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REQUEST FOR TECHNICAL ADVICE

ALTERNATIVE ACCOUNTING TREATMENTS FOR LONG-TERM EQUITY INVESTMENTS

MONTH 2019

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Executive Summary

European Commission Request

ES1 As part of its Action Plan on Sustainable Finance, in June 2018 the European Commission ('EC') asked EFRAG for technical advice on possible alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments ('long-term investments'). The EC highlighted that alternative accounting treatments for long-term investments should properly portray the performance and risks of long-term investment business models. The EC also highlighted that alternative accounting treatments for long-term investments should preferably enhance investors' insight in the long-term performance of investments.

ES2 In 2017 the EC had asked EFRAG to provide quantitative information about long-term equity investments, evaluate the possible impact of IFRS 9 on long-term investments and identify possible improvements to the accounting for long-term investments in IFRS 9. More details about EC requests and EFRAG previous responses can be found in Chapter 1 *Introduction* and Appendix 1 *Summary of Previous Research.*

EFRAG Public Consultation

ES3 In May 2018 EFRAG launched a public consultation to gather constituents' views on whether alternative accounting treatments to those in IFRS 9 are needed to portray the performance and risks of equity and equity-type instruments held in long-term investment business models. During EFRAG's consultation respondents were encouraged to read the EFRAG Secretariat background paper which explained how the consultation related to the EC's initiatives on sustainable growth, illustrated the accounting requirements in IFRS 9 and explored some possible alternative measurement approaches.

ES4 In general, respondents to the survey provided mixed views on whether an alternative accounting treatment to IFRS 9 is needed.

ES5 The majority of the respondents, approximately 70% of respondents, particularly from the financial sector, considered that there is a need for an alternative accounting treatment for equity instruments in IFRS 9. Many of these respondents, particularly those from the financial sector, would favour a FVOCI model with recycling and impairment, for non-trading equity investments and comparable instruments, without making differentiations on whether investments are related to sustainable activities.

ES6 However, approximately 30 % of respondents, were not convinced that there is a need to identify a long-term investment business model nor an alternative accounting treatment for long-term equity investments in IFRS 9. In general, these respondents considered that: IFRS 9 had only been in effect since January 2018 (although some insurance firms will not apply IFRS 9 until 2021 or later) and that the issues investigated in this request would be best considered through the post-implementation review of IFRS 9.

ES7 A detailed summary of the feedback received is provided in Chapter 3 *Summary of Questionnaire Results*.

Alternative accounting treatments

Equity instruments

ES8 Chapter 4 *Possible alternative treatments* considers a number of possible alternative accounting treatments as requested by the EC. The paper does not recommend a single approach that should be pursued as a basis for changing IFRS 9 *Financial Instruments* as that was not the focus of the request from the EC.

ES9 While noting that each approach could include a number of variants, the paper considers the variant that is most likely to garner support. For the major approaches, EFRAG considers the impact on the financial statements and the strengths and weaknesses.

Equity-type instruments

ES10 Chapter 5 *Equity-type instruments* considers how these could be defined and, for the purposes of this advice, considers that they should be limited to units in funds that invest in equity instruments, associated derivatives and necessary cash holdings to achieve a level playing field between direct and indirect investments in equities.

ES11 The Chapter concludes that there is no reason why the major models discussed for equity instruments could not be applied to such equity-type instruments.

CHAPTER 1: INTRODUCTION

Chapter 1 provides the context in which this report has bene developed and the reasons why EFRAG has developed the report.

The accounting requirements for equity instruments

1.1 Under IAS 39 *Financial Instruments: Recognition and Measurement*, equity instruments other than those held-for-trading are classified as Available-for-Sale ('AFS'). These instruments are measured at fair value and fair value changes are presented in other comprehensive income ('FVOCI'). On disposal, the cumulative gain or loss in other comprehensive income ('OCI') is recycled to profit or loss and when an entity assesses that an instrument is impaired, the decrease in value below the initial cost is reclassified to profit or loss as an impairment loss.

1.2 In accordance with IFRS 9 *Financial Instruments*, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI election'). If the entity applies the FVOCI election, changes in fair value are presented in OCI. However, these changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess these instruments for impairment[1].

1.3 As IFRS 9 is mandatorily effective since 1 January 2018, entities that used to classify equity instruments as AFS under IAS 39 need to change their accounting treatment and measure them at FVPL or FVOCI without recycling to profit or loss.

1.4 In addition, under IFRS 9 a financial instrument that meets the puttable exception in IAS 32 is not eligible for the FVOCI election (in contrast to IAS 39 where it could be classified as available for sale). As a puttable instrument does not meet the definition of an equity instrument per IAS 32, and is likely to fail the SPPI test in IFRS 9 it has to be measured at FVPL.

1.5 Finally, although IFRS 9 became effective for periods beginning or on after 1 January 2018, 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 (or later as proposed by the IASB in its ED/2019/04 *Amendments to IFRS 17*). As a consequence, IFRS 9 has not been applied by many insurers (the majority of which are long term investors).

EFRAG's endorsement advice on IFRS 9

1.6 In its Endorsement Advice to the EC on IFRS 9 (available here) issued in September 2015, EFRAG noted that the prohibition of recycling of gains or losses on equity instruments measured at FVOCI could limit the relevance of the information provided as gains or losses upon sale or impairment could be seen as an indicative of the performance of the investor and useful for assessing stewardship.

1.7 In addition, EFRAG highlighted that the default requirement to measure all equity investments at FVPL may not reflect the business model of long-term investors. EFRAG acknowledged that IFRS 9 provides an option to measure some equity instruments at FVOCI, however it highlighted that such an option it is not likely to be

[1] In the Basis for Conclusions of IFRS 9, the IASB notes that one of the primary reasons for not allowing recycling is that it would create the need for the IASB to introduce impairment requirements while their application in IAS 39 for AFS instruments is very subjective.

attractive to long-term investors as recycling is not allowed. Even so, EFRAG concluded that it was unlikely that long-term investors would change their investment strategy because of the accounting changes brought by IFRS 9.

1.8 Finally, EFRAG highlighted that measuring certain types of assets that are puttable at FVPL may not reflect the way the assets are managed in a long-term investment business model and may limit the relevance of the information provided. Nonetheless, EFRAG assessed that such limitation for puttable instruments were balanced by the fact that the approach is principle-based and avoids complexities which would otherwise result from overriding the definition of equity instruments.

Request from the European Commission in 2017

1.9 In May 2017, the EC requested EFRAG to investigate the potential effects on long-term investment of the requirements in IFRS 9 on accounting for equity instruments (available here). In particular, the EC asked EFRAG to:

a) **Phase 1:** obtain quantitative information about long-term equity investments and evaluate the possible impact of IFRS 9 on long-term investments; and

b) **Phase 2:** identify whether and how IFRS 9 could be improved with respect to the accounting treatment of equity instruments held for long-term investments, including:

(i) The significance of an impairment model to the removal of the ban on recycling from a conceptual perspective; and

(ii) If an impairment model is considered to be an important element of a "recycling" approach, the features of a robust impairment model and whether these could feasibly be made operational.

1.10 In January 2018, EFRAG issued its letter to the EC (available here) which presented EFRAG's findings on quantitative information about the significance of equity portfolios for long term investors before the entry into application of IFRS 9 and on whether, and to what extent, entities expect that IFRS 9 will affect their decisions in relation to investing in equity instruments (Phase 1).

1.11 In its letter to the EC, EFRAG noted that the aggregate amounts of equity instruments classified as AFS under IAS 39 by long-term investors was substantial; that the importance of AFS accounting varied among long-term investors (some make significant use of FVOCI with recycling); the asset allocation decisions of long-term investors were driven by a plurality of factors; entities that are concerned about the requirements in IFRS 9 often point to a form of 'economic linkage' between their holdings of equity investments and some of their liabilities; and entities in practice use different criteria to assess impairment of equity instruments.

1.12 In November 2018, EFRAG published its response to the EC request for technical advice on whether and how IFRS 9 could be improved with respect to the accounting treatment of equity instruments held for long-term investments (available here). In particular, EFRAG's response addresses the interaction between an impairment model and the reintroduction of recycling, and what characteristics an impairment model for equity instruments could have (Phase 2).

1.13 In its second letter to the EC, EFRAG noted that the reintroduction of recycling for equity instruments carried at FVOCI would need to be accompanied by a robust impairment model. However, EFRAG did not have, at the time, sufficient evidence to recommend the reintroduction of recycling.

Request from the European Commission in 2018

1.14 In June 2018 the EC requested EFRAG to provide technical advice on possible alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments ('long-term investments').

1.15 The EC highlighted that alternative accounting treatments for long-term investments 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.

1.16 The EC also highlighted that alternative accounting treatments for long-term investments should preferably enhance investors' insight 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.

The objective of this report

1.17 The objective of this report is to present EFRAG's Technical Advice in relation to the request made by the EC in June 2018.

1.18 In this report, EFRAG illustrates a number of possible alternative accounting treatments for long-term equity investments, assessing such alternatives with reference to the qualitative characteristics of the resulting financial information and the criteria identified by the EC in its request for advice, in absolute terms and in comparison with the existing treatment in IFRS 9.

1.19 Some of these alternatives were developed based on measurement models that already exist in IFRS Standards (e.g. historical cost). Other alternatives were aimed at reducing subjectivity or addressing specific concerns raised by stakeholders (e.g. volatility introduced by fair value changes, lack of comparability in the application of the impairment requirements in IAS 39) while at the same time providing relevant information to users about long-term equity investments. These other alternatives may not have been applied in practice in major EU economies and they may be more theoretical approaches to overcome the technical limitations of the measurement models that have been applied in practice.

CHAPTER 2: PUBLIC CONSULTATION SUMMARY

This Chapter summarises the feedback received from EFRAG's public consultation that was designed to obtain input for this report. The full summary is available in here.

EFRAG Public Consultation

2.1 In May 2019 EFRAG launched a public consultation to gather constituents' views on whether alternative accounting treatments to those in IFRS 9 *Financial Instruments* are needed to portray the performance and risks of equity and equity-type instruments held in long-term investment business models (the questionnaire can be found here). EFRAG requested comments by 5 July 2019.

2.2 EFRAG is now issuing a feedback statement, which describes the main comments received.

Overview of survey's respondents

2.3 EFRAG received sixty-three surveys responding to EFRAG questionnaire. A list of respondents is in Appendix I to this summary of responses. All surveys received are available on EFRAG's website, except for two surveys as these respondents asked to remain anonymous.

