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DISCUSSION PAPER

EQUITY INSTRUMENTS – ALTERNATIVE MEASUREMENT APPROACHES

MARCH 2019

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This Discussion Paper is issued by the European Financial Reporting Advisory Group ('EFRAG').

EFRAG welcomes comments on its proposals via the 'Questions to Constituents' at the end of each section. Such comments should be submitted through the EFRAG website by clicking [here-insert hyperlink] or should be sent by post to:

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B-1000 Brussels
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Comments should arrive no later than [10 May 2019]. EFRAG will place all comments received on the public record unless confidentiality is requested.

EFRAG Research Activities in Europe

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. [EFRAG carries out this research work in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level]. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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Executive Summary

ES 1 International Financial Reporting Standard 9 (‘IFRS 9’) *Financial Instruments* is effective for annual periods beginning on or after 1 January 2018 subject to an optional, temporary exemption for entities undertaking insurance activities. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss (‘FVPL’). At initial recognition, an entity may however make an irrevocable election to present changes in the fair value in other comprehensive income (‘OCI’) on an instrument-by-instrument basis (the ‘FVOCI election’). If an entity applies the FVOCI election, it does not assess these instruments for impairment and cannot reclassify in profit and loss gains or losses previously recognised in OCI on disposal of these instruments – also referred to as ‘recycling’.

ES 2 The European Commission (‘the EC’) has requested EFRAG to consider alternative accounting treatments for equity and equity-type investments. The EC request is provided in Appendix 1. The request asks EFRAG to consider alternative accounting treatments to fair value that would properly reflect the performance and risks of long-term investment business models.

ES 3 The DP explores alternative accounting treatments with a specific focus on reporting the performance of entities that hold long-term investment portfolios of equity instruments. The DP explores measurement at historical cost and at average fair value, which could be applied either:

- in a single measurement approach both in the statement of financial position and for related income and expenses in profit or loss; or
- in a dual measurement approach with equity instruments carried at reporting date fair value in the statement of financial position, with differences between the fair value movement and the amount reported in profit or loss presented in other comprehensive income.

ES 4 The DP also discusses how those approaches contribute to the technical criteria of relevance, reliability, comparability, understandability and prudence. The DP illustrates more briefly other potential approaches in Appendix 2.

ES 5 The DP also examines the issues of ‘equity-type instruments’ and ‘long-term investment’. The first issue is about what financial instruments, beyond equity instruments, should be considered when discussing alternative accounting treatments, and how the scope of application could be defined.

ES 6 The second issue is about whether the discussion on alternative accounting treatments should be limited to instruments held for the long-term, and if so, how this could be appropriately defined.

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

a) address the question as stated;

b) indicate the specific paragraph reference to which the comments relate; and/or

c) describe any alternative approaches that should be considered.

All comments should be received by [10 May 2019].

Question 1 – Historical cost and average fair value

Paragraphs 2.1 to 2.17 of the DP consider whether historical cost or fair value averages could provide an improved basis for reporting the performance of entities that hold long-term portfolios of such instruments.

Q1.1 Do you support either historical cost or average fair value as a basis to report performance of entities that hold long-term investment portfolios of equity instruments? Please explain the reasons for your views, including how this would improve the existing requirements in IFRS 9.

Q1.2 If you do not support either historical cost or average fair value as a basis to report the performance of entities that hold long-term investment portfolios of equity instruments, please explain the reasons for your views including possible application issues.

Question 2 – Single or dual measurement basis

EFRAG has focused on the reporting of performance and therefore the DP indicates that historical cost or average fair value could be used either in a single or in a dual measurement approach (see for instance paragraph 2.17 for an illustrative example).

Q2.1 In your view, if historical cost or average fair value was to be permitted or required for some or all equity instruments, should they be applied in a single or in a dual measurement approach? Please explain the reasons for your view.

Q2.2 Are there operational complexities that could arise from the use of a dual measurement approach? If so, how could they be addressed?

