project on Equity Instruments – Recycling and Impairment.
- 21 The objective of the consultation will be to gather input from European constituents on the advantages and disadvantages of alternative measurement bases for equity instruments, with the purpose of depicting their returns in the context of a long-term investment management.
Scope of application
- 22 In this part, the DP will specify what financial instruments the proposals would be applied to, and in particular refer to the current definition of equity instruments in IAS 32 *Financial Instruments: Presentation*, and the potential changes brought by the approach explored in the IASB’s DP *Financial Instruments with Characteristics of Equity*.
- 23 Based on the outcome of the discussion at the January EFRAG TEG meeting, the DP will illustrate how EFRAG proposes to apply the notion of equity-like instruments.

Alternative measurement bases and their significance

- 24 In this part, the DP will illustrate alternative views of how returns from equity instruments could be depicted with a specific focus on the profit or loss. The alternatives under consideration at this stage include a view that gives prominence to cash realisation; a view that gives prominence to reflect value changes in the reporting period; and a view that gives prominence to apportion returns over the holding period.
- 25 For each of these views, the DP will then illustrate the accounting bases and methods that could be employed to depict the returns. The DP will describe how they measure up to the qualitative characteristics of useful financial information and what operational challenges they could present.

Other aspects

- 26 Although the Discussion Paper is not expected to include a proposed definition of 'long-term investment', it may include suggestions on metrics entities may use to communicate about their investment strategy and performance.

Questions

- 27 Are there additional topics or aspects that should be addressed in the consultation?
- 28 Do you have suggestions on how to ensure that EFRAG respects the deadline?