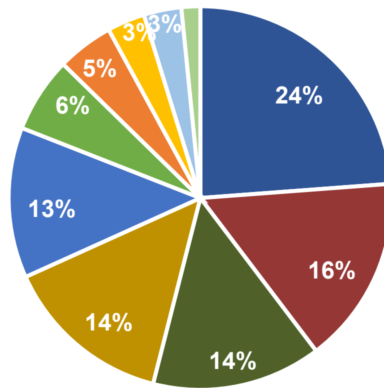
2.4 The questionnaires received came from national standard setters, business associations, professional organisations, listed companies and EU authorities. In particular:

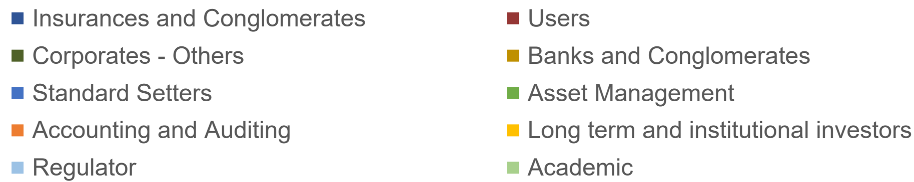
a) The majority of the respondents declared that they were engaged in a Long-term Investment Business Model (LTIBM) and/or sustainable activity;

b) Almost half of the respondents were from the financial sector, including insurance companies, banks, conglomerates and relative industry associations; and

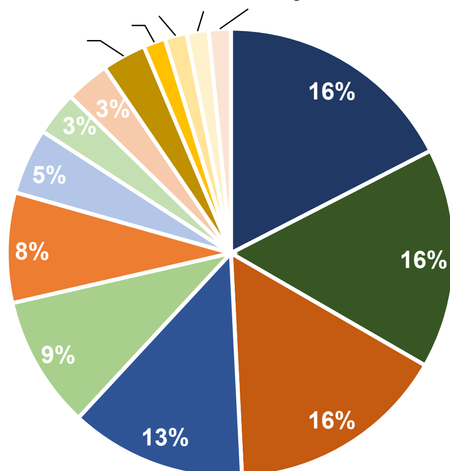
c) Approximately 15% of the respondents were users[(*)], a high rate of response when considering EFRAG's outreaches on other topics

Overview of respondents by sector

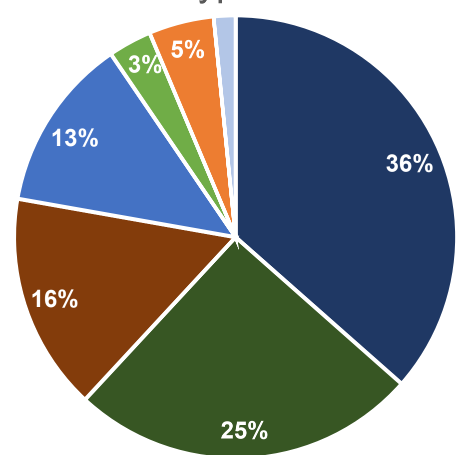


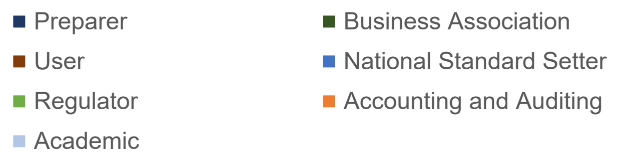


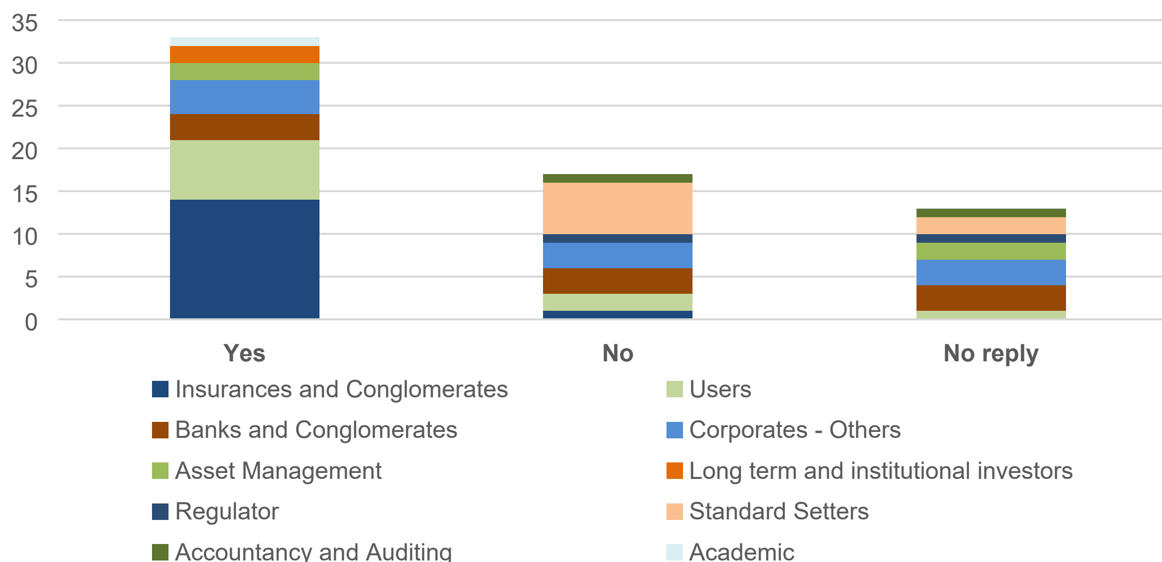
Overview of respondents by country



Overview of respondents by type







2.5 The majority of the respondents from the financial sector(*) and users of financial statements stated that they were engaged in LTIBM. Other respondents that were not engaged in a LTIBM or did not reply were mainly corporates, national standard setters, regulators and accounting/auditing professional associations.

Outreach activities

2.6 In addition to the surveys, EFRAG undertook a number of outreaches and meetings on this project, including with European Fund and Asset Management Association (EFAMA), Insurance Europe and Task Force on Long-Term Investment of the Paris Financial Marketplace. These entities subsequently submitted a survey to EFRAG.

2.7 The EFRAG Secretariat also discussed the contents of the DP with its Working Groups and external organisations. In particular, on 16 July 2019, EFRAG User Panel debated EFRAG's public consultation on whether alternative accounting treatments were needed for equity and equity-type instruments held in long-term investment business models.

2.8 In line with survey responses, EFRAG User Panel members provided mixed views and referred to different measurement approaches (even if there was a slight preference for the first approach described below):

a) *Fair value* through profit or loss: such an approach helps users assessing the entities' risk exposure to equity instruments. In addition, disclosures about the methodologies used to calculate fair value are fundamental for users;

b) Fair value through OCI with recycling: such an approach provides information about realised and unrealised gains and losses. The ability to identify realised vs. unrealised gains or losses is fundamental and highly relevant to the users of financial statements;

c) Adjusted cost – Equity Method: such an approach is particularly useful for situations where entities are currently applying level 3 fair value calculation; and

d) An approach that provides information about the future value of equity rather than focusing on the fair value of the equity instrument.

Key messages of the responses received

2.9 This feedback statement uses the following terms to describe the extent to which particular feedback was shared by respondents (both when referring to total respondents or a subset of respondents).

Term	Extent of response among respondents
Almost all	90%-100%
Most	80%-90%
Majority	50% to 80%
Many	20% to 50%
Some, others	10%-20%
A few	0%-10%
(*)	Statement reported, among others, by European associations

Definition of sustainable activities

2.10 Some respondents observed that currently there is not a single definition for "sustainable activities" and acknowledged the challenges of defining it. Nonetheless, some respondents defined sustainable activities as those that take into account environmental, social and governance ('ESG') objectives, aiming at having a positive impact on society in the long-term.

2.11 Although in general respondents supported the aim of encouraging sustainable activities, many respondents, particularly from the financial sector(*), considered that sustainable activities should not be a distinguishing feature in accounting.

2.12 In addition, EFRAG received mixed views on whether a change in IFRS 9 would contribute to the objective of the Action Plan on Sustainable Finance. Some respondents, particularly national standard setters and regulators, considered there is little evidence to support the assertion that IFRS 9 may impact investments in sustainable activities; others presented the view that the introduction of an alternative accounting treatment for equity instruments in IFRS 9 (particularly the reintroduction of recycling for Fair Value through Other Comprehensive Income ('FVOCI')), would positively contribute to the objective of the Action Plan on Sustainable Finance.

Definition and characteristics of long-term investment business models

2.13 Some respondents observed that currently there is no formal definition for 'long-term investment business model' and acknowledged the challenges of defining it.

2.14 Those respondents that provided a definition of LTIBM provided different views on what a LTIBM is. Nonetheless, it is worth noting that respondents often referred to the expected holding period and the use of thresholds to distinguish between short-term and long-term equity investments. Some respondents, particularly from the financial sector, also provided a definition LTIBM closer to their business model. For example, A few respondents defined it as a model in which the company acquires assets in order to match long-term insurance or savings related liabilities.

2.15 Nonetheless, many respondents, particularly from the financial sector(*), considered that it was not necessary to define LTIBM for the purpose of defining an alternative accounting treatment for equity instruments in IFRS 9. Instead, many of these respondents considered that the focus should be on determining whether an equity instrument is held for (non-)trading purposes. In addition, A few insurance companies(*) suggested that for the purpose of defining an alternative accounting treatment for equity instruments the focus should be on an efficient asset-liability management aimed at matching the investments with long-term insurance/savings liabilities.

2.16 When asked which characteristics should be required to identify a LTIBM, the majority of the respondents approximately 50%, referred to the "expecting holding period" and/or the "characteristics/business model of the investor". Only some respondents referred to the "long-term nature of the liabilities that fund the assets". Nonetheless, a significant number of respondents used the option "other" (i.e. none of the above).

Is there a need for an alternative to IFRS 9 requirements?

2.17 The majority of the respondents, approximately 70% of respondents, particularly from the financial sector(*), considered that there is a need for an alternative accounting treatment for equity instruments in IFRS 9. However, the majority of the respondents that called for an alternative accounting treatment did not relate the need for an alternative accounting treatment to the objective of "properly portraying the performance and risks of equity instruments held in a LTIBM. These respondents related the need for an alternative accounting treatment to the objective of properly portraying the performance and risk of "non-trading equity instruments" or an efficient asset-liability management.

2.18 In addition, the majority of the respondents, particularly those from the financial sector(*), would favour a FVOCI model with recycling and impairment, without making differentiations on whether investments are related to sustainable activities (i.e. scope similar to the FVOCI option under IFRS 9).

2.19 By contrast, many respondents, approximately 30% of respondents(*) (a mix of all types of respondents), were not convinced that there is a need to identify a LTIBM nor an alternative accounting treatment for long-term equity investments in IFRS 9. These respondents considered that:

a) there is no evidence to suggest that a change to IFRS 9 would advance the goals of the EC to foster investment in sustainable activities and support achieving the UN Sustainable Development Goals or the goals of the Paris Agreement on Climate Change;

b) whether an equity instrument is held in a LTIBM is a rather subjective assessment that most likely will result in divergence in practice;

c) IFRS 9 has only been in effect since January 2018 (although most European insurance firms have exercised the option to not apply IFRS 9 until 2021 or later) and the issues investigated in this request would be best considered through the post-implementation review of IFRS 9;

d) EFRAG previous research (here) was inconclusive on whether IFRS 9 was problematic and would impact on investment decisions; and

e) alternative accounting treatments such as FVOCI with recycling would enable earnings management and require a robust impairment model.

2.20 Finally, a few respondents simply mentioned it was too early to conclude whether IFRS 9 (potentially in conjunction with the accounting model in IFRS 17 *Insurance Contracts*) affects any asset allocation decisions to the disadvantage of long-term equity investments and reconsider any potential issues as part of the IFRS 9 *Post-Implementation Review*.

2.21 The table below summarises the feedback received by type of respondent. When answering to the question, it is clear from the table below that most insurance, banks, asset management and long-term investors consider that there is a need for an alternative accounting treatment.

Type of respondent	Response	Number	%
Academic (individuals)	Yes	1	2%
	No	0	0%
Users (individuals, associations, accounting valuators)	Yes	5	8%
	No	5	8%
Insurance and conglomerates (entities and associations)	Yes	14	22%
	No	1	2%
Banks and conglomerates (entities and associations)	Yes	6	10%
	No	3	5%
Asset Management (entities and associations)	Yes	4	6%
	No	0	0%
Long term and institutional investors (associations)	Yes	2	3%
	No	0	0%
Corporates – other sectors (entities and associations)	Yes	7	11%
	No	2	2%
Accounting and Auditing	Yes	0	0%
	No	3	3%
Standard Setters	Yes	4	6%
	No	4	6%
Regulators	Yes	0	0%
	No	2	3%
		63	**100%**

Why is there is a need for an alternative accounting treatment?