Question 3 – Relationship between accounting and investment decisions

Chapter 3 mentions some of the arguments that have been raised in relation to accounting and investment decisions. EFRAG has not conducted a comprehensive assessment and available evidence is still limited.

Q3.1 In your view, are there other arguments about the relation between accounting and investment decisions?

Q3.2 Do these arguments specifically apply to investment decisions in sustainable activities?

Question 4 – Scope of application

In addition to exploring possible alternative measurement bases for equity instruments as defined in IAS 32 Financial Instruments – Presentation, the DP considers whether these approaches could also be permitted or required for other 'equity-type' financial assets such as units in certain investment funds. Paragraphs 4.2 to 4.9 discuss how to define 'equity-type' instruments.

Q4.1 In your view, if an alternative measurement basis were to be permitted or required for some or all equity instruments as defined in IAS 32, should that measurement basis also be permitted or required for other financial assets as well? Please explain the reasons for your view.

Q4.2 If you support extending an alternative measurement basis to 'equity-type' financial assets, how would you define 'equity-type'? How would you determine whether a fund is 'equity-type' (by looking through to the composition of fund's underlying portfolio or in some other way)? Please explain.

Question 5 – Long-term investments

EFRAG has discussed whether an alternative measurement basis should be permitted or required only for equity instruments that are held within long-term investment business models. The DP discusses possible ways and qualifying criteria to define 'long-term investments' in paragraphs 4.10 to 4.36.

Q5.1 If an alternative measurement basis were developed, should this be permitted or required only for long-term investments?

Q5.2 If so, what criteria would you apply to qualify equity instruments as 'long-term investments'? How would you ensure that the definition is operational?

Question 6 – Other approaches

Appendix 2 of the DP briefly describes other approaches based on modified cost, modified fair value and allocation approaches. These alternatives would need to be further developed before being considered for standard-setting activities.

Q6.1 Would you recommend EFRAG to further develop any of the approaches in Appendix 2? If so, which one and what are your reasons for selecting this approach?

Q6.2 Is there any other alternative that you support? Please provide a rationale for your answer.

CHAPTER 1: CONTEXT AND OBJECTIVE OF THIS DP

Objective of this Discussion Paper

1.1 The main objective of this Discussion Paper ('the DP') is to gather constituents' views on possible ways of measuring equity and equity-type instruments as alternatives to the measurements required in IFRS 9 *Financial Instruments*. The DP considers the impact of these alternatives on the reporting of performance of entities that hold long-term investment portfolios of equity instruments.

1.2 The DP briefly illustrates how the accounting outcome would differ if the alternatives are used either as a single measurement basis or in a dual measurement approach.

1.3 The DP is intended to complement previous EFRAG discussions and consultations on the accounting treatment for equity instruments, For this reason, the DP 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[1]. Constituents' input from previous consultations will be duly considered by EFRAG in developing its technical advice to the European Commission. Other aspects of IFRS 9, such as the characteristics of the impairment model or hedging requirements, are not addressed in this DP.

The context for this Discussion Paper

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

1.5 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].

1.6 Several factors have contributed to the infrastructure investing gap, and the broader overall investing gap, the major one being the substantial reduction in Government investing. Among various factors, it has been suggested that accounting Standards could play a role in affecting the amount of available long-term financing. In the context of this DP, EFRAG has not made an assessment of the extent of the role of accounting in this regard.

How IFRS 9 changes accounting for equity instruments

1.7 In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). For those 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 other comprehensive income ('FVOCI'). The entity needs making the election at initial recognition and may apply it on an instrument-by-instrument basis.

[1] *Equity instruments: Impairment and recycling*, EFRAG Discussion Paper, March 2018

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

1.8 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.

1.9 In comparison, the predecessor Standard IAS 39 *Financial Instruments: Recognition and Measurement* required entities to carry equity instruments at fair value, with the changes recognised either in profit or loss (for instruments classified as held-for-trading) or OCI (for AFS instruments). Only instruments without a quoted price on an active market and whose fair value could not be reliably measured were carried at cost. For equity instruments classified as AFS, the amounts recognised in OCI were recycled to profit or loss upon disposal or impairment.

