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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, many respondents, 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.*

Main possible alternative accounting treatments

ES8 TO BE COMPLETED

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 OCI ('FVOCI'). On disposal, the cumulative gain or loss in 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 other comprehensive income ('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[*].

1.3 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 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.

[*] 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.

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 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) How significant is 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, what features would characterise a robust impairment model and could these 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 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 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.

Overview of survey's respondents

4.1 EFRAG received sixty-three responses to EFRAG questionnaire which are available on the EFRAG website, except for two confidential responses.

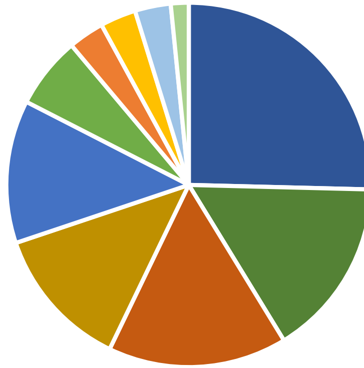
4.2 The responses came from national standard setters, business associations, professional organisations, listed companies and EU authorities. In particular:

a) The majority of the respondents were engaged in a long-term investment business model and/or sustainable activity;

a) Almost half of the respondents were from the financial sector, including insurance companies, banks, conglomerates and related business associations; and

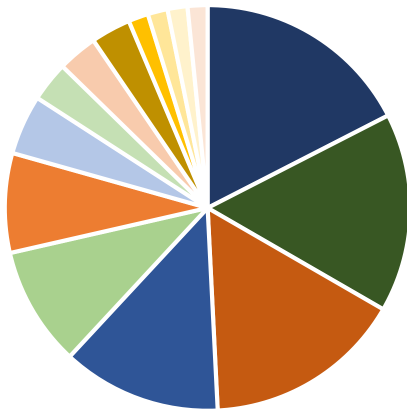
b) Approximately 15% of the respondents were users, a high response rate when considering EFRAG's outreaches on other topics.

Overview of respondents by sector



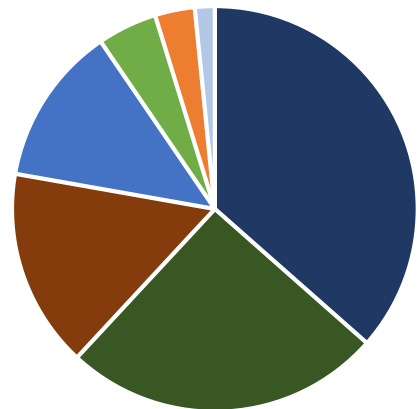
- Insurances and Conglomerates
- Corporates - Others
- Users
- Banks and Conglomerates
- Standard Setters
- Asset Management
- Accounting and Auditing
- Long term and institutional investors
- Regulator
- Academic