2.22 Most respondents(*) justified the need for an alternative accounting treatment in IFRS 9 by highlighting the limitations of accounting for equity instruments either at FVPL or FVOCI without recycling in accordance with IFRS 9 (consistently with previous EFRAG's consultations on the accounting for equity instruments under IFRS 9). In particular, respondents considered that:

a) FVPL is not appropriate to adequately depict the financial performance of LTIBM, particularly insurance companies, as it increases the volatility in the statement of profit or loss and generates a mismatch between the liabilities and the assets that fund the liabilities;

b) the use of FVPL for equity instruments does not reflect the business intention of holding equity investments for strategic reasons and market-to-market estimates fail to provide a faithful representation of the real strategy underlying long-term equity investments;

c) the use of FVOCI without recycling creates the false impression that the cumulative gains and losses at the time of disposal of equity instruments are not economically relevant and not a part of the financial performance. This is preventing entities, particularly insurance companies, to properly reflect their investment performance on non-trading equity instruments;

d) both dividends and gains on disposal of equity instruments represent a form of realisation of the fair value of the instruments. Therefore, both events should be presented in the same way; and

e) the ability to identify realised vs. unrealised gains or losses is fundamental and highly relevant to the users of financial statements.

2.23 As mentioned above, the majority of the respondents(*) that called for an alternative accounting treatment did not relate it to the need of properly portraying the performance and risks of equity instruments held in a LTIBM. Those that related to the need of properly portraying the performance and risks of equity instruments held in a LTIBM referred for example (in addition to the points already mentioned above):

a) fair value accounting loses significance for long-term investments as such investments may be considered closer to subordinated debt rather than equity ownership; and

b) fair value changes in profit or loss over-represent into the entity's performance the entity's ability to immediately dispose of an asset.

2.24 In addition, a few respondents from the financial industry referred to the limitations related to the elimination of the cost exception for equity instruments (i.e. exception in IAS 39 *Financial Instruments: Recognition and Measurement* from fair value measurement for unquoted equity instruments when the fair value is not reliably measurable).

2.25 Many respondents, particularly entities from the financial sector(*), also considered that IFRS 9 in its current form created disincentives for insurers to maintain and increase investments in long-term and/or illiquid assets.

Which alternative accounting treatments have been suggested?

2.26 When specifically referring to an alternative accounting treatment in IFRS 9 for equity instruments respondents indicated many different approaches.

2.27 The majority of the respondents which called for an alternative accounting treatment, particularly from the financial sector(*), supported fair value measurement of equity and equity-type instruments in the statement of financial position but called for the reintroduction of recycling in the FVOCI approach (please see table below for more details).

2.28 Some of these respondents considered appropriate further analysing other alternative measurement approaches for equity instruments if recycling was not reintroduced; others were not in favour of any other alternative measurement at all.

2.29 The cost model, in its possible variations (dual measurement, adjusted cost, cost exception, historical cost) was supported by 14% of these respondents.

2.30 It is also worth noting that in general there was little support or references to FVOCI without recycling as a preferred approach. However, it is worth noting that this outcome refers to those respondents that supported the need for an alternative accounting treatment; as stated above, many respondents were of the opinion that an accounting treatment is not needed, so implicitly they supported as well FVOCI without recycling.

2.31 The table below summarises the feedback received on which alternative accounting treatment respondents prefer (43 respondents want an alternative but 1 did not identify the alternative):

Type of respondent	Model	Number	%
Academic (individuals)	Dual Measurement	1	2%
Users (individuals, associations, accounting valuators)	Adjusted cost	1	2%
	FVOCI with Recycling	3	8%
	Variable fee approach	1	2%
Insurance and conglomerates (entities and associations)	FVOCI with Recycling	11	25%
	Cost exception	2	5%
	Historical Cost	1	2%
Banks and conglomerates (entities and associations)	FVOCI with Recycling	5	12%
	Cost exception	1	2%
Asset Management (entities and associations)	FVOCI with Recycling	3	8%
Long term and institutional investors (associations)	FVOCI with Recycling	1	2%
	Equity Method	1	2%
Corporates – other sectors (entities and associations)	FVOCI with Recycling	7	17%
Standard Setters	FVOCI with Recycling	3	8%
	Adjusted cost	1	2%
		42	**100%**

Which impairment models have been suggested if equity instruments are measured at FVOCI with recycling?

2.32 When mentioning specific impairment models, many respondents(*), approximately 30%, considered that an improved version of the IAS 39 impairment model could be used as a way forward. These respondents considered that a robust impairment model can be developed without undue costs by using IAS 39 as a starting point but with additional guidance to reduce subjectivity.

How can the impairment model be improved?

2.33 Respondents that suggested improvements to the impairment model referred to:

a) improve definition and criteria for the notion of ‘significant’ and ‘prolonged’ decline;

b) allow the reversals of impairments;

c) additional disclosures, including on methodology;

Should the different accounting treatment be restricted to equity instruments held in a long-term investment business model?

2.34 Most respondents(*) that replied to this question considered that the alternative accounting treatment should not be restricted to equity instruments held in a LTIBM. However, respondents provided mixed views to which instruments it should be applied and which approaches should apply.

2.35 The remaining respondents either preferred to restrict the alternative accounting treatment to equity instruments held in LTIBM, as FVPL seemed an appropriate measurement approach for equity instruments other than those held in LTIBM or rejected the need for an alternative accounting treatment.

2.36 The table below summarises respondents reply on whether an alternative accounting treatment should be restricted to equity instruments held in a LTIBM.

	Is there a need for an alternative accounting treatment?			If Yes (43 responses and 1 did not respond). Should the different accounting treatment be restricted to equity instruments held in **a LTIBM**?		
Type of respondent	**Response**	**Number**	**%**	**Response**	**Number**	**%**
Academic (individuals)	Yes	1	2%	Yes	1	2%
	No	0	0%	No	0	0%
Users (individuals, associations, accounting valuators)	Yes	5	8%	Yes	1	2%
	No	5	8%	No	4	10%
Insurance and conglomerates (entities and associations)	Yes	14	22%	Yes	2	5%
	No	1	2%	No	12	29%
Banks and conglomerates (entities and associations)	Yes	6	10%	Yes	2	5%
	No	3	5%	No	4	10%
Asset Management (entities and associations)	Yes	4	6%	Yes	0	0%
	No	0	0%	No	3	7%
Long term and institutional investors (associations)	Yes	2	3%	Yes	0	0%
	No	0	0%	No	2	5%
Corporates – other sectors (entities and associations)	Yes	7	11%	Yes	2	5%
	No	2	2%	No	5	12%
Accounting and Auditing	Yes	0	0%	Yes	0	0%
	No	3	3%	No	0	0%
Standard Setters	Yes	4	6%	Yes	0	0%
	No	4	6%	No	4	10%
Regulators	Yes	0	0%	Yes	0	0%
	No	2	3%	No	0	0%
		63	**100%**		**42**	**100%**

Should the different accounting treatment referred to in the previous questions be extended to instruments that are "equity-type"?

2.37 When referring specifically to equity-type instruments, most respondents(*) that replied to this question and supported an alternative accounting treatment, considered that the different accounting treatment referred to in previous questions should be extended to "equity-type" instruments (even if respondents were referring to many accounting treatments, as described above).

2.38 By contrast, some respondents considered that the alternative accounting treatment referred to in previous questions should not be extended to "equity-type" instruments. One respondent noted that it was difficult to define the "equity-type" in such a way that it is not complex to apply from a holder´s perspective and that in turn does not introduce inconsistency with the accounting treatment of other financial instruments.

2.39 Most of the remaining respondents did not think that new options were necessary. One respondent detailed that one of the objectives of IFRS 9 was to reduce complexity compared to IAS 39. Creating a new class of instruments that are "equity-type" would increase rather than reduce complexity (i.e. how to define instruments that are "equity-type").

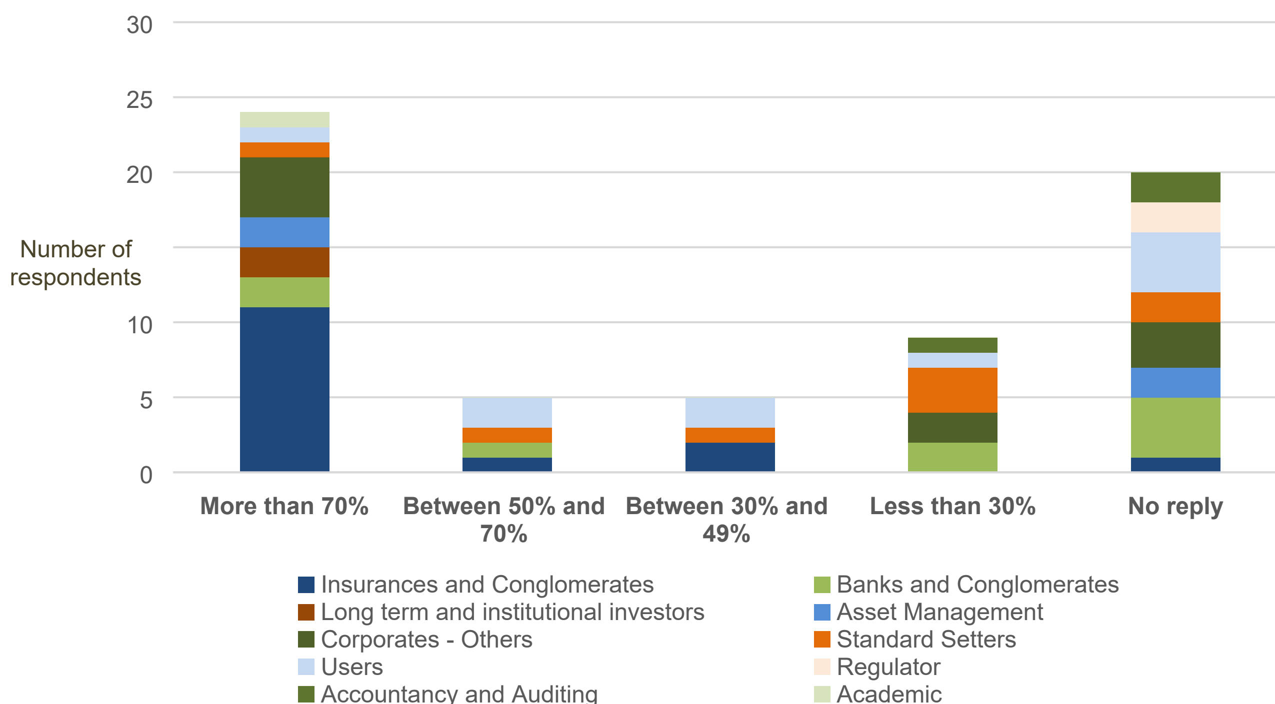
2.40 The table below summarises respondents reply on whether the different accounting treatment referred to in the previous questions be extended to instruments that are "equity-type".

	Is there a need for an alternative accounting treatment			If Yes (43 responses and 2 did not respond). Should the different accounting treatment referred to in the previous questions be extended to instruments that are "**equity-type**"?		
Type of respondent	**Response**	**Number**	**%**	**Response**	**Number**	**%**
Academic (individuals)	Yes	1	2%	Yes	1	2%
	No	0	0%	No	0	0%
Users (individuals, associations, accounting valuators)	Yes	5	8%	Yes	5	12%
	No	5	8%	No	0	0%
Insurance and conglomerates (entities and associations)	Yes	14	22%	Yes	13	32%
	No	1	2%	No	1	2%
Banks and conglomerates (entities and associations)	Yes	6	10%	Yes	5	12%
	No	3	5%	No	1	2%
Asset Management (entities and associations)	Yes	4	6%	Yes	3	7%
	No	0	0%	No	0	0%
Long term and institutional investors (associations)	Yes	2	3%	Yes	2	5%
	No	0	0%	No	0	0%
Corporates – other sectors (entities and associations)	Yes	7	11%	Yes	4	10%
	No	2	2%	No	2	5%
Accounting and Auditing	Yes	0	0%	Yes	0	0%
	No	3	3%	No	0	0%
Standard Setters	Yes	4	6%	Yes	3	7%
	No	4	6%	No	1	2%
Regulators	Yes	0	0%	Yes	0	0%
	No	2	3%	No	0	0%
		63	**100%**		**41**	**100%**

2.41 From the table above we notice that most of the respondents that considered that there is a need for an alternative accounting treatment considered that it should be extended to equity-type instruments.