1.10 The use of FVPL for investments in equity instruments will 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. Furthermore, some entities may decide not to elect the FVOCI option for eligible equity instruments because of the lack of recycling.

How is accounting part of the discussion?

1.11 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 received and from 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.

1.12 It has therefore been argued that neither of the IFRS 9 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.

1.13 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.

1.14 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).

The requests from the European Commission

1.15 The EC completed the endorsement process of IFRS 9 with the adoption of Commission Regulation No 2016/2067 on 22 November 2016. During the endorsement process, the European Parliament and some Member States called for close monitoring of the impact of IFRS 9 to ensure that it serves the European Union's long-term investment strategy.

1.16 To address these concerns the European Commission has directed two requests for technical advice to EFRAG. The first request in May 2017 included two distinct phases:

a) in the first phase ('the assessment phase'), the EC requests EFRAG to investigate the significance of the equity portfolio for long-term investors under IAS 39 and whether the new requirements in IFRS 9 are expected to affect asset allocation decisions; and

b) in the second phase, the EC requests EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is an important element in order to re-introduce recycling, then EFRAG should consider how the impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches. The EC also requests EFRAG to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements that could enable users to form a view about the performance of the equity investments.

1.17 The second request received in June 2018 is provided in Appendix 1. This request asks EFRAG to consider alternative accounting treatments to fair value. In the words of the request, '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' insights in the long-term performance of investments as opposed to recognising point in time market based value changes in reported profit or loss during the duration of the equity investment.'

Results of EFRAG's prior work

1.18 EFRAG reported its findings from the assessment phase to the EC in January 2018. 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.

1.19 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*.

1.20 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[3]. 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.

[3] 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.

1.21 Some partial information about the initial impact of IFRS 9 on classification and measurement is starting to be available. An initial report[4] 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.

1.22 EFRAG reported its technical advice for the second phase of the EC request in November 2018. 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.

1.23 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.

1.24 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.

Structure of the DP

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

1.26 **Chapter 3** provides an assessment of historical cost and average fair value in relation to the quality of financial information and potential impact on behaviour by preparers.

1.27 **Chapter 4** discusses the notion of 'equity-type' instruments and 'long-term investment' in the context of the scope of application of the possible changes to accounting requirements.

1.28 **Appendix 1** provides the EC request for technical advice.

1.29 **Appendix 2** provides further information on other accounting alternatives.

[4] EBA report *First observations on the impact and implementation of IFRS 9 by EU institutions* December 2018

CHAPTER 2: 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 approach.

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 in their separate (i.e. non-consolidated) financial statements.

2.3 This DP firstly explores historical cost and average fair value as possible alternatives. EFRAG has also considered some other approaches which are described in Appendix 2. These include:

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 a systematic way 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 circumstances. 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 DP explores whether historical cost as measurement basis could reflect the performance and risk 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 determining 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 the DP. Furthermore, the DP assumes that dividends will be recognised in profit or loss in accordance with IFRS 15 *Revenue from Contracts with Customers.* The interaction between recognition of dividends in profit or loss and the measurement of the cost of the investment might however need further consideration, e.g. if some dividends are considered in substance to represent a return of capital.

2.8 If historical cost were to be used to report the of performance of entities that hold long-term investment portfolios of equity instruments, EFRAG 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. An entity would not recognise remeasurement gains or losses during the holding period; it would only impairment losses and gains or losses when the equity instrument is derecognised;

b) A dual measurement approach, as the term is used in this DP, 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 to recognise impairment losses and gains or losses when the equity instrument is derecognised.