Overview of respondents by country

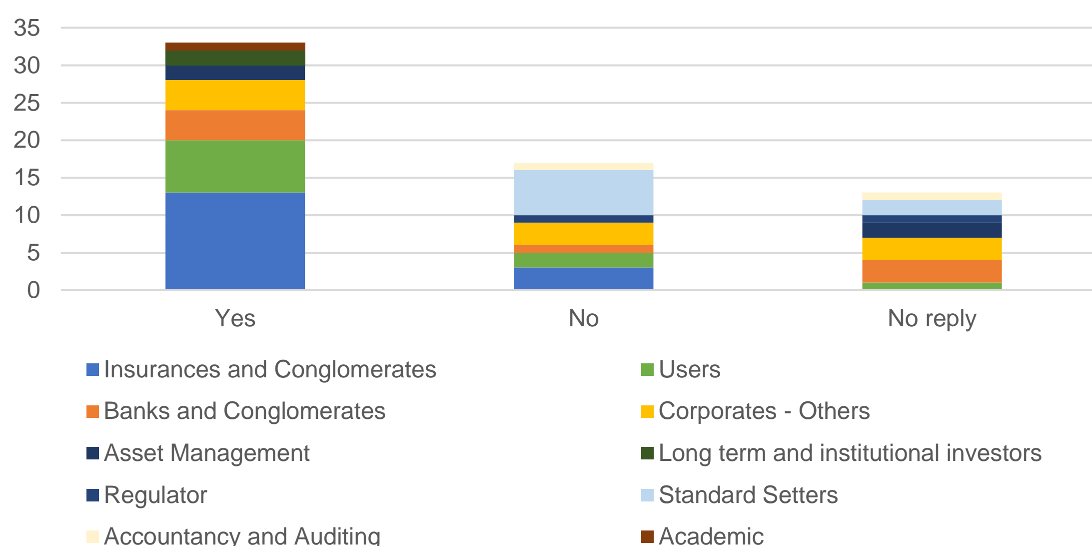


- France
- Germany
- Europe
- UK
- Belgium
- Italy
- Spain
- Sweden
- Denmark
- Austria
- Slovakia
- Netherlands
- Greece
- Bulgaria

Overview of respondents by type



- Preparer
- Business Association
- User
- National Standard Setter
- Regulator
- Auditing Association
- Academic



2.2 The majority of the respondents from the financial sector and users of financial statements stated that they were engaged in a long-term investment business model. Other respondents that were not engaged in a long-term investment business model or did not reply were mainly corporates, national standard setters, regulators and accounting/auditing professional associations.

Outreach activities

2.3 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.

2.4 The EFRAG Secretariat also discussed the project during it development with its Working Groups. 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.

2.5 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 unrealized 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 (which is based on a point-in-time approach).

Summary of the responses received

Definition of sustainable activities

2.6 Many respondents highlighted that currently there is not a single definition for "sustainable activities" and acknowledged the challenges of defining it. Nonetheless, a number of 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.

2.7 Although in general respondents supported the aim of encouraging sustainable activities, several respondents, particularly from the financial sector, considered that sustainable activities should not be a distinguishing feature in accounting.

2.8 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 the implementation of IFRS 9 will impact investments in sustainable activities; while others considered 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

2.9 A number of respondents observed that currently there is no formal definition for 'long-term investment business model' and acknowledged the challenges of defining such a business model.

2.10 Those respondents that provided a definition of Long-term investment Business Model (LTIBM) provided different views on what a LTIBM is. 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. A number of respondents, particularly from the financial sector, also provided a definition of LTIBM closer to their own business model. For example, some respondents defined LTIBM as a model in which the company acquires assets in order to match long-term insurance or savings related liabilities.

2.11 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. Instead, many of these respondents considered that the focus should be on determining whether an equity instrument is held for trading purposes or not held for trading. In addition, some 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.

2.12 When asked which characteristics should be required to identify a long-term investment business model, about half the respondents referred to the "expected holding period" and the "characteristics/business model of the investor". In contrast, 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) without further explanation.

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

2.13 The majority of the respondents, approximately 70%, particularly from the financial sector, considered that there is a need for an alternative accounting treatment for equity instruments in IFRS 9. However, not all respondents related the need for an alternative accounting treatment to the objective of "properly portraying the performance and risks of equity instruments held in a long-term investment business model". As already highlighted, many 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.

2.14 In addition, many respondents, particularly those from the financial sector, favoured a FVOCI model with recycling and impairment, for non-trading equity investments and comparable instruments, without considering whether investments are related to sustainable activities (i.e. scope similar to the FVOCI option under IFRS 9).

2.15 By contrast, many respondents, approximately 30% of respondents were not convinced that there is a need to identify a long-term investment business model or an alternative accounting treatment for long-term equity investments. These respondents considered that:

a) whether an equity instrument is held in a long-term investment business model is a rather subjective assessment that most likely will result in divergence in practice;

b) IFRS 9 has only been in effect since January 2018 (although some insurance companies 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;

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

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.

2.16 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) affects any asset allocation decisions to the disadvantage of long-term equity investments and suggested to reconsider any potential issues as part of the IFRS 9 post-implementation review.

2.17 The table below summarises the feedback received by type of respondent. When answering to the question, it is clear from the table above that most insurance companies, 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, associations)	Yes	1	2%
	No	0	0%
Users (individuals, associations, accounting valuators)	Yes	5	8%
	No	5	8%
Insurance and conglomerates (entities and associations)	Yes	15	24%
	No	1	2%
Banks and conglomerates (entities and associations)	Yes	5	8%
	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	3	5%
Accounting and Auditing	Yes	0	0%
	No	2	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?

