Examples of measurement of equity instruments under IFRS 9 Issues Paper

Objective

1 At its February 2019 meeting, the EFRAG Board decided to restructure the consultation on EFRAG's Research Project *Equity Instruments: Research and Measurement*.

2 Specifically, the EFRAG Board asked EFRAG TEG to:

(a) Develop an on-line questionnaire, using a small number of examples, as the basis for collecting input to help inform EFRAG's response to the EC request;

(b) Develop examples that illustrate different scenarios for holding long-term investments; and

(c) Reformulate the draft Discussion Paper as an EFRAG Secretariat background briefing paper supporting the questionnaire.

3 This paper presents the proposed questionnaire and examples developed by the EFRAG Secretariat. EFRAG TEG will be asked for views and comments on the examples and questions to constituents.

Structure of the questionnaire

4 The EFRAG Secretariat suggests including the following questions in the web-based consultation:

(a) In your view:

(i) Would an accounting treatment other than the approaches in IFRS 9 *Financial Instruments* (FVPL or, if applicable, FVOCI without recycling) improve the portrayal of the performance and risks of long-term investment business models, in particular for those equity and equity-type investments in sustainable activities; or

(ii) Do the approaches in IFRS 9 already allow an appropriate portrayal of performance?

(b) Explain the reasons for your reply

(c) Rate how relevant a new accounting treatment is to the financing of sustainable activities in Europe *(question type: slider)*

(d) Should any alternative accounting treatment be available only to investments held in a long-term investment business model?[1]

[1] Questions (d) to (h) may or may not be restricted to participants having responded 'Yes' to (a)(i).

(e) Is so, which characteristics would you require to identify a long-term investment business model? (*question type: checkbox)*

(f) Should any alternative accounting treatment be available:

(i) only for investments that meet the definition of equity instruments; or

(ii) also for other investments that are 'equity-like'?

(g) If you consider that an alternative accounting treatment should be available for 'equity-like' instruments, which characteristics would you use to define the scope of such instruments? (*question type: checkbox)*

(h) For each scenario described:

(i) Would an accounting treatment other than the approaches in IFRS 9 (FVPL or FVOCI without recycling) improve the portrayal of the performance and risks of the reporting entity/investor; or

(ii) Do the approaches in IFRS 9 already allow an appropriate portrayal of performance and risks of the reporting entity/investor?

(i) If you support an accounting treatment other than the approaches in IFRS 9:

(i) which (if any) of the accounting treatments explored in the background paper do you support? (*question type: checkbox);*

(ii) rate the elements in the scenario by order of relevance for your reply (*question type: drag and drop ranking*)

(j) If an accounting treatment other than the approaches in IFRS 9 was introduced, list the aspects that the Standard needs to regulate to make the treatment operational (unit of account, impairment model).

(k) Do you have suggestions to address these operational aspects?

Illustrative examples

5 When developing illustrative examples, the EFRAG Board suggested that the examples make reference to the following features:

(a) Nature of the activity of the investee – for instance, whether the investee is an infrastructure corporate;

(b) Whether the investor is a long-term investor. In the absence of a definition, reference could be made to the qualifying criteria in the background paper:

(i) The nature of the investor's business model;

(ii) The expected holding period;

(iii) The investor has a legal requirement to hold dedicated assets in relation to obligations such as decommissioning obligations; and

(iv) The investor holds those interests with a view to settle long-term liabilities (for example a life insurance contract).

(c) Whether the underlying is a wasting or depreciable asset (for example an equity instrument issued to earn returns over lifetime of an asset with a predetermined useful life);

(d) Whether the instrument is listed or unlisted;

(e) Whether the instrument is puttable to the issuer or another third party;

(f) Whether the investor holds the interest directly or indirectly through a unit fund[2]; and

(g) Whether the investor holds a single instrument or an open portfolio of interests in equity.

6 The EFRAG Secretariat understands these features to be relevant for the following reasons:

(a) Features in paragraph 5(a) and 5(b) may be relevant to the policy objective to provide stable financing to sustainable activities;

(b) Features in paragraph 5(c), (d) and (e) affect the investor's ability to dispose of the asset in the short-term and make changes to fair value both more difficult to determine and less relevant to depict the performance;

(c) The feature in paragraph 5(f) is relevant to the strategic nature of the interest in the underlying activity. An investor can only hold a strategic investment directly (unless the investor has control or a significant influence in the fund); and

(d) The feature in paragraph 5(g) affects the operational complexity of accounting.