How relevant a different accounting treatment is to the objective of reducing or preventing detrimental effects on investment in sustainable activities in Europe?

2.42 Many respondents(*), particularly from the financial sector, considered that an alternative accounting treatment was relevant to the objective of reducing or preventing detrimental effects on LTI. However, there was an equally a significant number of respondents, particularly standard setters, users, regulators and professionals in accounting and auditing that did not consider an alternative accounting treatment relevant or did not reply.



CHAPTER 3: BASE CASE IFRS 9 *FINANCIAL INSTRUMENTS*

In accordance with IFRS 9, equity instruments are measured at fair value which, in the IASB's view, provides the most useful information to users about such instruments. The requirements of IFRS 9 are designed to solve the concerns users and regulators expressed around the application of the impairment guidance in IAS 39.

The approach followed in IFRS 9

3.1 IFRS 9 has a mixed measurement approach for debt and equity instruments similar to IAS 39 although there are differences between the categories as well as the underlying rationale.

3.2 For debt instruments that meet the SPPI requirements[2], IFRS 9 allows the use of amortised cost, fair value through OCI or fair value through profit or loss depending on the related business model (IFRS 9, paragraphs 4.1.2 and 4.1.2A). For debt instruments that do not meet the SPPI requirements, the instrument has to be classified as fair value through profit and loss (IFRS 9, paragraph 4.1.4). Therefore, two elements drive the classification of financial assets: business model and contractual characteristics of the instrument, with the latter prevailing over the business model. Although not relevant for equity instruments, these requirements are relevant when considering equity-type instruments.

3.3 For equity instruments, IFRS 9 requires fair value through profit or loss for trading instruments but allows the use of fair value through OCI on an instrument-by-instrument basis for other equity instruments if the entity so chooses (IFRS 9 paragraph 4.1.4). Therefore, IFRS 9, similarly to IAS 39, requires fair value through profit or loss for equities as the base case and does not distinguish on the basis of intended holding period.

3.4 The IASB has chosen to eliminate from IFRS 9 the cost exception for certain equity instruments previously in IAS 39 for the following reasons:

a) fair value provides the most relevant information;

b) the cost exception required the calculation of impairments when they arise, the methodology of which is similar to determining fair value; and

c) this approach reduces complexity as it removes a third measurement attribute and would not require impairment methodology (IFRS 9 paragraph BC5.14).

3.5 However, the IASB has noted that in some cases cost may be representative of fair value and provided guidance of when this may be the case, but noted that this would not apply to equity investments held by financial institutions and investment funds (IFRS 9 paragraphs B5.2.3-B5.2.5 and BC5.18).

3.6 Fair value as referred to in IFRS 9 is defined in IFRS 13 *Fair Value Measurement* and is an exit value using a market approach. This disregards entity-specific expectations of cash flows or the entity's purpose and plans for holding the equity instrument.

[2] This refers to the requirements that payments under the contract should be solely for principal and interest. (IFRS 9 paragraph 4.1.3)

Fair value in the statement of financial position

3.7 The IASB has required fair value for equity instruments (with some exceptions) since the effective date of IAS 39 – 1 January 2001. Not many reasons were given for this requirement at the time, but as set out in paragraph 3.4 above, the IASB provided some insights in the Basis for Conclusions to IFRS 9.

3.8 The use of fair value is not without its critics. For example, Laux and Leuz[3] identifies the main argument against the use of fair value accounting as follows: "Some critics argue that fair value accounting exacerbated the severity of the 2008 financial crisis. Allegations include that fair value accounting contributes to excessive leverage in boom periods and leads to excessive write-downs in busts. The write-downs due to falling market prices deplete bank capital and set off a downward spiral, as banks are forced to sell assets at 'fire sale' prices, which in turn can lead to contagion as prices from asset fire sales of one bank become relevant for other banks." Despite this view, Laux and Leuz as well as Barth and Landman[4] have concluded that the use of fair value by banks did not contribute significantly to the 2008 crisis.

3.9 This is also the approach followed in US GAAP since 1993 on the balance sheet. See paragraphs 3.15 to 3.22 below for further information.

Recognition of fair value changes in the performance statements

3.10 For trading or short-term profit-taking activities it is generally accepted that these gains and losses should be recognised in profit or loss. For investments in assets that are expected to be realised in the longer term, views are more mixed resulting in the dual approaches in both IAS 39 and IFRS 9.

Recognition in profit or loss

3.11 The advantages of recognising changes in equity instruments at fair value in profit or loss include:

a) Many hold the view that this provides the best reflection of the economics of holding equity instruments;

b) No impairment indicators or methodology are required;

c) This accurately reflects a short-term profit-taking business model as well as items such as derivatives that can experience significant volatility; and

d) Many supporters of recycling do not consider OCI as properly reporting performance and research shows that the use of OCI is often not fully understood.

3.12 The disadvantages of recognising changes in equity instruments at fair value in profit or loss include:

a) Concerns have been raised that significant volatility in the financial results is not reflective of their performance other than for trading activities; and

[3] Christian Laux & Christian Leuz, 2010. "Did Fair-Value Accounting Contribute to the Financial Crisis?," Journal of Economic Perspectives, American Economic Association, vol. 24(1), pages 93-118, Winter. The paper can be located here

[4] See for example Mary E. Barth & Wayne R. Landsman (2010) How did Financial Reporting Contribute to the Financial Crisis? European Accounting Review, 19:3, 399-423, DOI: 10.1080/09638180.2010.498619 Access to the paper can be obtained here

b) It does not distinguish between realised and unrealised fair value changes which are of importance to some users and preparers and often a basis for purposes of distributable dividends.

Recognition in other comprehensive income ('OCI') (without recycling)

3.13 The advantages of recognising changes in fair value of equity instruments in OCI without recycling (as is the option under IFRS 9) include:

a) Impairment indicators or methodology are not required;

b) Presenting fair value changes in profit or loss for some equity investments may not be indicative of the performance of the entity. For example, if the entity holds those equity instruments for non-contractual benefits such as where there is a requirement to hold such an investment when an entity sells its products in a particular country. In such cases, the entity holds the equity instruments for non-contractual benefits rather than for value increases. (IFRS 9 paragraph BC5.22); and

c) The prohibition on recycling means that results are not impacted by opportunistic decisions to sell equity instruments. This also avoids situations where realised gains may not accurately reflect that the portfolio has performed poorly (or vice versa) as highlighted by Warren Buffett in his letter to shareholders of 2017. 5

3.14 The disadvantages of recognising changes in fair value of equity instruments in OCI without recycling are as follows:

a) The Basis for Conclusions of IFRS 9 dose not explain why these gains or losses are never recognised in profit or loss which is a similar treatment to gains on the revaluation of property, plant and equipment under IAS 16 *Property, Plant and Equipment*), but in contrast to the currency translation reserve on foreign operations on disposal or cash flow hedging reserve which are recycled;

b) Some consider that all gains and loses should be presented in profit or loss at some time as profit or loss is the primary statement of performance under the *Conceptual Framework for Financial Reporting*;

c) Some consider that the prohibition of recycling results in irrelevant information as it does not reflect their business model or fails to convey information about management performance and stewardship; and

d) The realised gains or losses are not reflected in profit or loss, which may raise questions or concerns around the distributability of profits depending on the legal framework. Concerns have also been raised that the information about realised gains or losses upon disposals is useful information for assessing performance and this accounting treatment doesn't make this information visible.

Comparison with US GAAP

3.15 US GAAP has required fair value on the balance sheet for equity securities held since the issue of FAS 115 *Accounting for Certain Investments in Debt and Equity Securities* for years beginning after 15 December 1993. Up to 2017 US GAAP had

[5] https://www.berkshirehathaway.com/letters/2017ltr.pdf

two options similar to IAS 39: fair value through profit or loss (FVPL) and available-for-sale (fair value through OCI (FVOCI) with recycling). Unlisted equity investments generally were carried at cost, unless impaired or the fair value option is elected. Certain exceptions required that investments in unlisted equity securities were carried at fair value for specific industries (e.g. broker/dealers, investment companies, insurance companies, defined benefit plans).

3.16 However, since 2018, US GAAP requires all investments in equity to be measured at fair value with changes in fair value recognised in net income except for those without readily determinable fair values (Topic 321 paragraph 10-35-1).

3.17 Under US GAAP, the fair value of an equity security is readily determinable if it meets any of the following conditions (Paragraph 10-20):

a) If sales prices or bid-and-asked quotes are available on an SEC-registered exchange or OTC markets where these prices are publicly reported as defined.

b) An equity security traded only in a foreign market meets the requirement if the scope and breadth of that market is comparable to US markets in a).

c) An investment in a mutual fund or similar structure such as a limited partnership or a venture capital entity meets the requirement if the fair value per share (unit) is published and forms the basis for current transactions.

3.18 Those equity investments that do not have readily determinable fair values may be carried at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. A similar exception as mentioned in paragraph c) exist for those industries where substantially all investments are carried at fair value. US GAAP requires an impairment where a qualitative assessment indicates that the investment is impaired, and the fair value of the investment is less than its carrying value. (Paragraph 35-3). Impairment indicators include, but are not limited to:

a) A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee;

b) A significant adverse change in the regulatory, economic, or technological environment of the investee;

c) A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates;

d) An offer to purchase or to sell, or a complete auction process for the same or similar investment below its carrying amount;

3.19 Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative operating cash flows, working capital deficiencies, or non-compliance with capital requirements or debt covenants.

3.20 If the instrument is impaired, an impairment loss is recognised for the difference between fair value as defined in Topic 820 and the carrying amount of such an investment.

3.21 The advantages of recognition of changes in fair value in profit or loss only are:

a) It significantly reduces complexity and improves comparability as there is only one measurement approach for equities; and

b) All amounts are recognised in profit and loss, but no impairment indicators or methodology are required.

3.22 The disadvantages of recognising changes in fair value in profit or loss only are:

a) The amounts in profit and loss include unrealised gains or losses which are not distributable in many jurisdictions and also does not explain the performance of the entity; and

b) It may generate significant volatility which would require detailed communication and explanations to users.

Feedback received from EFRAG survey

3.23 The majority of the respondents, approximately 70% of respondents, considered that there is a need for an alternative accounting treatment for equity instruments in IFRS 9. These respondents were mostly from the financial sector, with Insurers and conglomerates being the most significant contributors. Users were split with those in the UK being supporters of IFRS 9.

3.24 Many respondents related the need for an alternative to the objective of properly portraying the performance and risk of “non-trading equity instruments” or an “efficient asset-liability management” rather than “equity instruments held in a long-term investment business model”. Justifications for a change included that the volatility created by measuring equity instruments held in a LTIBM did not appropriately reflect performance, the inability to recycle realised gains and losses and the elimination of the cost exception for equity instruments (i.e. exception in IAS 39 from fair value measurement for some unquoted equity instruments). Many respondents, particularly entities from the financial sector, also considered that, in its current form, IFRS 9 creates disincentives for insurers to maintain and increase investments in long-term and/or illiquid assets (and contrary to the objectives of the European Commission as part of the European strategy for a Capital Markets Union).