2.18 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 particular, respondents considered that:

a) FVPL does not adequately depict the financial performance of long-term investors, particularly insurance companies, as it increases the volatility in the profit or loss statement and generates a mismatch between the liabilities and the assets that fund those liabilities;

b) the use of FVPL for equity instruments does not reflect the business intention of holding equity investments for strategic reasons and mark-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, from properly reflecting their investment performance from non-trading equity instruments;

d) both dividends and gains on disposal from the sale of equity instruments represent a form of realisation of the fair value of the instruments. Therefore, both transactions 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.

2.19 In addition, some respondents referred to the limitations related to the elimination of the cost exception for equity instruments (i.e. the exception in IAS 39 from fair value measurement for some unquoted equity instruments).

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

Which alternative accounting treatments have been suggested?

2.21 Respondents that would support an alternative model to that required by IFRS 9, when specifically referring to an alternative accounting treatment for equity instruments, indicated many different approaches.

2.22 Most respondents, particularly from the financial sector, supported fair value measurement on the balance sheet of equity and equity-type instruments but called for the reintroduction of recycling for the FVOCI approach. Some of these respondents only considered further analysing other alternative measurement approaches for equity instruments if recycling was not reinstated; others were not in favour of any other alternative measurement at all.

2.23 There was little support for FVOCI without recycling.

2.24 The "cost" model, in its possible variations (dual measurement, adjusted cost, cost exception, historical cost) was supported by 14% of these respondents. The table below summarises the feedback received on which alternative accounting treatment respondents prefer (43 respondents want an alternative but 1 did not identify which alternative):

Type of respondent	Model	Number	%
Academic (individuals, associations)	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	13	31%
	Cost exception	1	2%
	Historical Cost	1	2%
Banks and conglomerates (entities and associations)	FVOCI with Recycling	4	10%
	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%**

2.25 Finally, some respondents referred to other alternative accounting treatments in addition to their preferred treatment reported in the above table:

f) historical cost, adjusted cost method, revaluation model, cost exception, average fair value were mentioned in this context;

g) new ideas of measurement approaches aimed at reflecting the strategic orientation of the investment or the matching with long-term liabilities (including at portfolio approach or for matching insurance liabilities).

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

2.26 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 cost by using IAS 39 as a starting point but with additional guidance to reduce subjectivity.

How can the impairment model be improved?

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

a) improve the definition and criteria for the notions of 'significant' and 'prolonged';

b) allow the reversals of impairments;

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

d) require additional disclosures, including on methodology; and

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

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

2.28 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 as to which instruments should be eligible for this treatment and which approaches should apply.

2.29 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.

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

Type of respondent	Is there a need for an alternative accounting treatment? Response	Number	%	If Yes (43 responses and 1 did not respond). Should the different accounting treatment be restricted to equity instruments held in **a long-term investment business model**? Response	Number	%
Academic (individuals, associations)	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	15	24%	Yes	2	5%
	No	1	2%	No	13	31%
Banks and conglomerates (entities and associations)	Yes	5	8%	Yes	2	5%
	No	3	5%	No	3	7%
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	3	5%	No	5	11%
Accounting and Auditing	Yes	0	0%	Yes	0	0%
	No	2	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"?

2.31 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 should be extended to equity-type instruments (even if respondents were referring to different accounting treatments, as described above).

2.32 By contrast, some respondents considered that the different accounting treatment should not be extended to equity-type instruments. One respondent noted that it was difficult to define equity-type in such a way that it is not complex to apply and does not introduce inconsistency with the accounting treatment of other financial instruments.

2.33 Most of the remaining respondents did not think that new options were necessary. One respondent explained 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.

