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~~REQUEST FOR TECHNICAL ADVICE~~SUPPORTING MATERIAL

ALTERNATIVE ACCOUNTING TREATMENTS FOR LONG-TERM EQUITY INVESTMENTS

JANUARY 2020

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CHAPTER 1: INTRODUCTION

Chapter 1 provides the context in which this ~~report~~ supporting material has been developed, the reasons why EFRAG has developed the ~~report~~ supporting material and outlines the structure of the ~~report~~document

The accounting requirements for equity instruments

1.1 Under IAS 39 *Financial Instruments: Recognition and Measurement*, equity instruments other than those held-for-trading are classified as Available-for-Sale ('AFS'). These instruments are measured at fair value and fair value changes are presented in other comprehensive income ('FVOCI'). While the cumulative fair value changes may be negative where there is no impairment, once impairment is triggered, non-recoverable amounts were recognised immediately in profit or loss. Future increases in fair value were recognised in OCI again, i.e. reversals through profit and loss were not allowed[1]. On disposal, the cumulative gain or loss in other comprehensive income ('OCI') is recycled to profit or loss and when an entity assesses that an instrument is impaired, the decrease in value below the initial cost is reclassified to profit or loss as an impairment loss.

1.2 In accordance with IFRS 9 *Financial Instruments*, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI election'). If the entity applies the FVOCI election, changes in fair value are presented in OCI. However, these changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess these instruments for impairment[2].

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 Insurance Contracts*)[3]. As a consequence, IFRS 9 has not been applied by many insurers, considered as long-term investors in the action plan for the EU Capital Market Union.

[1] In paragraph 130 of the Basis for Conclusions of IAS 39, the IASB notes there is no acceptable way to distinguish reversals of impairment losses from other increases in fair value. Therefore, reversals of impairment on available-for-sale equity instruments were prohibited.

[2] 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.

[3] In accordance with Commission Regulation (EU) 2017/1988 of 3 November 2017

EFRAG's endorsement advice on IFRS 9

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

1.7 In addition, EFRAG highlighted that the default requirement to measure all equity investments at FVPL may not reflect the business model of long-term investors. EFRAG acknowledged that IFRS 9 provides an option to measure some equity instruments at FVOCI, however it highlighted that such an option it is not likely to be attractive to long-term investors as recycling is not allowed. Even so, EFRAG concluded that it was unlikely that long-term investors would change their investment strategy because of the accounting changes brought by IFRS 9.

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

Request from the European Commission in 2017

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

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

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

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

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

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

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

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

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

Request from the European Commission in 2018

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

1.15 The EC highlighted that alternative accounting treatments for long-term investments should properly portray the performance and risks of long term investment business models, in particular for those equity and equity type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change.

1.16 The EC also highlighted that alternative accounting treatments for long-term investments should preferably enhance investors' insight in the long-term performance of investments as opposed to recognising point in time market based value changes in reported profit or loss during the duration of the equity investment.

Objective and outline of this ~~report~~document

~~1.17~~ The objective of this ~~report~~ document is to present supporting material for EFRAG's t~~T~~echnical a~~A~~dvice in relation to the request made by the EC in June 2018. This document has to be read in conjunction with the letter sent to the European Commission on XX January 2020.

~~1.18~~1.17 In the period May-July 2019 EFRAG ran a public consultation to gather constituents' views on alternative accounting treatments to those in IFRS 9 for equity and equity-type instruments held in a LTIBM.

~~1.19 A summary of the feedback received is provided in **Chapter 2 *Public Consultation Summary***; the detailed feedback is issued as a separate EFRAG research document, as well as being attached to the present Advice. As with any other consultation, the feedback cannot be taken to represent all the views that exist, however it offers an updated understanding of the range of views that exist in Europe on accounting for equity investments under IFRS 9.~~

~~1.20~~1.18 **Chapter 2~~3~~ *Base Case: IFRS 9 Financial Instruments*** summarises the current status of accounting treatment for equity 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.

