# EFRAG Research project Equity Instruments –

# Research on Measurement

## 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.

2 This paper does not include any preliminary indication on alternative measurement basis that the project would consider.

*The request from the European Commission*

3 The full request is enclosed as paper 05-02a. In short, the European Commission is asking EFRAG to consider alternatives to fair value as the measurement basis equity long-term investment portfolios of equity and equity-like instruments.

## Elements of the project plan

*Scope of application*

4 The EFRAG Secretariat notes that the request of the EC 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.

5 EFRAG Secretariat notes that there mixed views about the better way to depict the performance of investments in equity instruments. While we may exclude that a consensus can be found, it is possible that restricting the scope of application of the alternative measurement identified (if any) could contribute to achieve a compromise acceptable to different parties.

6 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 we accept that eventually it is decided not to use any of them.

7 Initial candidates as defining criteria may be:

(a) The nature of the activities of the investee – this would tie-in to the request of the EC, which refers in particular to investments *needed to achieving the UN Sustainable Development Goals and the goals of the Paris agreement on climate change.* The EFRAG Secretariat notes that the EC in May issued proposals to establish a unified EU classification system of sustainable economic activities ('taxonomy'), which could be used as a starting point to set a qualifying criterion based on the nature of the activities. On the other side, it is unlikely that the IASB will use a definition from a EU piece of legislation to introduce changes to their international accounting standards;

(b) The characteristics/ business model of the investor – this would tie-in to the notion on long-term investor. EFRAG has made some work in the past to identify different types of business models. Additional work could be done to refine the definition included in the EC Staff working document on *Long-Term Financing of the European Economy* accompanying the document *Green Paper Long-term financing of* the *European Economy* issued in 2013. On the other side, respondents to that consultation did not support a rigid definition;

(c) The (expected) holding period – this would tie-in to the notion of long-term investment (rather than investor). The expected or actual holding period would potentially provide a more objective anchor than a qualitative definition. On the other side, it would create the issue of transfers between portfolios, and could lead to the use of bright-lines;

(d) The linkage between assets and liabilities – some IFRS Standards allow the use of accounting mechanisms to reflect a linkage between assets and liabilities. Examples are the presentation of the return on qualifying assets held in a defined benefit plan in IAS 19 *Employee Benefits,* and the presentation of financial income/expenses in IFRS 17 *Insurance Contracts* for contracts with direct participation features, when the entity holds the underlying assets. On the other side, this would likely require qualification criteria – like those required in IAS 19 to qualify as plan assets, or those required in IFRS 17 to apply the variable fee approach.

8 Also the reference to equity-like 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. One issue that arise is whether entities should adopt a 'see-through' approach to assess if the investment qualifies for the alternative measurement, if any. This could apply for instance when the fund net assets included derivatives.

*Managing the process*

9 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.

10 However, it should be reminded 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.*

*Involvement of EFRAG Working Groups*

11 The EFRAG Secretariat plans to involve the following EFRAG Working Groups:

(a) FIWG and IAWG – the members of these Group will be consulted to offer suggestions on alternative measurement basis and comment on our assessment of the strengths and weaknesses of the alternative measurement identified (if any);

(b) User Group – the members of this Group will be consulted on how differently they would use the information under the alternative measurement identified (if any);

(c) Academic Panel – the EFRAG Secretariat discussed Phase 2 with the Academic Panel in May to obtain input on possible research methodologies. In order to understand the behavioural impact, it was suggested to compare investment trends in jurisdictions applying IFRS 9 to other jurisdictions (the US), but it would be difficult to isolate the effect of the new accounting requirements from other factors. Some members noted that structured interviews could be useful, but also quite time-consuming – a two-year period would be at least needed to complete the study;

(d) (tentative) Banking Working Group – assuming the new Banking Working Group is set-up and operating in a timing compatible with the deadline to respond, the EFRAG Secretariat envisages to involve it in a way similar to the FIWG and IAWG.

*Involvement of external parties*

12 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.