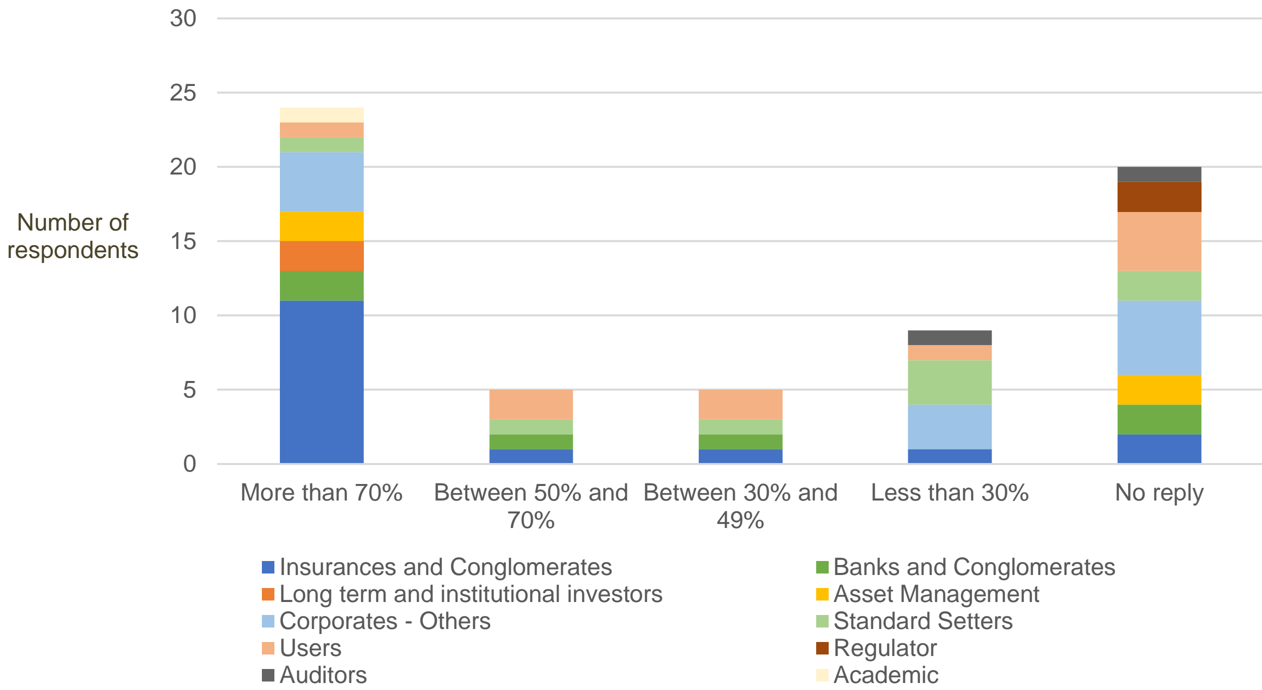
2.34 The table below summarises responses on whether the different accounting treatment referred to in the previous questions be extended to instruments that are equity-type?

	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, associations)	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	15	24%	Yes	15	37%
	No	1	2%	No	0	0%
Banks and conglomerates (entities and associations)	Yes	5	8%	Yes	3	7%
	No	3	5%	No	2	5%
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	11%
	No	3	5%	No	2	5%
Accounting and Auditing	Yes	0	0%	Yes	0	0%
	No	2	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%**

2.35 The table above shows 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?

2.36 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 LTIBM. However, there was an equally a significant number of respondents, particularly standard setters, users, regulators and accounting and auditing professionals that did not consider an alternative accounting treatment relevant or did not reply.


How relevant a different accounting treatment is to the objective of reducing or preventing detrimental effects on LTI?
Number of respondents
30
25
20
15
10
5
0
More than 70%
Between 50% and 70%
Between 30% and 49%
Less than 30%
No reply
Insurances and Conglomerates
Banks and Conglomerates
Long term and institutional investors
Asset Management
Corporates - Others
Standard Setters
Users
Regulator
Auditors
Academic

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†, 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 BC 5.18).

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.

† 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[‡] 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[§] 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) Preparers have voiced concerns that significant volatility in the financial results is not reflective of their performance other than for trading activities; and

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‡ 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

§ 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 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 equities. 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. **

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 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 disreputability of profits depending on the legal framework.