3.25 Approximately 30% of respondents did not think that changes to IFRS 9 are required. Their views included:

a) IFRS 9 has been effective for a short period and a post-implementation review is more appropriate to consider these aspects;

b) holding an equity instrument in a long-term investment business model as a classification criterion would be subjective and likely to result in divergence in practice;

c) EFRAG’s previous research that was inconclusive on whether IFRS 9 was problematic and would impact on investment decisions; and

d) there is no evidence to suggest that a change to IFRS 9 would advance the goals of the European Commission to foster investment in sustainable activities and support achieving the UN Sustainable Development Goals or the goals of the Paris Agreement on Climate Change.

CHAPTER 4: POSSIBLE ALTERNATIVE TREATMENTS

This chapter considers some alternative models to the requirements of IFRS 9. The introduction scopes the detailed discussion of alternative models. The second section considers range of models that have been applied in practice and other, more theoretical models. Finally, the Chapter considers a range of approaches to impairment that could be applied to the alternatives other than FVPL (where no impairment model is needed).

Introduction

4.1 This section explains the environment in which the alternative accounting treatments for long-term investments in equity instruments are considered.

4.2 Firstly, many respondents to the survey did not generally consider that a special treatment should be developed for a long-term investment business model (LTIBM) that related to achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change. In their view, holdings of equity instruments should be classified as held for trading or other equity instruments. That is, their view was that all equity instruments other than those held for trading were held in a LTIBM.

4.3 In the discussion of the various models, this paper:

a) Selects the most supported features of the models provided rather than reflecting all possible variants (for example, the fair value through OCI with impairment and recycling is limited to the case where reversals of impairment are permitted as that was the variant most generally supported).

b) Assumes that dividends received continue to be recognised in profit or loss;

c) Ignores the different ways to measure impairment for an equity instrument measured on a cost basis and an equity instrument measured on a fair value basis; and

d) Considers the unit of account to be a single equity instrument even though entities may manage their investments in portfolios. Some respondents to the survey proposed a dedicated portfolio approach but this has been excluded from this paper on the grounds that the focus of this paper is on the measurement of individual equity instruments.

Alternative accounting treatments

4.4 This section considers a range of alternative accounting treatments using the following classification:

a) Valuation models:

(i) Fair value through OCI with impairment, reversals of impairment and recycling:

(ii) Mandatory fair value through profit or loss;

b) Cost models:

(i) Historical cost less impairment;

(ii) Modified historical cost;

c) Other models mentioned by respondents to the survey:

(i) Management orientation and strategy (entity-specific DCF); and

(ii) Strategic investments approach.

d) Theoretical models:

(i) Fair value moving average

(ii) Revaluation

Valuation Methods

Fair value through OCI with impairment, reversals of impairment and recycling

Description of the model

Balance sheet	Fair value
Profit or loss	Impairment charges and reversals Realised gain or loss
OCI	Impairment charges and reversals Unrealised gain or loss

4.5 A fair value through OCI with impairment, reversals of impairment and recycling was the most popular model with those respondents to the EFRAG survey that supported an alternative measurement approach to the approaches in IFRS 9. This model extends the FVOCI option in IFRS 9 by adding impairment and reversals, and requiring recycling on disposal. As noted in Chapter 2, some support this approach for all equity instruments other than those held for trading while others consider it is appropriate for a LTIBM. In the context of the request from the EC, this paper considers the model from the perspective of a LTIBM.

4.6 The model envisages that there can be unrealised losses that do not meet the test for impairment. The impairment charges that are transferred to profit or loss are those unrealised losses that meet the impairment model selected. This section does not address specific impairment models as it relies on the separate section at the end of this chapter which considers how impairment could be measured.

Characteristics of a fair value through OCI with recycling, impairment and reversals of impairment model

4.7 Those who support this approach for a LTIBM consider that:

a) It best reflects the performance and risk of a LTIBM by removing unrealised gains and losses from profit or loss as unrealised gains and losses, other than impairments, do not provide relevant information on the performance of the entity;

b) It recognises that equity instruments held in a LTIBM may become impaired, so it prudently ensures that assets are not carried on the balance sheet above their recoverable amount where any decline is not expected to reverse.

c) By providing for reversals of impairment, the approach ensures that more extreme periodic fluctuations are smoothed over the long term and eliminates a potential disincentive to early recognise impairment losses; and

d) As profit or loss is the primary measure of performance, it ensures that realised gains or losses are reflected in profit or loss.

4.8 Those who do not support this approach for a LTIBM consider that:

a) A gain or loss on a specific instrument should only be reflected once in the performance statement as recycling does not provide useful information;

b) There is no evidence that IFRS 9 will reduce investments in the equity instruments of entities undertaking sustainable activity;

c) This approach permits earnings management as an entity can choose when to recognise profit through the timing of disposal of an equity instrument;

d) The best measurement of management performance of an instrument with the characteristics of equity is to recognise changes, whether realised or unrealised, in profit or loss immediately; and

e) An impairment model imposes costs on preparers and is likely to be judgemental and reduce comparability for users.

Results of the EFRAG survey in May 2019

4.9 This model was the approach most supported by respondents to the EFRAG survey. Of the respondents (68%) that supported an alternative measurement for equity instruments held under a long-term business model, the majority (80%) supported FVOCI with recycling equity instruments that are held for long-term.

Mandatory fair value through profit or loss

Description of the model

Balance sheet	Fair value
Profit or loss	Changes in fair value

4.10 A mandatory fair value through profit or loss model reflects all changes in the fair value of equity instruments in profit or loss, regardless of whether they are realised or unrealised. This model applies a consistent treatment to all equity instruments regardless of the reason for holding the instruments.

Characteristics of mandatory fair value through profit or loss

4.11 Those who support this approach consider that this approach:

a) provides the best measurement of management performance for the year which is to recognise changes in the value of equity instruments, whether realised or unrealised, in profit or loss immediately;

b) ensures that long term investors can recognise returns in profit without having to sell the asset, thereby reducing their holding periods, which is at odds with their business model;

c) provides the most useful information on financial position; and

d) does not require an impairment model which avoids the need for judgement as to when an equity instrument is impaired;

4.12 Those who do not support this approach for a LTIBM consider that:

a) the resultant volatility in profit or loss does not properly reflect a LTIBM;

b) the reliability of the fair value measurement for unlisted equities is questionable, including for long term infrastructure projects and whether profits should be recognised before realisation;

c) changes in market prices, which may reverse in future periods, should not be reflected in profit or loss merely as the result of the choice of a particular balance sheet date for equity instruments that are held under a LTIBM; and

d) the approach does not distinguish between realised and unrealised fair value changes which are of importance to some users and preparers and often a basis for identifying distributable dividends.

Results of the EFRAG survey in May 2019

4.13 Approximately 30% of respondents (a mix of all types of respondents), were not convinced that there is a need to identify an alternative accounting treatment for long-term equity investments in IFRS 9. However, two respondents (a user and a standard setter) added that the option of designating the equity instruments to FVOCI included in IFRS 9 should be eliminated as it would improve comparability between entities and ensure that any performance generated should be included in profit or loss.

Cost models

Historical cost less impairment

Description of the model

Balance sheet	Historical cost less impairment
Profit or loss	Impairment charges and reversals Realised gain or loss

4.14 Under an historical cost model, equity instruments are recognised at the consideration paid when they are acquired, including transaction costs. It will generally be relatively easy to identify the consideration on acquisition but it may be necessary to estimate the cost of an equity instrument on disposal if the equity instruments in the same entity were acquired at different dates as it may not be clear which specific instruments are disposed of.

4.15 Historical cost is commonly applied to property, plant and equipment where depreciation is recognised as the value in the asset is consumed. This is not relevant for equity instruments as they are usually indefinite-life instruments. In the case of equity instruments, an impairment model is needed to ensure that the equity instrument is not over-valued on the balance sheet. For the purpose of this paper, we assume that any impairment charge would be reversed if the situation changes.

Characteristics of historical cost less impairment

4.16 Supporters of historical cost argue that:

a) historical cost provides relevant information to users of financial statements, because the information is derived, at least in part, from the price paid when acquiring the asset;

b) historical cost is simpler to apply than other measurement bases such as fair value, particularly in situations when the fair value is not readily available and entities would need to resort to a level 2 or level 3 measurement when applying IFRS 13 Fair Value Measurement. Some question the relevance of a level 2 or level 3 fair value measurement, and argue that, in the absence of a market value, historical cost might be a more reliable representation of the entity's financial position and its financial performance;

c) the price of the transaction is useful for stewardship as it identifies the amounts paid for resources. The gain or loss on disposal reflects the impact of management's decisions to acquire, hold and sell these instruments; and

d) not recognising unrealised gains in profit or loss is prudent because changes in market prices, which may reverse in future periods, are not reflected in profit or loss merely as the result of the choice of a particular balance sheet date. Reflecting market participant's assumptions about timing, amount and risks associated with future cash flows does not necessarily reflect the performance of equity instruments that are held under a LTIBM.

4.17 However others, including users, argue against historical cost on the grounds that:

a) not reflecting changes in value of an equity instrument in profit or loss is a key reason why historical cost is not appropriate for equity instruments. Some consider that the only cases when historical cost might be appropriate for equity instruments is when the equity instrument does not have an observable market value, and fair value is determined using a valuation technique based on level 2 or level 3 inputs under IFRS 13;

b) historical cost does not provide relevant information when an equity instrument has been held for a substantial time as there is evidence that, generally, stock prices are rising over the long term;

c) historical cost measurement hinders comparability and weakens the holder's ability to exercise their fiduciary duties where that means maximising investment returns while at the same time taking into account factors supporting sustainability;

d) historical cost is likely to can lead to identical instruments being measured at different amounts if they were acquired at different times; and

e) the interaction between the recognition of dividends in profit or loss under an historical cost model needs further consideration to examine whether dividends (some dividends) are in substance a reimbursement of the initial cost of the investment, which could trigger a need to write down the investment.

Results from EFRAG survey in May 2019

4.18 Some respondents supported the historical cost (with impairment) as being the most appropriate measurement attribute to faithfully reflect the performance of an equity instrument under a long-term business model. These respondents consider the uncertainty inherent to the long-term investment business model further justifies the need for prudence and the use of cost to avoid the recognition of unrealised gains in profit or loss.

4.19 Some respondents noted that historical cost measurement could be considered for equity instruments that have no (active) primary or secondary market and which fall under a level 2 or level 3 category under IFRS 13.

4.20 One respondent noted that research indicates that institutional investors (such as insurers and pension funds) subject to fair value accounting have adopted investment strategies that are more prudent than those adopted by investors subject to historical cost accounting. The research also notes that during financial crises, historical cost prevents asset fire sales making it a better fit to facilitate long-term investment in equity instruments. On the other hand, the research indicates that historical cost could cause institutional investors to hold on to downgraded assets in the hope of a turnaround, while fair value measurement could serve to deter excessive risk taking.

Modified historical cost

Description of the model

Balance sheet	Modified historical cost less impairment
Profit or loss	Modifications to historical cost Realised gain or loss

4.21 This section considers two possible modifications to historical cost:

a) adjusting for the share of the profit or loss of the investee; and

b) adjusting for observable market conditions.

Adjusting for the share of profit or loss of the investee

4.22 Under this modified historical cost model an entity would 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 *Investment in Associates*.

Characteristics

4.23 This model 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.

4.24 An entity would need access to the financial information on the investee. This could be possible where there are significant holdings of an interest in an entity, 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 investment portfolios holding a large range of instruments.

4.25 Some argue that this alternative would be suitable for unlisted equity instruments or for equity instruments where it is difficult to determine a reliable fair value. However, it is even more unlikely that the necessary information would be available.

Adjusting for observable market conditions

4.26 The measurement of an equity instrument could 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.

4.27 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 not necessarily be on an annual basis as they are based on observable, external transactions that may occur randomly.

Characteristics

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

4.29 Under this model, 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.

4.30 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.