2.10 The application of the two approaches is illustrated below.

2.11 EFRAG notes that the use of fair value 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 EFRAG has not investigated such phenomena and expresses no opinion 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

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***	
	SMA[5]	**DMA**[6]	**SMA**	**DMA**
***As at 31 December 20x8* – in LC**				
Investment held	100	120	108	120
Retained earnings: Remeasurement of investment	-	-	8	8
Investment held reserve	-	20	-	12
***As at 31 December 20x9* – in LC**				
Investment held	100	130	122	130
Retained earnings: Remeasurement of investment	-	-	22[7]	22
Investment held reserve	-	30	-	8

[5] Single measurement approach
[6] Dual measurement approach
[7] This amount equals LC 8 (from prior year) plus LC14 of current year

CHAPTER 3: ASSESSMENT OF HISTORICAL COST AND AVERAGE FAIR VALUE

Introduction

3.1 In this chapter, EFRAG makes an assessment of historical cost and fair value in terms of quality of financial information.

3.2 The main focus of the assessment is the depiction of performance in profit or loss of entities that hold long-term portfolios of equity instruments. This is because profit or loss is the main indicator of performance. EFRAG also acknowledges that the other elements of the financial statements – including amounts reported in OCI (when applicable), the statement of financial position, statement of cash flows and the disclosures – also contribute to the overall depiction of performance. In particularly, whichever measurement basis is applied in profit loss, disclosures can play an important role both in supplementing and in explaining the information provided. Chapter 5 of this DP illustrates some disclosures currently used by long-term investors to communicate performance.

3.3 It may be useful to consider that the IASB's 2018 *Conceptual Framework* states that the selection of the most appropriate measurement basis should take into consideration the characteristics of the assets as well as the business activity to which they relate.

3.4 Most agree that for equity investments held for trading, the depiction of an entity's performance should include changes in fair value. This is due to the nature of the business model, which achieves its objective by short-term profit taking.

3.5 There is less consensus on how to depict the performance of an entity holding long-term equity instruments. The objective of a long-term equity investing business model normally combines generating periodic returns in the form of dividends and gains on disposal. Therefore, some infer that the performance reported by these entities should reflect both elements.

3.6 FVPL and historical cost accounting both result in reporting all returns on the original investment. The key difference is the timing of when the gain is reported and the treatment of fair value changes during the holding period. FVPL accounting reports fair value changes throughout the holding period and does not differentiate between realised and unrealised gains or losses. Historical cost accounting reports the gain only at the time of disposal and thereby treats realisation as the critical event in the depiction of performance.

Relevance

3.7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

Historical cost and the long-term business model

3.8 Past discussions have shown that there are different assessments of the relevance of disposal gains in depicting performance.

3.9 One view is that conversion into cash is an important event that modifies the risk exposure of the holder. Therefore, ultimate realisation of a gain should have an impact in the depiction of performance. Gains on disposal also provide information on the stewardship of the management and should be visible in the performance.

3.10 Under this view, the inclusion of changes in fair value during the holding period results in volatility that is not reflective of the long-term performance of the portfolio.

3.11 Another view is that reporting the cumulative gain or loss only in the period of disposal is not indicative of performance in the period when the instrument is sold. The cumulative gain or loss arises progressively (albeit not necessarily evenly) over the entire holding period and reporting it in full might distort the depiction of performance both in that period and during the holding period.

3.12 It has also been argued that since management has the ability to hold or dispose of individual investments in equity instrument in each reporting period, omitting fair value changes diminishes the ability to assess management stewardship in relation to the decisions to hold investments.

3.13 Some further challenge the emphasis on conversion into cash that is implicit in historical cost measurement, particularly in the context of large, open portfolios of liquid investments. They note that proceeds from selling are typically reinvested and that portfolios are continuously rebalanced, calling into question the notion that crystallisation upon sale represents the conclusion of an earnings or investing cycle. They further note that historical cost accounting results in recognising a gain or loss even if an entity sells an investment immediately reinvests in the same instrument.

3.14 In principle, an impairment loss on an equity instrument is an incurred loss and is therefore economically similar to a loss on disposal. The inclusion of incurred losses enhances the relevance of profit or loss as the primary source of information about an entity's financial performance, including from a stewardship perspective.

Does historical cost have predictive value?

3.15 From the perspective of the statement of financial position, fair value is generally considered to provide relevant information because it reflects market participants' expectations about the amount, timing and uncertainty of future cash flows at the reporting date.