~~1.21~~1.19 **Chapter 3~~4~~4** ***Possible alternative treatments*** 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.

~~1.22~~1.20 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.

~~1.23~~1.21 **Chapter 4~~5~~** ***Equity-type instruments*** considers how these could be defined and, ~~for the purposes of this advice~~as working assumption, considers that they should be limited to units in funds that invest in equity instruments, associated derivatives and necessary cash holdings to achieve a level playing field between direct and indirect investments in equities.

~~1.24 **Chapter 6 *Concluding remarks*** presents the results of the research activity and the advice to the EC.~~

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

2.1 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.

2.2 For the measurement of debt instruments that meet the (Solely Payment of Principal and Interest "SPPI") requirements[4], 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.

2.3 For equity instruments, IFRS 9 requires a measurement at fair value through profit or loss for trading instruments but allows the use of FVOCI 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 FVPL for equities as the base case and does not distinguish on the basis of intended holding period.

2.4 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 an impairment methodology (IFRS 9 paragraph BC5.14).

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

2.6 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.

[4] 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

2.7 The IASB has required fair value for equity instruments (with some exceptions) since the effective date of IAS 39 – 1 January 2001. As set out in paragraph 2.4~~3.4~~ above, the IASB provided some insights for the use of fair value in the Basis for Conclusions to IFRS 9.

2.8 The use of fair value is not without its critics. For example, Laux and Leuz[5] describes the main argument of critics 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, some holding this view, Laux and Leuz as well as Barth and Landsman[6] have concluded that the use of fair value by banks did not contribute significantly to the 2008 crisis.

2.9 This is also the approach followed in US GAAP since 1993 on the balance sheet. See paragraphs 2.15~~3.15~~ to **Error! Reference source not found.**~~3.1~~ below for further information.

Recognition of fair value changes in the performance statements

2.10 For trading or short-term profit-taking activities it is generally accepted that gains and losses from fair value changes 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

2.11 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.

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

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

[5] 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

[6] 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)

2.13 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 FVPL for some equity investments may not be indicative of the performance of the entity. For example, if the entity holds those equity instruments for non-contractual benefits such as where there is a requirement to hold such an investment when an entity sells its products in a particular country. In such cases, the entity holds the equity instruments for non-contractual benefits rather than for value increases. (IFRS 9 paragraph BC5.22); and the prohibition on recycling means that profit or loss is not impacted by opportunistic decisions to sell equity instruments. Further, this avoids situations where realised gains on 'good assets' may mask a poor-performing portfolio (or vice versa) as highlighted by Warren Buffett in his letter to shareholders of 2017[7];

c) recycling does not reflect the performance for period (such as a financial year) if it includes fair value changes over a longer period; and

d) does not require a model for impairment.

2.14 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 does not explain why these gains or losses are never recognised in profit or loss which is a similar treatment to gains on the revaluation of property, plant and equipment under IAS 16 *Property, Plant and Equipment*), but in contrast to the currency translation reserve on foreign operations on their disposal or the cash flow hedging reserve which are subsequently 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*[8];

c) some consider that the prohibition of recycling results in irrelevant information as it does not reflect an entity's 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 availability for distribution of profits depending on the legal framework. Concerns have also been raised that the information about realised gains or losses upon disposals is useful information for assessing performance and this accounting treatment does not make this information visible.

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

[8] The Conceptual Framework acknowledges that amounts should be recognised in profit or loss when it results in more relevant information, but also notes that constituents' views are mixed on the merit of recycling.

Comparison with US GAAP

2.15 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: FVPL and available-for-sale (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).

2.16 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 *Investments – Equity Securities* paragraph 10-35-1).

2.17 Under US GAAP, the fair value of an equity security is readily determinable if it meets any of the following conditions (Topic 321 paragraph 10-20):

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

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

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.