** https://www.berkshirehathaway.com/letters/2017ltr.pdf

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 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 quotations 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 recognition 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. Particularly these respondents were from the financial sector, with Insurers and conglomerates being the most significant contributor. Users were split with those in the UK being supporters of IFRS 9.

3.24 However, 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 requested change included 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 its current form, IFRS 9 created disincentives for insurers to maintain and increase investments in long-term and/or illiquid assets (and contrary to the objectives of the 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.

3.26 Respondents noted that IFRS 9 has been effective for a short period and a post-implementation review is more appropriate to consider these aspects. Some considered that holding an instrument in a long-term investment business model as a classification criterion would be subjective and likely to result in divergence in practice. Others pointed to EFRAG’s previous research that was inconclusive on whether IFRS 9 was problematic and would impact on investment decisions. Finally, some thought that 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 ALTERNATIVES

This chapter considers some alternative models to the requirements of IFRS 9. These are a mix of models that have been applied in practice (FVPL with recycling impairment and reversal, value in use, historical cost less impairment, revaluation model) and theoretical models (fair value moving average, fair value excluding average industry volatility, modified historical cost).

Valuation Methods

Fair value through OCI with recycling, impairment and impairment reversal

Description of the model

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

4.1 A fair value through OCI with recycling, impairment and reversals of impairment was the most popular model with respondents to the EFRAG survey. This model extends the FVOCI option in IFRS 9 by adding impairment and reversals, an 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 appropriates for a LTIBM. In the context of the request from the EC, this paper considers the model from the perspective of a LTIBM.

4.2 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.

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

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

a) It best reflects the performance and risk of LTIBM by removing unrealised gains and losses from profit or loss as unrealised gains and losses, other than impairments, do not provide reliable 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 assts are not carried on the balance sheet above their recoverable amount.

c) By providing for reversals of impairment, the approach ensures that more extreme periodic fluctuations are smoothed over the long term; 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.

4.4 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 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

4.5 This model was the approach 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.

Fair value moving average.

Description of the model

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

4.6 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.

4.7 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.

4.8 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.

Advantages and disadvantages of a fair value moving average

4.9 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. When valuing the equity instruments at the reporting date, the information included in profit or loss may not be the primary indicator of performance for entities with long-term business models.

4.10 Using a fair value moving average would remove market 'noise' from the measurement of an equity instruments as well as smoothing market volatility due to isolated events. In a business model where or short periods of time which does not affect the long-term business model profit on the assumption that the averaging occurs over the same period of time.

4.11 Fair value approaches are often considered to provide users with the most relevant information. However, it is often noted that fair value changes at the reporting date may not be the most relevant information for assets held in a non-trading business models. The reason is because this changes may reverse in a long term strategy business model even before the disposal of the equity instrument.

4.12 The events that are accounted for in a consistent way through time and by different entities would not be affected for comparability purposes using on average for fair value. However; the define period to calculate any of the two possible methods of fair value moving average should be externally prescribed by an authority in order to achieve the needed comparability.

4.13 The use of fair values moving average poses some practical issues. One is that entities may have to produce a higher number of estimates for those equity instruments that do not have a market price. For this reason this method could be more suitable for listed equity instruments. Another is that impairment should be assessed when the moving average is higher than the closing price at the end of the period.

4.14 Fair value has been used for many years under IAS 39, so the application of fair value moving averages would possibly not impact understandability. These methods systematically provide a smoothing mechanism to fair value changes and it is unlikely understandability would be compromised as the methodologies can be easily and clearly explained. However; EFRAG is not aware that this method was used in the accounting requirements of any major EU economies.

Results of the EFRAG survey in May 2019

4.15 No respondent has commented on the fair value moving average approach .

Fair value excluding average industry volatility

Description of the model

Balance sheet	Fair value excluding average industry volatility
Profit or loss	Changes in fair value excluding average industry volatility
OCI	Period changes in fair value excluding average industry volatility

4.16 A component of the fluctuation, observed in the fair value of equity instruments, may relate to isolated market events that affect the entire industry or business sector. An average industry coefficient is a measure of the volatility, or systematic risk, of an individual equity instrument compared to the unsystematic risk arising from exposure to general industry movements as opposed to idiosyncratic factors.