Results of the EFRAG survey in May 2019

4.31 Only 2 respondents supported an adjusted cost approach.

4.32 One respondent that generally disagreed with the adjusted cost alternatives noted that the adjusted cost approach could result either in excessive volatility due to non-recurring adjustments or they may suffer from availability and delays of the necessary information when adjusting for the share of profit or loss of the investee.

Models proposed in the survey and not identified above

Management orientation and strategy (entity-specific DCF)

Description of the model

Balance sheet	Value in use
Profit or loss	Changes in value in use Impairment charges and reversals Realised gain or loss

4.33 One component of the fluctuation observed in fair value possibly relates to it being a point in time value as well as not taking into account the possible future performance of the equity instruments. It is argued that point in time fair value does not reflect the real value of the instrument in a LTIBM.

4.34 A way to reflect the present value of an equity instrument could be to use a discounted cash flow model, including expected dividends for the estimated holding period, plus a terminal value, being the expected value at the end of the estimated holding period. A risk adjustment could be included in the measurement through the expected cash flows or the discount rate.

4.35 Given that this model smooths market fluctuations, it appears appropriate to include changes in value in use in profit or loss. As value in use may diverge from fair value, it is also appropriate to require that equity instruments measured under this model are reviewed for impairment.

4.36 This approach is used in practice in measuring:

a) goodwill impairment (the IASB is considering limited amendments following the post-implementation review of IFRS 3 *Business Combinations*}; and

b) impairment of equity instruments in associates or joint ventures accounted for using the equity method.

Characteristics of entity-specific DCF

4.37 This model has operational limits as it requires updated and reliable information about expected pay-out ratios and business plans, which may not be easy to collect without a relationship of (for example) significant influence. It is more complex to calculate than the other valuation models proposed and is only fully for reliable for companies that have a proven track record of stable dividend payments. However, it takes into consideration the cost of capital as the dividends and expected outflows are discounted back to the present, presenting a more accurate value of the instrument in a LTIBM.

4.38 As mentioned above, a pure fair value approach may not provide users with the most relevant information in a LTIBM. This model reflects the fact that dividends are 'sticky' and not prone to fluctuations in the short term.

4.39 While it may be seen as way to smooth volatility and reflect the real performance of the entity, entity-specific DCF implicitly assumes that the dividends paid out are correlated to earnings over the longer term. This means that higher earnings will translate into higher dividends over time and vice versa. However, in practice, some entities maintain stable dividend payments, even if they are facing extreme variations in their earnings as entities' dividend policies can be diverse. There have been some cases where entities have been simultaneously borrowing cash while maintaining a dividend payments.

Results of the EFRAG survey in May 2019

4.40 No respondent proposed the value in use approach. Nonetheless, there was one respondent who referred to a long-term projected value for portfolios managed over the long-term by incorporating all forecast cash flows in accordance with analysis supporting the investment decision.

Strategic investments approach

4.41 Some respondents to the survey proposed that the accounting for a LTIBM should follow the strategy of the investor. This could relate to:

a) asset-liability matching where equity instruments (and other investments) are designed to match the emergence of the associated liabilities;

b) the primary business purpose of the entity or its business model. That is, the measurement should be closely aligned with management strategy, including objectives, governance, asset classes, classic or alternatives, diversification strategies, performance (regular income, capital gains, mix of both), risk management policy etc.

c) strategic investments approach where an entity acquires a non-controlling interest in an entity that secures its current or future business or technology and financial performance is not the primary goal of the entity. In some cases, this is a preliminary stage of a business, dividends are rarely expected and any gain on sale is remote. Instead, the investor purchases an "option". Accounting for such an investment should be at cost with an impairment test (or even amortisation if no terminal value is reasonably expected) as it would more appropriately reflect that business model.

4.42 Generally, these potential models were not specified in detail. To the extent that they were specified, they would fall into one of the models discussed above.

Theoretical models

Fair value moving average.

Description of the model

Balance sheet	Fair value moving average
Profit or loss	Changes in fair value moving average Impairment and reversals

4.43 A component of the volatility observed in the fair value of equity instruments relates to it being a point in time value as well as the frequency of measurement. One way to reduce the recognition of volatility could be to use a moving average of fair value measures rather that the fair value estimated at specific dates. A moving average could be developing for a defined period (say five years) and based on daily, quarterly or annual data which would smooth the volatility impact in a long-term business model entity. As the balance sheet measurement smoothed by using a moving average, changes in the moving average are reflected directly in profit or loss, as would any impairment.

4.44 There are two possible ways to apply a moving average

a) the simple moving average (SMA), which is the simple average of an asset over a defined number of years; and

b) the exponential moving average (EMA), which gives greater weight to more recent valuations and less weight to older valuations.

4.45 The SMA valuation method could be easier to calculate and understand than the EMA valuation method, so it could be easily implemented, the EMA valuation model is more complex although if would lead to a valuation that is closer to the fair value estimated at reporting date.

4.46 To apply this method, it will be necessary to consider the period over which to calculate the moving average. Options include:

a) A longer term (such as five years) to reflect the fact that this method is designed to smooth fluctuations for long-term holdings; or

b) A shorter term (such as two weeks before and after reporting date) to smooth the fluctuations that commonly arise on, or close to, the reporting dates.

4.47 EFRAG is not aware that this method has been used in the accounting requirements of any major EU economies.

Characteristics of a fair value moving average

4.48 One of the central issues of this DP is whether the fair value is the method that better portrays the performance and risk of long-term business models. It is frequently argued that short-term fluctuations in value being included in profit or loss does not provide a key indicator of performance for entities with a LTIBM. In particular, IT is often noted that changes in fair value are not relevant for equity instruments held in a LTIBM because these changes may reverse over time and before the disposal of the equity instrument

4.49 A fair value moving average removes market 'noise' from the measurement of an equity instrument. As moving averages are a common tool for investors, the use of this approach for measuring equity instruments should be understandable.

4.50 Given that the moving average may be above fair value at the end of the reporting period, it will be necessary to introduce an impairment model. Possible impairment models are discussed later in this chapter.

Results of the EFRAG survey in May 2019

4.51 Two respondents mentioned average fair value as the best accounting treatment.

Revaluation model

4.52 Description of the model

Balance sheet	Fair value
Profit or loss	Declines in fair value below acquisition cost that are greater than previous gains above historical cost Realised gain or loss
OCI	Gains above acquisition cost and declines in fair value below acquisition cost that are less than previously recognised gains

4.53 In a revaluation model all declines in fair value below the acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI. This model assumes that realised gains or losses on disposal would be recognised in profit or loss.

4.54 The revaluation model would be similar to the revaluation model in IAS 16 *Property, Plant and Equipment* which is well understood.

Characteristics

4.55 One of the main arguments in favour of this model is that it is simple and includes little discretion which would enhance comparability.

4.56 However, arguments against the revaluation model are that the approach:

a) results in short-term value decreases being recognised in profit or loss, which would not result in relevant information for users

b) is a source of volatility, which many consider inappropriate for a LTIBM; and

c) results in asymmetric treatment of gains and losses.

Results of the EFRAG survey in May 2019

4.57 A few respondents mentioned this model although is was not a preferred approach.,

Impairment Models

4.58 Many of the models discussed above refer to the need for impairment. This section considers various impairment models.

4.59 A robust and operational impairment model also eliminates or reduces any accounting-related incentive to retain loss-making equity investments for an indefinite period. Allocation decisions would therefore be less affected by accounting requirements and this would reduce the opportunity costs for shareholders that management does not pursue better investments.

4.60 An impairment model would enhance the relevance of profit or loss as the primary source of information about an entity's financial performance as all the components of the performance of the investments (dividends, impairment and gains and losses when the asset was sold) will be recognised in the same place.

Impairment models suggested in the user survey

4.61 When mentioning specific impairment models, approximately 30% of respondents considered that an improved version of the IAS 39 impairment model could be used as a way forward. These respondents considered that a robust impairment model can be developed without undue cost by using IAS 39 as a starting point but with additional guidance to reduce subjectivity.

4.62 Respondents that suggested improvements to the impairment model referred to:

a) improving the definition and criteria for the notion of 'prolonged' and 'decline';

b) allowing the reversals of impairments;

c) defining a methodology for the determination of recoverable amount;

d) requiring additional disclosures, including on methodology; and

e) considering a portfolio approach in order to align the impairment with the unit of account used for managing the performance and the diversification effect.

4.63 Despite the popularity of an impairment model based on IAS 39, this paper considers other alternatives in more depth that the information from the survey.

Qualitative impairment model

Qualitative IAS 39 impairment model

4.64 In a model similar to the model of IAS 39 for equity instruments classified as AFS with the ***qualitative triggers "significant or prolonged***". In this case the entity should impair when consider the loss not recoverable.

4.65 Paragraph 67 of IAS 39 requires an entity to recognise an impairment loss on available-for-sale equity instruments if there is objective evidence of impairment. Paragraph 61 of IAS 39 states: 'A significant or prolonged decline in the fair value' of an investment in an equity instrument below its cost is also objective evidence of impairment. The determination of what constitutes a significant or prolonged decline is a matter of fact that requires the application of judgement.

Characteristics

4.66 The IAS 39 impairment model has already been applied by preparers and analysed by users, which makes it easy to apply and understand. It also mitigates the risk that impairment losses are not recognised on a timely basis.

4.67 One of the main arguments in favour of an impairment model similar to IAS 39 is that it distinguishes between permanent declines in the fair value of the underlying equities versus their short-term market-driven fair value changes. As a result, it avoids the unintended volatility in profit or loss, when fair value is below the original cost.

4.68 However, experience had shown that the IAS 39 "significant or prolonged' approach failed to be effective regarding comparability between entities due to the inconsistent range of interpretations in practice. This could be addressed by introducing a quantitative impairment model or imposing triggers for the determination of significant or prolonged.

Qualitative IFRS 9 impairment model

4.69 In a model similar to the model of IFRS 9 for debt instruments, a model could identify potential triggers and vulnerabilities that could amplify volatility cycles. This model introduces the concept of "significant increase in credit risk since initial recognition" of an equity instrument, and the related newly introduced forward-looking approach to expected loss.

4.70 Through a comprehensive review of these models, it may be possible to identify variables commonly associated with equity valuation, and therefore appropriate to use as impairment triggers. The models would not be used for measurement purposes because their role is not to provide a fair value alternative to market prices; but to identify factors that can be associated with equity valuation in the same way a significant increase in credit risk is used to assess impairment of debt instruments.

Characteristics

4.71 The key to this approach would be to identify a trigger for impairment based on measures such as earnings per share, residual income, or clean accounting surplus or qualitative triggers such as the entity having been downgraded its credit rating or the industry where the entity belongs is in distress.

4.72 Clearly, there are conceptual limitations because stock valuation models are usually based on future expectations – expected dividends, results or cash-flows – and refer to a variety of factors. However, using expected amounts would limit comparability; and using many factors would create complexity when they are moving in different directions.

4.73 This approach is mostly applicable to equities with a quoted price or possibly at level-2 of the fair value hierarchy. Equities at level-3 are already being measured with some equity valuation model and declines in fair value would be treated as impairment.

Results of the EFRAG survey in May 2019

4.74 No respondent commented on the qualitative IFRS 9 impairment model.

Approach based on indicators IAS 36

4.75 For assets that are subject to annual depreciation or amortisation, IAS 36 *Impairment of Assets* requires an entity to assess if an impairment loss may have occurred based on a number of indicators. If there is an indication of impairment loss, an entity is required to determine the recoverable amount of that asset.

4.76 IAS 36 provides a list of external and internal indicators of impairment. A similar approach could be developed for impairment of equity instruments.

Characteristics

4.77 The key to this approach would be to identify a trigger for impairment based on measures such as earnings per share, residual income, or clean accounting surplus or qualitative triggers such as the entity has been downgraded its credit rating or the industry where the entity belongs is in distress.