2.18 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. (Topic 321 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; and

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

2.19 The following factors may also 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.

2.20 If the instrument is impaired, an impairment loss is recognised for the difference between fair value as defined in Topic 820 *Fair Value Measurements and Disclosures* and the carrying amount of such an investment.

Feedback received from EFRAG survey

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

2.22 Many respondents (approximately 30%) related the need for an alternative to the objective of properly portraying the performance and risk of "non-trading equity instruments" or an "efficient asset-liability management" rather than "equity instruments held in a long-term investment business model". Justifications for a change included that the volatility created by measuring equity instruments held in a LTIBM did not appropriately reflect performance, the inability to recycle realised gains and losses and the elimination of the cost exception for equity instruments (i.e. exception in IAS 39 from fair value measurement for some unquoted equity instruments). Many respondents, particularly entities from the financial sector, also considered that, in its current form, IFRS 9 creates disincentives for insurers to maintain and increase investments in long-term and/or illiquid assets and this would be contrary to the objectives of the European Commission as part of the European strategy for a Capital Markets Union.

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

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

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

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

d) there is no evidence to suggest that a change to IFRS 9 would contribute to 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 34: POSSIBLE ALTERNATIVE TREATMENTS

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

Introduction

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

3.2 Firstly, many respondents to the survey did not generally consider that a special treatment should be developed for a LTIBM that related to achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change. In their view, holdings of equity instruments should be classified as held for trading or other equity instruments. That is, their view was that all equity instruments other than those held for trading were held in a LTIBM. Furthermore, no evidence was presented to confirm a link between the accounting treatment and investments in sustainable finance.

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

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

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

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

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

Alternative accounting treatments

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

a) valuation models:

(i) FVOCI with impairment, reversals of impairment and recycling:

(ii) mandatory FVPL;

b) cost models:

(i) historical cost less impairment;

(ii) modified historical cost;

c) other models mentioned by respondents to the survey:

(i) management orientation and strategy (entity-specific Discounted Cass Flow (DCF)); and

(ii) strategic investments approach.

d) theoretical models:

(i) fair value moving average

(ii) revaluation

Valuation Methods[9]

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

Description of the model

Measurement basis Balance sheet	Fair value
Elements flowing through Profit or loss	Impairment losses and reversals Realised gains and losses
Elements flowing through OCI	Impairment losses and reversals Unrealised gains and losses (changes in fair value)

Table 4.1 - FVOCI with impairment, reversals of impairment and recycling

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

3.6 The model envisages that there can be unrealised losses that do not meet the test for impairment recognition. The impairment losses that are recognised and transferred in profit or loss are those unrealised losses that meet the impairment model selected. This section does not address specific impairment models. These models are addressed in a separate section at the end of the chapter.

Characteristics of a model based on FVOCI with recycling, impairment and reversals

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

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

[9] All these models do not consider taxation.

b) it recognises that equity instruments held in a LTIBM may become impaired. So, it prudently ensures that assets are not carried on the balance sheet above their recoverable amount;

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

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

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

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

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

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

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

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

Results of the EFRAG survey in May 2019

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

Mandatory fair value through profit or loss

Description of the model

Measurement basis Balance sheet	Fair value
Elements flowing through Profit or loss	Changes in fair value

Table 4.2 - Mandatory FVPL

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

Characteristics of mandatory fair value through profit or loss

3.11 Those who support this approach consider that this approach:

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

b) highlights economic mismatches between liabilities and assets backing those liabilities (e.g. decommissioning liabilities, pension liabilities and insurance contracts) and as such are informative about the risks relating to balance sheet structure including asset-liability mismatches;

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

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

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

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

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

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

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

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

Results of the EFRAG survey in May 2019

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

Cost models

Historical cost less impairment

Description of the model

Measurement basis Balance sheet	Historical cost less impairment
Elements flowing through Profit or loss	Impairment losses and reversals Realised gains and losses

Table 4.3 - Historical cost less impairment

3.14 Under an historical cost model, equity instruments are recognised at the consideration paid when they are acquired, including transaction costs. It will generally be relatively easy to identify the consideration on acquisition but where different units of the same instrument were acquired over time, a policy decision may be required to approximate the amount of acquisition that has been disposed (for example methods such as weighted average price or first in first out etc.).