4.17 Changes in the fair value excluding average industry volatility could be recognised on OCI or in profit or loss. Given that this approach is designed to reflect a long term business model., to would appear more appropriate to reflect annual changes in OCI. This would require an impairment model, including whether impairments should be reversed.

Advantages and disadvantages of fair value excluding average industry volatility

4.18 The yield industry average is important because it measures the risk of an equity instrument that cannot be reduced from allocating your capital in a way that reduces the exposure to any one particular asset or risk. The yield industry average risk is the only kind of risk for which long term investors should receive an expected return higher than the risk-free rate of interest.

4.19 Furthermore, on an individual equity instrument level, measuring the yield industry average could present the real data to volatility and liquidity in the industry. However, this alpha should be taken into account by the entity by reflecting this industry volatility in the long term analysis.

4.20 One of the possibilities is to account the changes of the yield industry average, that are considered the ones related to the industry, in Other Comprehensive Incomes (OCI) while the difference between the yield industry average and the fair value could be considered real gain or loss of the entity and should be accounted at reporting date in profit or loss.

4.21 A consistent classification for the entities considered in calculating the yield industry average is necessary to ensure comparability over time. For that reason; the yield industry average could be externally given by an authority in order to achieve the needed comparability.

4.22 In EFRAG’s view a robust impairment model is a necessary complement to the fair value excluding average industry volatility, to address those permanents declines in value for the industry that would not be recover at realisation time.

Results of the EFRAG survey in May 2019

4.23 No respondent has commented on the Fair value excluding average industry volatility approach.

Value in Use (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

4.24 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.

4.25 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 explicit period plus a terminal value which determines the value of an equity instrument beyond the expected period at realisation or including expected dividends for the expected holding period plus the estimated exit value.

4.26 A risk adjustment could be included in the measurement and would relate to the uncertainty of the amount and timing at recovery, this could be adjusted by the weighted average cost of capital model (WACC) which is the minimum return value the entity should earn on the equity instrument.

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

4.28 This approach is used in practice in measuring:

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

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

Advantages and disadvantages of value in use

4.29 This value in use 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 at 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.

4.30 As mentioned in paragraphs 4.9 and 4.10, a pure fair value approach may not provide users with the most relevant information in a LTIBM. The value in use model reflects the fact that dividends are 'sticky' and not prone to fluctuations in the short term.

4.31 This model reduces the subjectivity regarding the definition of dividends. Whereas there is subjectivity as to what determines earnings and cash flow, uncertainty as to what constitutes a dividend is less common. A robust impairment model is a necessary complement to the value in use model.

4.32 While it may be seen as way to smooth volatility and reflect the real performance of the entity, value in use 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 and vice versa. However, in practice, some entities maintain stable dividend payments, even if they are facing extreme variations in their earnings as the entity policy 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

4.33 No respondent proposed the value in use approach .

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

4.34 Under an historical cost model, equity instruments would be recognised based on the consideration at which they were 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 the equity instrument on disposal as it may not be clear which specific instruments are subject to disposal if they are acquired over time.

4.35 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 have assumed that any impairment charge would be reversed if the situation changes..

Advantages and disadvantages of historical cost less impairment

4.36 Historical cost is often viewed as simpler 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 relevant and reliable representation of both the entity's financial position and its financial performance.

4.37 Nonetheless, the historical cost of an asset may be relevant to users of financial statements, because it uses information derived, at least in part, from the price of the transaction or other event that gave rise to that asset or liability. However, historical cost may not provide relevant information when an equity instrument has been held for a substantial time. There is evidence that, generally, stock prices are rising over the long term.

4.38 Supporters of historical cost argue that the price of the transaction is useful for stewardship as it monitors the amounts paid for resources. The gain or loss on disposal reflects the management approach to holding these instruments.

4.39 Supporters of historical cost measurement consider that not recognising unrealised gains in profit or loss is prudent. They argue that 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. In their view, reflecting market participant's assumptions about timing, amount and risks associated with future cash flows does not necessarily reflect performance on the underlying asset, particularly for equity instruments that are held under a LTIBM.