7 To the extent possible, the above features have been considered in developing the examples discussed below, which discuss different scenarios of investments in equity instruments from the **perspective of the investor**.

8 The examples are intended to be simple illustrations to help EFRAG constituents respond to questions on the measurement of equity instruments under IFRS 9.

9 There is a very large number of possible combinations of the features in paragraph 5. The EFRAG Secretariat has attempted to develop illustrative examples that are simple but sufficiently realistic and collectively address all the features listed above. Each example includes some of the features, and respondents will be asked to rank the importance of each of them in determining their answer.

10 The EFRAG Secretariat also considered if the examples should be numerical. This could help respondents in their analysis, but it would require a number of assumptions, including when an entity would recognise impairment losses and how it would measure them. The EFRAG Secretariat concluded that numerical examples would be complex to include in a web-based questionnaire and was concerned that the replies would depend on the assumptions chosen rather than on the analysis of the features in the example.

Example 1 – Wind farm with predetermined useful life

11 On 1 January 20x1, Entity A buys a 10% non-controlling equity interest in Entity B. The equity interest does not qualify as an associate.

12 Entity B has been set up to build and operate a wind farm as part of a **long-term renewable energy programme**. At the end of the **economic life of the wind farm** (10 years) no residual value is expected, and Entity B could either seek additional financing to build a new asset or be put into liquidation.

13 Entity A initially expects Entity B to generate a stable annual profit and distribute it to shareholders. Furthermore, given the business purpose of the equity instrument, the terms and conditions of investing in Entity B **prohibit investors from selling**

[2] Under IFRS 9, an equity instrument in a unit fund is required to be accounted for at FVPL, whereas a directly held equity instruments may be accounted for either at FVPL or at FVOCI.

their equity investment during the 10-year period. Entity A is therefore required to hold its investment in Entity B for the full economic life.

Example 2 – Unlisted single equity instrument

14 On 1 January 20x1, Entity A buys a **10% equity interest** in Entity B from Entity C for CU 1000. Entity B is an **unlisted** start-up company manufacturing electronic scooters to be used in the e-scooter sharing industry.

15 Entity A intends to hold its interest in Entity B for the purpose of creating value in the long term by generating a capital gain after several years, during which Entity B is likely to have gone through a significant transformation.

16 Entity A **does not have a put option** and there are no observable recurring transactions in the equity of Entity B. Due to these conditions, Entity A does not expect to dispose of its share in the near future.

Example 3 – Open portfolio of equity instruments held with a view to service a long-term liability

17 On 1 January 20x1, Entity A **acquires a portfolio** of various equity instruments. The objective of entity A is to use the proceeds from the portfolio to fund a long-term liability to clean up a site currently being used to explore solar energy under a municipal renewable energy programme.

18 Entity A sets up a dedicated 'asset base' to fund the long-term **clean up obligation** which is expected to materialise in 10 years' time. The portfolio **mainly comprises shares in listed corporates**, although there is no legal constraint on the composition of the portfolio.

19 Entity A regularly monitors the value changes in the portfolio and may occasionally sell part of it and reinvest the proceeds, with a view to achieve its target returns.

20 The long-term liability is accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The discounting effect of 'unwinding' the liability is accounted for in profit or loss and recognised as interest expense.

Example 4 – Long-term investment held indirectly through a unit fund

21 On 1 January 20x1, Entity A **acquires units in Exchange Traded Funds (ETF)** as part of a larger investment portfolio**.**

22 Each ETF invests in a diversified portfolio of financial and non-financial assets. Entity A does not have control on the investment decisions of the funds, which are managed independently.

23 The funds' net asset values are available on a daily basis and entity A has the **ability to redeem its units** at any moment. Entity A's past practice indicates that, on average, it will hold these units for approximately six months although the holding period varies considerably from one investment to another. When the units are redeemed, Entity A expects to acquire another investment or investments.

24 In its management report and other public statements, Entity A presents itself as a **long-term investor** whose strategy is to allocate assets so to generate an economic return over time.

Questions for EFRAG TEG

25 Does EFRAG TEG agree with the structure of the questionnaire as set-out in this paper?

26 Does EFRAG TEG have comments on the illustrative examples created to reflect some of the possible scenarios and/or attributes that may be relevant or significant to the discussion on alternative measurement bases for equity instruments?

27 Does EFRAG TEG agree not to include numerical examples?