13 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.

14 As noted above, there is a risk of consultation fatigue on the topic. Not only EFRAG has consulted twice in the last year (although the scope of Phase 1 and 2 were slightly different), but the interaction between accounting requirements, long-term investment and sustainability is also a focus of the EC fitness check on public reporting by companies.

15 The EFRAG Secretariat considers that the use of an online questionnaire could prove less cumbersome to constituents than consulting on another Discussion Paper.

*Relevant input*

16 The EFRAG Secretariat considers that input from prior consultation should be carefully weighted. In particular, we refer to:

(a) EFRAG DP on Equity Instruments – Impairment and Recycling. The DP noted explicitly that EFRAG was not questioning the use of fair value as a measurement basis for equity instruments. Some respondents however commented that EFRAG should have investigated alternatives. It is clear that the depiction of performance is the same if an entity uses FVOCI with recycling or cost – therefore we can assume that some of those in favour of the reintroduction of recycling would also support the use of cost (or some variant of cost); and those against the reintroduction of FVOCI would rather support the use of fair value;

(b) European Union on fitness check – Question 20 of the fitness check notes that since the adoption of IFRS by the EU in 2005, topics such as sustainability and long-term investment have come to the forefront of the regulatory agenda. The consultation asks

(i) if the EU endorsement process appropriate to ensure that IFRS do not pose an obstacle to broader EU policy objectives such as sustainability and long-term investments?

(ii) If the EU regulatory framework should make explicit that in order to endorse IFRS that are conducive to the European public good, sustainability and long term investment must be considered.

Since the EU request to EFRAG is specifically referring to investments needed to achieving the UN Sustainable Development Goals and the goals of the Paris agreement on climate change, the EFRAG Secretariat believes that the response to the questions in the EU consultation will provide relevant input.

*Data collection and other evidence*

17 The EU request to EFRAG asks to collect data on the significance of equity instruments carried at FVOCI and the possible impact on long-term equity investments.

18 These data will be difficult to collect. Paragraph 11A of IFRS 7 requires entities that make use of the election to disclose the amount of equity instruments carried at FVOCI, but this information will be publicly available only after the 2018 financial statements are issued (and it will not include insurance entities).

19 No specific requirement exists for investments in equity-liked instruments, that do not qualify for the use of the election. In the context of its initial consultation on Phase 1, EFRAG had asked constituents to indicate both their direct and indirect holdings. Only a few respondents provided the information, with insurance companies and banks reporting 23% and 5% of indirect holdings on total equity instruments in AFS respectively.

20 In the Capital IQ database some further disaggregation for financial institutions may be available, but again the timing of availability of the data will be an issue considering the deadline to reply.

21 Information that could help in assessing the potential impact is information about how entities that build infrastructure are financed. For instance, it would be interesting to know if investors reporting under IFRS in Europe (such as banks or insurance) are purchasing equities in these companies on the primary or the secondary market; or what is the debt-to-capital ratio of these companies.

22 We have not yet made any attempt to look for this information, but the EFRAG Secretariat thinks it could be found via a manual research on a case-by-case basis. Alternatively, EFRAG could ask Academic Panel members if they are aware of any relevant study already available.

23 EFRAG could outsource a literature review on the use of fair value for equity instruments. There is likely a broader literature on this topic than on the narrower topic of recycling. On the other side, the prior review was inconclusive on the real impact of accounting regulations on investment decisions and holding periods.

*Timetable – next steps*

24 The EC request for advice asks EFRAG to reply by the second quarter of 2019. If the EFRAG agrees in substance with this plan we envisage to be able to bring issues papers on the topic mentioned above in (a) and initial ideas on alternative measurement basis respectively at the 29 September and 20 December EFRAG TEG meetings. Data collection, to the extent possible, will be carried out over the same period.

**Questions for EFRAG Board**

25 What data would you recommend to collect to support the technical discussion on alternative measurement basis?

26 Do you have suggestions or comments on the draft project plan?