4.40 However, others, including users and investors, argue that 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 of these users and investors 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.

4.41 Furthermore, some users and investors argue that historical cost measurement hinders comparability. It also weakens the holder's ability to exercise their fiduciary duties which often means maximising investment returns while at the same time taking into account factors supporting sustainability. In their view, fair value provides the best basis to compare investments and evaluate sustainability impacts.

4.42 Finally, some argue that 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

4.43 Only a few 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.

4.44 Some respondents noted that historical cost measurement could be considered for equity instruments that are not "marketable" – i.e. instruments that have no (active) primary or, if any, secondary market and which fall under a level 2 or level 3 category under IFRS 13.

4.45 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

4.46 This section considers two possible modifications to historical cost:

†† Palea V. 2019 *Accounting for Sustainable Finance: Does Fair Value Accounting Fit for Long-term Investing in Equities?*

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

4.47 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*.

Advantages and disadvantages

4.48 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.

4.49 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.

4.50 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

4.51 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.

4.52 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.

Advantages and disadvantages

4.53 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.

4.54 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.

4.55 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

4.56 Only 2 respondents supported an adjusted cost approach.

4.57 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 upon occurrence of observable transactions or they may suffer from availability and delays of the necessary information when adjusting for the share of profit or loss of the investee. This respondent considered that making adjustments to the inputs in fair value measurement while smoothing the volatility lacked merits. This respondent also questioned why the risk free-rate should be kept constant while other inputs would be adjusted based on market development. Furthermore, the approach could not be applied for comparable company valuation multiple models because they do not use discounting as an input. Average fair value approaches could address the end of year noise in the market prices but as such they hardly remove the volatility.

Revaluation model.

4.58 Description of the model

Balance sheet	Fair value
Profit or loss	Impairment charges reducing the equity instrument below historical cost Realised gain or loss
OCI	Gains above historical cost

4.59 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 gains of losses on disposal would be recycled and could be recycled to profit or loss.

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

Advantages and disadvantages

4.61 One of the main arguments in favour of this model is that it would be simple; and it would be less discretionary which would enhance comparability.

4.62 However, some 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

4.63 A few respondents mentioned his model although is was not a preferred approach.,

Impairment Models

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

4.65 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.

4.66 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

4.67 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.

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

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

e) allowing the reversals of impairments;

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

g) requiring additional disclosures, including on methodology; and

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

4.69 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

4.70 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.

4.71 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.

Advantages and disadvantages

4.72 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.

4.73 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, even if some detractors remark that experience had proven that the IAS 39 "significant or prolonged' approach failed to be effective regarding comparability among entities due to the wide range of thresholds retained.

4.74 However, it would avoid the unintended volatility in profit or loss, when the current fair value was below the original cost. The application of an impairment approach for equity instruments that was consistent with the one for debt instruments measured at FVOCI and entities would be familiar with the model from IAS 39.

4.75 However, there is evidence that the principle-based impairment model in IAS 39 has been applied inconsistently. 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

4.76 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.

4.77 By a comprehensive review of these models, it may be possible to identify variables commonly associated with equity valuation, and therefore fit to use as impairment triggers. The models would not be used for measurement purposes because their role is not to provide a fair value in 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.

Advantages and disadvantages

4.78 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.

4.79 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.

4.80 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

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

Approach based on indicators IAS 36

4.82 For assets that are subject to annual depreciation or amortisation, IAS 36 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.

4.83 IAS 36 provides a list of external and internal indicators of impairment. More specifically, the indicators are:

a) External sources:

i) indications that the asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use

ii) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated;

iii) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;

iv) the carrying amount of the net assets of the entity is more than its market capitalisation

b) Internal sources:

i) obsolescence or physical damage

ii) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite

iii) worse economic performance than expected

iv) for investments in subsidiaries, joint ventures or associates, the carrying amount is higher than the carrying amount of the investee's assets, or a dividend exceeds the total comprehensive income of the investee

4.84 A similar approach could be developed for impairment of equity instruments.

Advantages and disadvantages

4.85 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.

