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## **EFRAG Research project Equity Instruments – new request for technical advice**

### **Objective of the paper**

- 1 This paper explains the content of the new request for technical advice received by the European Commission in relation to the accounting for equity instruments under IFRS 9, and the initial thoughts of the EFRAG Secretariat on the content and process to perform this next phase of the project.

### *The request from the European Commission*

- 2 The full request is enclosed as paper 03-01a. The European Commission is asking EFRAG to consider alternatives to fair value as the measurement basis for equity long-term investment portfolios of equity and equity-like instruments.

### **Issues to investigate**

#### *Scope of application*

- 3 The EFRAG Secretariat notes that the request of the European Commission mentions in its first paragraph sustainable finance, long-term investment and equity-like instruments. None of these are defined in IFRS Standards, and each of these could be used – together or in isolation- to restrict the scope of application of alternative accounting requirements.
- 4 Constituents and EFRAG TEG have expressed concerns about defining a sub-set of equity, both on a conceptual and operational basis. The EFRAG Secretariat still deems necessary to have a discussion about the use of some defining criteria, although the conclusion may still be not to use any of them. Potential candidates as defining criteria include:
  - (a) The nature of the activities of the investee;
  - (b) The characteristics/ business model of the investor;
  - (c) The characteristics of the instrument;
  - (d) The market on which the instrument is exchanged;
  - (e) The (expected) holding period;
  - (f) The linkage between assets and liabilities.
- 5 In particular, the reference to equity-type instruments requires a further investigation. Many respondents to the EFRAG DP on *Equity Instruments – Impairment and Recycling* made reference to indirect holdings of equity via units of investment funds, but there is a variety of similar instruments.

*Possible alternative measurement basis*

- 6 There is a range of possible alternatives to fair value to be considered. The request does not suggest a specific model, although it notes that it should enhance investor's insights into the long term performance of investments.
- 7 The EFRAG Secretariat has preliminarily identified four basic alternatives to be analysed in detail. Some may be difficult to adapt to equity-like instruments.
  - (a) Cost: the purchase cost has the advantage of reliability and verifiability. It is also already used in IFRS 9 for debt instruments that meet the SPPI test. However, the use of cost gives rise to a number of operational issues:
    - (i) The treatment of acquisition costs;
    - (ii) The treatment of dividends;
    - (iii) The impairment model.
  - (b) Adjusted cost: cost could be adjusted to reflect changes in the economic circumstances over the reporting period other than market price changes. For instance:
    - (i) US GAAP allow cost for those investments where the fair value cannot be readily determinable – but require the entity to adjust the cost to reflect exchange prices in subsequent transactions on the same instrument;
    - (ii) The original purchase cost could be adjusted to reflect the holder's share of gains or losses in the investee for each reporting period;
    - (iii) Finally, some have suggested that appropriate depiction of the performance in a long-term investment business model is to allocate the expected gain in a regular pattern over the expected holding period. A way to achieve that would be to progressively accrete the initial purchase cost to the expected selling price. This would however require regular reassessment of the expected return.
  - (c) Value in use: value in use would be generally close to fair value, although some input may differ (for instance, the entity may use a discount rate different from the rate used by a market participant).
  - (d) Modified fair value: fair value could be adjusted to reduce the impact of short-term price changes (use of averages instead of reporting date fair value) or exclude the impact of certain factors (changes in risk-free rates).

*Managing the process*

- 8 Input from EFRAG TEG and constituents during the recycling and impairment discussion has indicated that EFRAG should use evidence to the available extent and consult as widely as possible.
- 9 However, EFRAG has already conducted two public consultations on investments in equity portfolio and there is a risk of consultation fatigue among constituents. Moreover, insurance undertakings will also be busy during the second half of 2018 with the endorsement process of IFRS 17 *Insurance Contracts*.
- 10 The EFRAG Secretariat has identified some possible steps to enhance effectiveness in the process:
  - (a) EFRAG could consult constituents with an online questionnaire, rather than issuing another Discussion Paper;

- (b) EFRAG could outsource a literature review on the use of fair value for equity instruments. There is likely a much broader academic literature on this topic than on the narrower topic of recycling;
  - (c) EFRAG could launch a call to national Standard Setters in Europe to create a Research Group. This could be helpful especially considering that EFRAG Secretariat staff members with a background in financial instruments are already engaged in the IFRS 17 endorsement and the FICE preliminary impact assessment. Establishing a Research Group may fit better into the timetable than an Advisory Panel that requires a former call for candidates and appointment by EFRAG TEG.
- 11 In the context of its initial consultation on Phase 1, EFRAG had asked constituents to indicate both their direct and indirect holdings. Only some respondents provided the information, with insurance companies and banks reporting 23% and 5% of indirect holdings on total equity instruments in AFS respectively.
- 12 It is unlikely that the split between direct and indirect holdings of equity instruments in AFS can be found in the notes to the financial statements. Some data could be found from publicly available sources.

**Questions for EFRAG TEG**

- 13 What data would you recommend to collect to support the technical discussion on alternative measurement basis?
- 14 Do you have suggestions or comments on the draft project plan?