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

Characteristics of historical cost less impairment

3.16 Supporters of historical cost argue that:

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

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

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

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

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

a) changes in fair value of an equity instrument are relevant to assess the intrinsic risk of the instrument and the performance of the period and therefore should be recognised in profit or loss. Some consider that the only cases when historical cost might be appropriate for equity instruments is when the equity instrument does not have an observable market value, and fair value is determined using a valuation technique based on level 2 or level 3 inputs under IFRS 13;

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

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

d) 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

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

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

3.20 One respondent noted that research indicates that institutional investors (such as insurers and pension funds) who are subject to fair value accounting have adopted investment strategies that are more prudent than those adopted by investors who are subject to historical cost accounting. The research also notes that during the 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

Measurement basis Balance sheet	Modified historical cost less impairment
Elements flowing through Profit or loss	Modifications to historical cost Realised gains and losses

Table 4.4 - Modified historical cost

3.21 This section considers two possible modifications to historical cost:

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

b) adjusting for observable market conditions.

Adjusting for the share of profit or loss of the investee

3.22 Under this modified historical cost model an entity would recognise its share of profit or loss of the investee. This adjustment would reflect the underlying performance of the investee and is similar to the equity method but without the need to apply all the consolidation procedures required in IAS 28 *Investment in Associates*.

Characteristics

3.23 This model would reduce the incentive to make selective disposals, because gains would be recognised regardless of dividend distribution or disposal. Recognition of the share of loss would also mitigate the risk that impairment losses are not recognised timely.

3.24 However, 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. Nonetheless 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.

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

Adjusting for observable market conditions

3.26 The measurement of an equity instrument could incorporate observable price changes on the basis of orderly transactions for the identical or a similar instrument of the same issuer. A similar approach is used in US GAAP for unquoted instruments where the fair value is not readily determinable.

3.27 This adjustment would periodically align the historical cost to a current value, thus reducing the loss of relevance of historical cost over time. However, these adjustments would not necessarily be on an annual basis as they are based on observable, external transactions that may occur randomly.

Characteristics

3.28 An entity would be required to monitor to see if observable transactions are occurring on their investment. This could be operationally burdensome for an entity with many small investments.

3.29 Under this model, the carrying amount of listed equity instruments is continuously adjusted based on observable market transactions. This alternative would result substantially in a FVPL measurement for listed equity instruments.

3.30 Compared to FVPL, the adjustments to unquoted equity instruments on this basis 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

3.31 Only 2 respondents supported an adjusted cost approach.

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

Models proposed in the survey and not identified above

Management orientation and strategy (entity-specific DCF)

Description of the model

Measurement basis Balance sheet	Value in use
Elements flowing through Profit or loss	Changes in value in use Impairment losses and reversals Realised gains and losses

Table.4.5 - Management orientation and strategy (entity-specific DCF)

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

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

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

3.36 This approach is used in practice in measuring:

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

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

Characteristics of entity-specific DCF

3.37 This model has operational limits as it requires updated and reliable information about expected pay-out ratios and business plans, which may not be easy to collect without a relationship of (for example) significant influence. It is more complex to calculate than the other valuation models proposed and is only fully reliable for companies that have a proven track record of stable dividend payments. Furthermore, the determination of cost of capital to use for discounting is often regarded as a subjective exercise and would mean less comparability. However, the model 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.

3.38 As mentioned above, a pure fair value approach may not provide users with the most relevant information in a LTIBM. This model reflects the fact that dividends are ‘sticky’ and not prone to fluctuations in the short term given the negative impact that changes in dividend pay-out often have on share prices.