3.16 Historical cost in the statement of financial position loses relevance over time and it is not predictive of the disposal cash flows. By contrast, fair value in the statement of financial position even if immediate disposal is not the expected way of recovery and current holding gains will not correspond to the ultimate disposal gains.

3.17 However from the perspective of reporting performance, there are different views on the comparative predictive value of historical cost and fair value. Historical cost results in the performance of the entity reflecting disposal gains and not holding gains. One argument in favour of historical cost is that disposal gains have predictive value for an entity with a large diversified portfolio and where market conditions are stable so that the entity is able to generate a steady level of disposal gains. However, in such conditions the use of fair value might result in a similar depiction of performance. Another argument is simply that that historical cost avoids the volatility inherent in the use of fair value and that this volatility detracts from predictive value.

3.18 Arguments against the relevance of historical cost are that the entity may not be able to replicate the same level of disposal gains, and therefore these are not predictive of future performance and prospective cash flows.

3.19 Holding gains could be regarded as assisting in the evaluation of stewardship. Some regard holding gains or losses as reflective of the economic characteristics of equity instruments because they are exposed to market value changes and do not have contractual cash flows.

Average fair value

3.20 In relation to relevance, the average fair value is still a form of current value and so it is difficult to differentiate between average fair value and period end fair value. It could be argued that average fair value has slightly more predictive value if it dampens the effect of point in time peaks and troughs on reported performance.

Reliability

3.21 Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

Historical cost

3.22 Historical purchase cost is generally considered to be a reliable measurement basis, with the inputs mainly derived from transactions with third parties. Also, disposal gains are similarly reliably measured. However, the requirement to assess impairment losses introduces more judgement, particularly on the impairment 'trigger' and any reversal (if relevant in accordance with the selected impairment model) and may require the use of fair value to measure the amount of impairment.

Average fair value

3.23 There are concerns about the reliability of fair value for instruments that do not have an observable price in an active market. Average fair value may intensify these concerns, as it in principle it could require more estimates to be produced. This may be avoided by resorting to a single valuation that uses averaged assumptions, which would result in the approach being more an adjusted fair value than a real 'average' fair value. The application of the approach would then differ between listed and unlisted equities (although this is also the case for period end fair value estimates).

Comparability

3.24 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

3.25 IFRS 9 included an option to account for equity instruments in two different ways that results in outcomes that cannot be easily compared. Based on the election, an entity would report changes in fair value either in profit or loss or in OCI. Paragraph 82A of IAS 1 *Presentation of Financial Statements* would require an entity using the FVOCI election to present line items for items of OCI classified by nature.

3.26 Replacing one of the two options in IFRS 9 with either historical cost or average fair value would not enhance comparability. If for instance historical cost replaced FVPL, historical cost and FVOCI without recycling would still result in different reported performance due to impairment losses and disposal gains. Average fair value and FVPL would probably be not too dissimilar, assuming the averaging period is not too extended.

3.27 The use of average fair value may decrease comparability unless a standard period and frequency is specified. The selection of a specific average would be necessarily arbitrary, and some may argue that it should be adjusted to the expected holding period. This discussion would in substance replicate the debate about defining the 'significant' and 'prolonged' threshold in relation to the impairment model.

Understandability

3.28 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

3.29 Historical cost is a well understood measurement approach that is commonly used. Entities would need to provide explanation about the criteria to recognise an impairment loss as well as the methods and assumptions to estimate the loss, unless the Standard included a prescriptive model. The reported gains on disposals may warrant additional disclosures if unusual in size in accordance with the requirements of IAS 1.

3.30 Conceptually, a fair value average, if clearly explained, should not raise an understandability issue. The amounts could be less understandable if the average fair value was used in a dual measurement model as in paragraph 2.17b above, since the profit or loss reported would differ from the change in the carrying amount of the investment.