4.78 Clearly, these are conceptual limitations because usually stock valuation models are based on future expectations – expected dividends, results or cash-flows – and refer to a variety of factors. However, using expected amounts would limit comparability and may be difficult for investors that have small holdings; and using many factors would create complexity when they are moving in different directions.

Results of the EFRAG survey in May 2019

4.79 No respondent commented on the qualitative IFRS 9 impairment model.

Quantitative impairment triggers.

4.80 In this model the concept of “significant or prolonged” would be similar to the model of IAS 39 for equity instruments classified as AFS. However, the entity would apply quantitative triggers which would reduce the extent of judgement in assessing whether a decline in fair value below cost represents objective evidence of an impairment. This would enhance comparability (across entities and over time).

Characteristics

4.81 One of the best arguments for quantitative triggers is to achieve comparability between entities and over time. Further, any quantitative trigger included could be expressed as a rebuttable presumption.

4.82 However, some of the reasons not to consider defined triggers include:

a) a single bright line approach might not be appropriate in all circumstances or for all equity instruments;

b) it is less principles-based; and

c) it does not allow for consideration of the characteristics of the business model or portfolio and may impact relevance.

4.83 If quantitative triggers are applied there could be a presumption that no impairment should be apply under those limits. It may be necessary to recognize and impairment loss before this period has elapsed or before the quoted price has dropped by the percentage triggers set in the Standard.

Results of the EFRAG survey in May 2019

4.84 Some respondents proposed quantitative triggers. Suggestions for quantitative triggers included:

a) A "significant" decline could be defined as a specific percentage decline from acquisition cost, for example unrealised losses are greater than 20% of cost;

b) "prolonged" could be defined as a specific time period where fair value has been below acquisition cost, for example more than 6 months;

c) a ‘significant deterioration of the credit quality’ of the issuer or, for quoted instruments, a decrease of the stock price that is strong and permanent;

d) an approach similar to the Solvency II thresholds for equity; and

e) require the entity to specify and disclose its quantitative impairment triggers.

CHAPTER 5: EQUITY-TYPE INSTRUMENTS

If an alternative accounting treatment was also to be applied to 'equity-type' instruments, then 'equity-type' would need to be defined. This chapter considers possible definitions of 'equity-type' and whether the models described in Chapter 4 could be applied to such instruments.

What are equity-type instruments?

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

5.2 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 instruments'.

5.3 Based on information received from EFRAG Working Groups, responses to this and previous consultations on this topic, EFRAG understands that these relate to instruments from the holder's perspective that are mostly units in investment funds. These can include, for example, interests in Undertakings for Collective Investment Transferable Securities (UCITS) where the units can be put back to the manager of the fund, and Exchange Traded Funds (ETFs) where the units can be traded on an external market.

Considerations in defining equity-type instruments

5.4 A key consideration is whether, for the purpose of this project, equity-type instruments should be limited to units in funds (however described) where the fund only invests in equities or whether all units in funds should be classified as equity-type instruments. The definition could focus on the following aspects:

a) The nature of the units in an investment fund;

b) All instruments that qualify for each of the puttable exceptions under IAS 32;

c) A test at fund level to identify whether investments in such a fund would qualify for the alternative treatment;

d) The type of underlying assets the equity-type investments have invested in; or

e) The sustainable nature of the activities invested in.

5.5 The discussion below identifies that there can be significant interaction between these aspects, so the determination of equity-type instruments is unlikely to be a simple choice between these aspects. For example, if equity-type instruments were to be defined as all instruments that qualify for the puttable exception, this could include units in funds whose portfolio include not only equity instruments but other assets, such as material open positions in derivatives for trading purposes or debt instruments that may suffer credit losses.

The nature of the units in an investment fund

5.6 Equity-type instruments could encompass any form of financial instrument that entitles the holder to a return based on the net assets of the fund. This return could be through trading the instruments or by requiring the fund to redeem the instrument at the holder's request.

5.7 That is, there would be no distinction between the accounting for a corporate form where some form of "share" in the returns can be identified. This definition is very broad and would include units in UCITS and ETFs.

IAS 32 puttable exceptions

5.8 Equity-type instruments could be limited to instruments that meet the puttable exception[6] in 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. Furthermore, with further issuances, the status of the investment may change which would require a change in measurement.

Equity-type test

5.9 In this case, an equity-type test similar to the test as to whether cash flows for contractually linked instruments represent solely payments for principal and interest as set out in IFRS 9 paragraphs B 4.1.20 to 26. Such a test could, for example, rely on the following principles:

a) The contractual terms of the units meet the definition of a puttable instrument in accordance with IAS 32 paragraphs 16A-16D; and

b) The underlying pool of assets solely includes:

c) equity instruments or equity-type instruments that meet this test (in which case the entity must look through until it can identify the underlying pool of instruments that are creating the cash flows);

d) cash or cash equivalents to meet the liquidity constraints of the funds; and

e) instruments that reduce the cash-flow variability (e.g. hedge of foreign exchange risk exposure) and/or aligning differences in cash flows relating to interest rate (whether fixed or floating); foreign exchange and timing of cash flows.

5.10 Like paragraph B4.1.26 of IFRS 9, other considerations could include when the holder is unable to assess the requirements or where the underlying pool of instruments change after recognition.

Types of underlying assets

5.11 Equity-type instruments could be limited to instruments that represent investments in funds that only hold equity instruments. This would lead to any change in the treatment of equity instruments being limited to equity instruments as this special treatment should be reserved for equities that are directly or indirectly held. It would exclude instruments such as derivatives on the underlying equities which would limit the scope of equity-type instruments.

The sustainable nature of the activities invested in

5.12 If the objective is to incentivise investments in sustainable activities, access to any new accounting requirements could be limited to funds with an environmental or ethical focus. Although many asset managers offer green and ethical funds, and non-

[6] 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.

government organisations and rating agencies have developed their own definitions, there is no common standard or definition. As a result, it may be extremely challenging to base the application of accounting requirements on such a notion.

5.13 If the nature of the activities invested in is the determinant of classification as equity-type, then the assets invested in may not be limited to equities. For example, the assets invested in may be long-term bonds or derivatives.

Working assumption

5.14 Any of the above approaches or combinations thereof can be followed in order to define equity-type more precisely for standard-setting. However, for the purposes of this advice, the working assumption is that the target population is investments in units of those funds that invest only in equity investments, related derivatives and necessary cash holdings. This would ensure that direct and indirect investments in equity instruments are subject to similar accounting treatment.

Summary of results from survey

5.15 More than 55% of respondents to the survey thought that a different accounting treatment should be applied to equity-type instruments.

Category of respondent	Yes	No	Did not answer
Academic	1	-	-
Accounting and Auditing	-	1	2
Asset Management	3	-	1
Banks and Conglomerates	5	2	2
Corporates - Others	5	3	1
Insurers and Conglomerates	14	1	-
Long term and institutional investors	2	-	-
Regulator	-	1	1
Standard Setters	4	4	-
Users	5	3	2
Total	**39**	**15**	**9**

5.16 Those that answered yes to the question provided the following insights into the types of instruments that should qualify for a different accounting treatment.

Category of respondent	Fund units & puttable exception	Nature of the assets invested	Other	Mutual funds
Academic	1			1
Asset Management	2		1	
Banks and Conglomerates	4	1	1	
Corporates - Others	3	1		2
Insurances and Conglomerates	12	1		
Long term and institutional investors	2	2	1	1
Standard Setters	3	3		
Users	2	2	2	
Grand total	**29**	**10**	**5**	**4**

5.17 The number of responses is greater than 39 as some respondents indicated more than one answer. One respondent indicated that the activities invested in should be of a sustainable nature in order for these instruments to also qualify for an alternative treatment.

Treatment under IFRS 9 and US GAAP

5.18 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.

5.19 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 does not meet the definition of an equity instrument and is therefore not eligible for the FVOCI election.

5.20 The IASB did not set out to change the accounting treatment for these types of instruments under IFRS 9. However, this change follows from the requirement that debt instruments to be classified as FVOCI should meet the SPPI guidance which in turns follows from the fact that the SPPI guidance replaced the requirements around embedded derivatives.

5.21 US GAAP measures equity instruments at FVPL. Accompanying this, US GAAP allows a practical expedient for entities to estimate fair value using the net asset value per share or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated consistently with the measurement principles of Topic 946 (Financial Services – Investment Companies) as of the reporting entity's measurement date.

5.22 This applies to investments without readily determinable fair value and the investment is in an investment company (within scope of Topic 946) or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements that are consistent with the measurement principles in Topic 946.

5.23 According to ASC 320-10-55-9, a mutual fund is considered an equity security even if it invests only in U.S. government debt securities. Consequently, investments in bond funds and fixed-income mutual funds are considered equity securities and must be accounted for at FVTNI under the ASU.

What models could be applied to equity-type instruments?

5.24 This section considers whether any of the alternative models described in Chapter 4 could not be applied to equity-type instruments. The issue is whether a change to the recognition and measurement of equity instruments could equally be applied to equity-type instruments.

Fair value models

5.25 The different fair value models described in chapter 4 were:

a) Fair value through OCI with impairment, reversal of impairment and recycling; and

b) Mandatory fair value through profit or loss.

5.26 In principle, all potential equity-type instruments could be recognised and measured using any of the fair value models discussed in Chapter 4.

5.27 However, for UCITS and similar instruments that are redeemed on application to the fund manager, it may be difficult to measure fair value because the fair value at reporting date may not be readily available. Nevertheless, this is no different to the current position.

5.28 Impairment will be discussed separately below.

Cost models

5.29 The cost models described in chapter 4 were:

a) Historical cost less impairment; and

b) Modified historical cost.

5.30 The considerations around cost for equity-type instruments is the same as for equity instruments and, theoretically, potential equity-type instruments could be recognised and measured using any of the cost models discussed in Chapter 4. It may be appropriate to consider amortisation if the equity-type instrument relates to a fund with a limited life.

Theoretical and other models

5.31 In theory, it should be possible to apply any of these models to equity-type instruments. However, as with the cost models, it may be appropriate to consider amortisation if the equity-type instrument relates to a fund with a limited life.

Impairment

5.32 Determining whether a decline in value of an equity-type instrument is an 'impairment' could be as judgemental and complex as for equity instruments. Similarly, there would be good arguments for either or both quantitative and qualitative triggers.

5.33 The recoverable amount would be the market value, redemption or net asset value depending on the nature of the fund. Where these are readily available on a timely basis, the main judgement would be whether any decline should be recognised in profit or loss. Where this is not the case, determining a 'recoverable amount' may be difficult depending on the information available. However, there is nothing that prevents the application of the methods suggested in the previous chapter for equity instruments to equity-type instruments.

5.34 Where reversals of impairment are considered appropriate for equity instruments and if it is determined that it equity-type instruments should be treated as equity instruments (i.e. ignoring any implicit put feature), there is no reason why impairment reversals should not be recognised for these instruments as well.

CHAPTER 6: CONCLUDING REMARKS

6.1 In the request from the EC, EFRAG was requested "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." Responding to this request is challenging, as there remains the need for definitions of *long-term investment business model* as well as for *sustainable investments* as, at this stage, there are no accounting definitions to appropriately support the exercise requested by the EC.

6.2 The following key messages emerged from the 2019 survey:

c) there was no consensus on a definition for LTIBM. A few respondents provided a definition close to their business model, e.g. a model in which the company acquires assets in order to match long-term insurance or savings-related liabilities. Many respondents considered it unnecessary to define LTIBM, but preferred to rather focus on whether equity instruments are held for (non)-trading purposes. A few insurers suggested that the focus should be on efficient asset-liability management aimed at matching the investments with long-term insurance/savings liabilities.

d) on sustainable investment, there were no fully-fledged definitions proposed during the survey that could be used in standard setting. Many respondents considered that sustainable activities should not be a distinguishing feature in accounting. EFRAG notes the ongoing work of the EC around its taxonomy for sustainable finance which may provide a useful basis in this regard in the future.