4.86 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

4.87 No respondent has commented on the qualitative IFRS 9 impairment model .

Quantitative impairment triggers.

4.88 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 should apply some ***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, especially if set within the IFRS Standard. This enhances comparability (across entities and over time) but may reduce relevance.

Advantages and disadvantages

4.89 One of the best arguments for quantitative triggers set in the Standard is achieve comparability between entities and over time. In this case any quantitative trigger included should be accompanied by some rebuttable presumption.

4.90 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 entities or all equity instruments;

b) it would be more principles-based; and

c) it allows for consideration of the characteristics of the business model or portfolio and relevance was more important than comparability.

4.91 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

4.92 Some respondents proposed quantitative triggers. FURTHER INFORMATION TO BE ADDED

Models proposed in the survey and not identified above

4.93 Respondents provided other alternative accounting treatments for equity instruments that have not been analysed above. These include:

a) **Dedicated portfolio approach**: a dedicated portfolio of assets that covers the financial risk of other types of long-term liabilities. The portfolio of assets to be measured at fair value in the balance sheet, with all changes, realised and unrealised recognised in OCI. Changes accumulated in OCI would be recycled into profit or loss to the extent that the accretion or financial charge of the underlying liability (measured under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) is affecting profit or loss in the period with the net effect being nil. Where the cumulative OCI per portfolio is negative, that amount should be recognised in profit or loss.

b) **Strategic investments approach:** where an entity acquires a non-controlling interest in a company that secures its current or future business or technology amongst others and financial performance is not the primary goal of the investment. These could be considered as "strategic" investments. In some cases in the preliminary stage of a business, dividends are rarely expected and any gain on sale is remote. The investor rather purchases a kind of "option" to get "insight" information. Accounting for such investment should be at cost with an impairment test (or even amortisation of the assets if no terminal value is reasonably expected) to appropriately reflect that business model.

c) **Connection with variable fee approach:** New accounting rules should be more aligned to the variable fee approach in IFRS 17, with a risk-based long-term impairment model.

4.94 It is worth noting that some of these respondents suggested alternative accounting treatments other than FVOCI with recycling only as the second best approach. For example, one respondent stated that, if the re-introduction of recycling is not accepted by the IASB, a third measurement basis could be a suitable alternative.

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 investments'.

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

d) 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 the four 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 some form of return based on the net assets of 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 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.

Types of underlying assets

5.9 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

5.10 If the objective is to incentivise investments in sustainable activities, access to the new accounting requirements could be limited only to funds with an environmental or ethical focus. Most asset managers offer green and ethical funds, and non-governmental organisations and rating agencies have developed their own definitions and methodologies. However, there is no common standard or definition and, it may be extremely challenging to base the application of accounting requirements on such a notion.

5.11 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.

Summary of results from survey

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

Category of respondent	Units in funds & puttable exception	Nature of the assets invested	Other	Mutual funds
Academic	1			1
Accounting and Auditing				
Asset Management	2		2	
Banks and Conglomerates	3	1	3	
Corporates - Others	3	1	1	2
Insurances and Conglomerates	13	1	2	
Long term and institutional investors	2	2		1
Regulator				
Standard Setters	4	2	4	
Users	2	6	3	
Grand total	**30**	**13**	**15**	**4**

Treatment under IFRS 9 and US GAAP

5.13 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.

5.14 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.

5.15 US GAAP measures equity instruments at fair value through profit or loss. 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 in a manner consistent with the measurement principles of Topic 946 (Financial Services – Investment Companies) as of the reporting entity's measurement date.

5.16 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.

What models could be applied to equity-type instruments?

5.17 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.

5.18 This section ignores the need under some of the definitions to assess whether the instrument should be classified as equity-type at reporting date. For example, if the nature of that assets in the fund is to be the determinant, it will be necessary to assess whether the investment profile has changed and, consequently, whether the instruments should still be classified as equity-type.

Fair value models

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

5.20 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.

[‡‡] 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.

Cost models

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

5.22 TO BE COMPLETED

CHAPTER 6: SUMMARY

TO BE COMPLETED

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:

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

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

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

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

iv) 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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