Prudence

3.31 For the purpose of this DP, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

3.32 Cost may be seen as a prudent basis of accounting because the entity is prevented from recognising income for positive changes in value that may potentially revert before realisation. Also, EFRAG supports that recognising impairment losses is consistent with the notion of prudence and therefore, an impairment model would be a necessary complement to historical cost.

3.33 Average fair value may result in prudent accounting, but only when year-end fair values correspond to high peaks. This will depend on the circumstances. Similarly an impairment model would be a necessary complement to this measurement basis.

Could there behavioural effects of accounting?

3.34 The European Commission is committed to promoting sustainable investment decision-making. Some constituents have expressed concerns that IFRS 9 requirements for equity instruments may not be conducive to sustainable and long-term investment.

3.35 The European Commission wants to ensure that accounting standards do not discourage sustainable and long-term investment and has therefore asked EFRAG to contribute to the debate.

3.36 Little evidence is currently available to conclude on the relation between these new accounting requirements and possible investment decisions.

3.37 Based on the results of prior consultation, these are some of the key messages from the evidence gathered in the assessment phase:

a) the aggregate amount/value of equity instruments classified as AFS under IAS 39 by entities that consider themselves long-term investors is substantial. Our findings indicated a high level of concentration of holdings of equity instruments classified as AFS in a relatively small number of entities;

b) the importance of AFS accounting varies among entities that consider themselves long-term investors. For some, recycled gains and losses represent a significant proportion of net profits in the years examined. However, some make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9's requirements;

c) asset allocation decisions of long-term investors are driven by a plurality of factors; and

d) entities that are concerned about the IFRS 9's requirements often point out to a form of 'economic linkage' between their holdings of equity investments and some of their liabilities.

3.38 EFRAG has not conducted an extensive assessment of the possible behavioural implications of this aspect relating to the adoption of IFRS 9.

3.39 In its endorsement advice on IFRS 9, EFRAG assessed that the measurement requirements in respect of investments in equity instruments might have limitations for the reporting of performance by some long-term investors. However EFRAG does not expect their investment strategies to be significantly affected.

3.40 The following paragraphs illustrate some of the arguments raised by constituents or in academic studies.

3.41 The use of FVPL for equity instruments imports more volatility attributable to market price changes into the reported performance, while historical cost ignores market price changes (with the exception of impairment losses). Many preparers have expressed concern that this additional source of variability could impact the attractiveness of their issued equity instruments, and therefore, to avoid this outcome, they would be forced to reduce their exposure to equity instruments. The concern is that such volatility in the price of its issued equities could have implications for future capital raising ventures.

3.42 Others counter that the market response is due to unexpected outcomes and a lack of clear communication rather than volatility in performance *per se.* This is especially relevant where the volatility could be modelled, for example due to general volatility in market prices of equity instruments. The concerns around volatility could also lead to entities disinvesting when markets are experiencing losses, thus increasing a financial market downturn.

3.43 It is also suggested that the use of fair value can have pro-cyclical effects where capital regulations draw heavily on the accounting. The argument is that, if a bank has to write down its assets to reflect a decrease in market prices, the bank's regulatory capital may be depleted, which can negatively affect the availability of financing for the real economy.

3.44 Historical cost allows provides an opportunity for selective profit-taking, since the entity has control over the timing of disposal. This may conflict with the objective of encouraging long-term holding of equity instrument, because entities would have an incentive to dispose of investments to achieve a reporting target in a given period.

3.45 It should be noted though, that these arguments are raised in relation to equity instruments as a whole and are not specific to investment in sustainable activities, which is the focus of the EC policy objective. EFRAG has no evidence about whether these potential effects would be more or less significant for sustainable activities compared to the rest of the economy.

CHAPTER 4: SCOPE OF APPLICATION

Equity instruments

4.1 The instruments under consideration for the DP are those that meet the definition of equity instruments in IAS 32 *Financial Instruments: Presentation* paragraph 11, i.e. "[a] contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".

Equity-type instruments

4.2 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[8] and responses to our previous consultations on this topic, our understanding is that these relate to puttable instruments from the holder's perspective such as units in investment funds.