6.3 No compelling evidence has come to the attention of EFRAG that accounting is an impediment to investments in sustainable activities. In the 2019 survey there were mixed views whether a change in IFRS 9 would contribute to achieving the objective of the Action Plan on Sustainable Finance. Furthermore, EFRAG notes the ongoing work of ESMA in response to the EC request on Sustainable Finance where ESMA will analyse potential sources of undue short-termism, including existing rules that may contribute to mitigating undue short-termism and areas where the rules may exacerbate short-term pressures. EFRAG notes as well the ongoing debate on how to enhance broader corporate reporting on the basis of the lessons learnt from the first year of application of the Non-Financial Reporting Directive (hereafter 'NFRD'), in order to enhance the consistency and comparability of non-financial information disclosed throughout the Union.

6.4 EFRAG received 63 responses to its consultation aimed at collecting constituents' views on the request by the EC. The number of responses confirms that this is a topic that generates considerable debate in Europe, specifically for the financial sector. The respondents expressed mixed views on whether an alternative accounting treatment is needed to portray risks and performances of equity and equity-type instruments held in a LTIBM. However, the clear majority of the respondents favours FVOCI with the reintroduction of recycling. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9.

6.5 With reference to FVOCI with recycling EFRAG acknowledges that the current situation in IFRS 9 is the result of a compromise, as illustrated in the Basis of Conclusions to IFRS 9:

e) The lack of contractual cash flows in equity investments means that amortised cost is not applicable;

f) Fair value provides the most useful information about equity investments to users. However, presenting these fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment;

g) Recycling of gains and losses to profit and loss was prohibited as it would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets.

6.6 The EFRAG 2019 survey conducted to collect useful input to this advice indicated that a majority of respondents supported a change to IFRS 9. Reasons given related to the view that IFRS 9 creates volatility in profit or loss which does not permit an appropriate reflection of the business model of long-term investors, although it should be noted that many defined “long-term” as other than held-for-trading. Some also argued that the requirements in IFRS 9 will discourage investment in equity instruments although there is insufficient evidence to determine if this view is correct.

6.7 The result of the above-mentioned survey reflects that the preparer respondents strongly support changes to the accounting treatment of equity instruments in IFRS 9. The strongest support is in the financial sector where 24 insurance, banking and asset managing respondents considered a change is necessary as compared to four who disagreed. The two long-term investors also supported a change. Standard setters and users had mixed views, with half supporting change and half opposing it. Those regulators and auditing firms that responded considered that no changes are required.

6.8 In the above-mentioned survey, many respondents, approximately 30%, considered that an improved version of the IAS 39 impairment model could be used as a way forward. These respondents considered that a robust impairment model can be developed without undue costs by using IAS 39 as a starting point but with additional guidance to reduce subjectivity. Nonetheless, a few respondents highlighted that additional impairment requirements have proven to be difficult to agree upon and would introduce additional complexity into financial reporting which is unlikely to be to the benefit of users of the information.

6.9 In its advice of November 2018, EFRAG noted that the reintroduction of recycling for equity instruments carried at FVOCI would require a robust impairment model. At that time, there was insufficient evidence to recommend the reintroduction of recycling. EFRAG also considered that the underlying objective of a robust impairment model should be to distinguish declines in the fair value of an equity instrument below its purchase price that reflect objectively identifiable and adverse changes in the issuer’s economic condition from declines that reflect temporary market fluctuations. EFRAG noted that the first type of decline in fair value is less likely to reverse in the future than the second type. EFRAG also noted that putting this objective into practice is inherently challenging and subjective.

6.10 A number of respondents to the 2019 survey proposed using the impairment model in IAS 39 as a basis for a new model with improvements such as clarifying the terms 'prolonged' and 'significant decline'. Some respondents proposed thresholds such as longer than six months and more than 20% or below cost for longer than 12 months or more than 39%. EFRAG notes, that the SEC has previously indicated that under US GAAP the use of only quantitative indicators may lead to inappropriate recognition of impairment (both too late and too early).

6.11 As noted previously, the IASB concluded that the IAS 39 impairment model was unduly subjective, and ESMA[7]'s findings confirmed that it was not applied consistently in practice. However, in response to the previous EFRAG survey[8], there was no consensus on how to reach an appropriate balance between relevance and comparability. Some respondents stressed the need to achieve sufficient comparability which could likely be achieved only if the Standard included general quantitative thresholds. Others oppose this because they believe that the impairment solution should prioritise relevance over comparability, and therefore that each entity should set its own thresholds. EFRAG considers that a degree of rigour in the use of the election or the impairment model would be essential to ensure comparability.

6.12 EFRAG also concluded[9] that a model similar to the IAS 39 model should allow the possibility to reverse impairment losses. If a decline in the value of an equity instrument is recognised in profit or loss because it results from an adverse change in the economic condition of the issuer, subsequent recoveries in value that result from a reversal of that adverse change should similarly be recognised. This was confirmed in the current survey as mentioned above.

6.13 Furthermore, EFRAG is sympathetic to the concerns around the accounting for investments in units of funds under IFRS 9. EFRAG supports that similar fact patterns should be treated similarly, and some mutual funds and puttable instruments respond to movements in market variables similarly to equity instruments even though these do not meet the definition of an equity instrument in IAS 32. Any changes to the accounting for these instruments aimed at allowing for direct and indirect equity instruments to be treated similarly for accounting purposes would require careful consideration to evaluate the challenges of developing an appropriate standard setting solution and considering knock-on effects to the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and operability of assessing the nature of the underlying assets and business model at the level of the fund itself.

[7] See *Review of Accounting Practices – Comparability of IFRS Financial Statements of Financial Institutions in Europe*, ESMA (2013).

[8] EFRAG Technical advice to the European Commission on Equity Instruments on 28 November 2018

[9] EFRAG Technical advice to the European Commission on Equity Instruments on 28 November 2018

APPENDIX 1: SUMMARY OF PREVIOUS RESEARCH

As referred to in Chapter 1:, in 2017 the EC asked EFRAG to provide quantitative information about long-term equity investments, evaluate the possible impact of IFRS 9 on long-term investments and identify possible improvements to the accounting for long-term investments in IFRS 9. The EC also asked EFRAG to make the assessment in two phases.

Phase 1: Obtain quantitative information about long-term equity investments and evaluate the possible impact of IFRS 9 on long-term investments

A1 The first phase of the project was an assessment and consisted of collecting quantitative information about the significance of the equity portfolios for long term investors before the entry into application of IFRS 9 and assessing the possible effects of the application of IFRS 9 on the equity portfolios of long-term investors.

Quantitative data about the significant of the equity portfolios for long-term investors

A2 EFRAG's findings in relation to the assessment phase were mostly based on a public consultation conducted in 2017 and a review of a sample of financial statements.

A3 From the public consultation, EFRAG highlighted that the total amount of equity instruments held on average by 26 respondents for the years 2014-2016 was 753 billion Euros, of which 166 billion Euros being classified as AFS. This means an overall ratio of AFS/Equity Instruments equal to 22%. However, EFRAG noted that at an entity level the ratio for some respondents was 60% or higher as the holdings of equity instruments were highly concentrated in a small number of the respondents.

A4 From the review of the financial statements, EFRAG highlighted that the total amount of equity instruments held by the 30 entities included in the sample of 2016 financial statements was 315 billion Euros, of which 57 billion Euros being classified as AFS. This means an overall ratio of AFS/Equity Instruments equal to 18%. However, at the individual level the ratio for some entities was 55% or higher, as the holdings of equity instruments were highly concentrated in a small number of the entities.

A5 EFRAG also noticed that the entities from the non-financials industry (both in consultation and the sample of financial statements) have higher percentage of equity instruments classified as AFS over total equity instruments.

Possible effects of the application of IFRS 9 on the equity portfolios of long-term investors

A6 In its endorsement advice on IFRS 9, based on the limited evidence available at the time, EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of the implementation of IFRS 9.

A7 The assessment phase confirmed that while the majority of respondents do not expect to modify their holding period for equities with the introduction of IFRS 9, some entities expect to modify their asset allocation decisions. The assessment phase also confirmed that for most respondent the asset allocation decisions are driven by a plurality of factors including business, economic and regulatory factors.

A8 Finally, EFRAG highlighted that insurance entities are still at an early stage of assessment since they have an option to defer application of IFRS 9 until 2021.

Phase 2: Identify whether and how IFRS 9 could be improved with respect to the accounting treatment of equity instruments held for long-term investments

A9 In the second phase of the project, EFRAG investigated whether and how the requirements in IFRS 9 on accounting for holdings of equity instruments could be improved.

A10 As part of its due process to develop its response, in March 2018 EFRAG published a Discussion Paper *Equity Instruments – Impairment and Recycling* ("EFRAG DP"). The EFRAG DP (available here) sought constituents' views on recycling and impairment of equity instruments designated at fair value through other comprehensive income. In addition, EFRAG commissioned a literature review to an international academic team on the topic which complemented EFRAG's DP (available here).

How significant is an impairment model to the removal of the ban on recycling from a conceptual perspective

A11 In its response to the EC in November 2018, EFRAG considered that an impairment model was a necessary complement to any reintroduction of recycling for equity instruments carried at FVOCI. In particular, EFRAG highlighted that having some form of impairment would:

a) be consistent with other IFRS Standards and categories of assets;

b) enhance the relevance of profit or loss as the primary source of information about the entity's financial performance, including from a stewardship perspective;

c) provide information that is relevant for the assessment of future cash flows;

d) eliminate or reduce any accounting-related incentive to maintain loss-making equity investments for an indefinite period; and

e) be consistent with the notion of prudence.

A12 EFRAG also concluded that additional or amended disclosure or presentation requirements would not provide a suitable alternative to a robust impairment solution.

If an impairment model is considered to be an important element of a "recycling" approach, what features would characterise a robust impairment model and could these feasibly be made operational?

A13 In its response to the EC in November 2018, EFRAG considered that the underlying objective of a robust impairment model should be to distinguish declines in the fair value of an equity instrument below its purchase price that reflect objectively identifiable, adverse changes in the issuer's economic condition from declines that reflect temporary market fluctuations. EFRAG noted that the first type of decline in fair value is less likely to reverse in the future than the second type.

A14 EFRAG also explored two possible solutions aimed at reducing subjectivity of the accounting for long-term equity investments:

a) A revaluation model with fair value changes below the original acquisition cost being recognised in profit or loss and fair value changes above the original acquisition cost being recognised in OCI; and

b) An impairment model similar to the IAS 39 model but with additional guidance. For example, the impairment model would be less subjective if thresholds for "significant or prolonged decline in the fair value of an investment in an equity instrument below its cost" was defined or other more specific guidance was provided (e.g. quantitative thresholds for a significant or prolonged decline in the fair value of long-term equity investments).

A15 EFRAG's response to the EC highlighted that the majority of the respondents to EFRAG DP that expressed a view were in fact more supportive of an impairment mode similar to IAS 39. However, there was no consensus on how to reach an appropriate balance between relevance and comparability, particularly on the use of thresholds.

A16 EFRAG also highlighted that respondents in general agreed with EFRAG conclusion that a model similar to the IAS 39 model should allow the possibility to reverse impairment losses as this would ease the pressure on the entities and be conducive to a more balanced impairment assessment.

A17 Finally, EFRAG referred that in the course of developing its response to the EC request, EFRAG considered the arguments in favour and against the reintroduction of recycling in its Discussion Paper. EFRAG found lack of consensus on the matter among European constituents and considered that this lack of consensus was partially due to the fact that IFRS 9 has come into effect only very recently and very limited evidence of its impacts on the choices of preparers and users of financial statements was available. Therefore, EFRAG concluded that at that stage it did not have sufficient evidence to recommend the reintroduction of recycling.

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