4.3 The last part of the March 2018 DP 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. .

4.4 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.

4.5 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.

4.6 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[9] does not meet the definition of an equity instrument and is therefore not eligible for the FVOCI election.

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

[9] 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.

4.7 If an alternative accounting treatment is considered also for equity-type instruments, a first question arises on how to define the scope of application. One way to address would be to include in the scope all instruments that would 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.

4.8 A second issues arises in relation to the composition of the portfolio of the fund. 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. This would introduce inconsistency in the accounting treatment of directly and indirectly held financial instruments.

4.9 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 hold by the fund do not include material items that under IFRS 9 need to be carried at FVPL. This requirement would however increase the complexity already noted in paragraph 4.7 above.

Long-term investment

4.10 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.

4.11 IAS 1 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.

4.12 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).

4.13 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.

4.14 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 considered as 'long-term'.

4.15 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[10], 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.

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

4.17 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.

4.18 Measurement requirements based on a notion of expected duration can only 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.

4.19 EFRAG debated 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. It also debated how such a definition could be developed, but no consensus emerged as to what this would include.

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

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

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;

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

4.21 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.

4.22 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.

4.23 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.

4.24 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.

4.25 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.

The expected or actual holding period

4.26 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.

4.27 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

4.28 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.

4.29 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.

4.30 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 equities to generate cash inflows to settle their obligations in relation to decommissioning of nuclear plants.

4.31 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 a more stringent link between the liabilities and the investments in concern would be needed.

4.32 Secondly, and subject to the above, the range of qualifying liabilities could include items that are measured differently (amortised cost, fulfilment cost, 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.

4.33 Specific questions on the scope of application and definition of long-term are included in the Questions to Constituents.

Other qualifying criteria

4.34 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[11] (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.

4.35 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).

4.36 EFRAG acknowledges that it would be extremely challenging to develop a conceptually sound and operational qualifying criteria for an accounting treatment on this basis.

[11] Regulation 2015/760

CHAPTER 5: COMMUNICATING LONG-TERM PERFORMANCE

5.1 While the objective of this DP 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 DP 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:

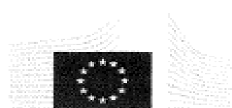
Metric	Purpose	Calculation
Gross investment return as a percentage of opening portfolio value	Performance measure of proprietary investment portfolio	Realised and unrealised gains along with dividends, fees and interest as well as related foreign exchange
Cash realisations	Provides information on the 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[*]).

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.

[*] Real estate, infrastructure and forest land

Appendix 1 – REQUEST FROM THE EC



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
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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 2 – OTHER APPROACHES

1. EFRAG also debated 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

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. 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 *Investments in Associates and Joint Venture.*

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.

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

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.

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.

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.

9. EFRAG 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.

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

11. Paragraph 15 of IFRS 13 *Fair Value Measurement* 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

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

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.

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

Allocation-based approaches

15. When looking at performance, the following summarises the impact of the more known alternatives:

    a. FVPL – immediate recognition of all price changes;;

    b. FVOCI election in IFRS 9 – no recognition of price changes;

    c. Cost/ FVOCI with recycling – no recognition during holding period (except for dividends and impairment losses), full recognition in the period of disposal.

16. An alternative view would be to require recognition of price changes in a systemic way over the term that reflects the investment perspective. This objective could be pursued via a systemic allocation mechanism. The mechanism could be articulated in different ways but in all cases would need to identify a relevant period and allocation pattern.

17. One variant would be to estimate the holding period at initial recognition and apply an expected return rate over this period to compute the return in profit or loss.

18. Another variant would use the expected duration of a designated (linked) liability. The entity would need designation mechanism to associate equity instruments with liabilities held by the entity. The allocation pattern could be based on either the rate applied to the liability (assuming the liability is measured at amortised cost); or include in profit or loss expenses or income that exactly match the income or expenses included in profit or loss for the linked liability.

19. 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.

20. However, an allocation approach is heavily reliant 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.

21. 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.

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

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