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

Results of the EFRAG survey in May 2019

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

Strategic investments approach

Description of the model

Measurement basis Balance sheet	Assets to match liability
Elements flowing through Profit or loss	Income to match expenses

Table.4.6 – Strategic investment approach

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

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

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

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

Characteristics

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

3.43 These approaches would have the advantage of being based on entity-specific information and so provide insights into the overall asset-management strategy and the entity's specific business model. They would also provide the opportunity for management to explain and communicate their strategy and execution.

3.44 However, in other aspects, this would require significant changes to IFRS 9 with respect to aspects such as the unit account which is currently based on an individual instrument as compared to reflecting asset-liability matching. Furthermore, the strategic direction taken may differ significantly and require differing accounting solutions.

Models not used in practice currently

Fair value moving average.

Description of the model

Measurement basis Balance sheet	Fair value moving average
Elements flowing through Profit or loss	Changes in fair value moving average Impairment losses and reversals

Table 4.7 - Fair value moving average

3.45 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 developed for a defined period (say five years) and based on daily, quarterly or annual data which would smooth the volatility impact in LTIBM entity. As the balance sheet measurement is smoothed by using a moving average, changes in the moving average are reflected directly in profit or loss, as would any impairment losses

3.46 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.

3.47 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 method is more complex although if would lead to a valuation that is closer to the fair value estimated at reporting date.

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

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

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

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

Characteristics of a fair value moving average

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

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

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

Results of the EFRAG survey in May 2019

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

Revaluation model

Description of the model

Measurement basis Balance sheet	Fair value
Elements flowing through Profit or loss	Declines in fair value below acquisition cost or previously impaired amounts Realised gains and losses
Elements flowing through OCI	Total gains above acquisition cost or previously impaired amounts

Table 4.8 – Revaluation model

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

Characteristics

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

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

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

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

c) results in asymmetric treatment of gains and losses.

3.57 A few respondents mentioned this model although it was not a preferred approach.

Impairment Models

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

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

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

Impairment models suggested in the user survey

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

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

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

b) allowing the reversals of impairments losses;

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

d) requiring additional disclosures, including on methodology; and

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

3.63 Despite the popularity of an impairment model based on IAS 39, this paper considers other alternatives in more depth.

Qualitative impairment model

Qualitative IAS 39 impairment model

3.64 In a model similar to the model of IAS 39 for equity instruments classified as AFS with the ***qualitative triggers "significant or prolonged***" the entity should recognise an impairment loss when the carrying amount is considered not recoverable.

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

Characteristics

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

3.67 One of the main arguments in favour of an impairment model similar to IAS 39 is that it distinguishes between declines that signify that the cost of the equity instrument may not be recovered versus short-term market-driven fair value changes. As a result, it avoids the unintended volatility in profit or loss, when fair value is below the original cost.

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

Qualitative IFRS 9 impairment model

3.69 The IFRS 9 model for debt instruments 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.

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

Characteristics

3.71 The key to this approach would be to identify a trigger for impairment losses based on measures such as earnings per share, net profit after taxation, or qualitative triggers such as the entity having been downgraded its credit rating or the industry where the entity belongs in is in distress.

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

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

Results of the EFRAG survey in May 2019

3.74 No respondent commented on a qualitative IFRS 9 impairment model.

Approach based on indicators in IAS 36

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

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

Characteristics

3.77 The key to this approach would be to identify a trigger for impairment based on measures such as earnings per share, net profit after taxation or qualitative triggers such as when the entity has seen its credit rating downgraded its or the industry in which the entity belongs is in distress.

3.78 Clearly, these are conceptual limitations because usually stock valuation models are based on future expectations – expected dividends, results or cash-flows – and refer to a variety of factors. However, using expected amounts would limit comparability and may be operationally 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

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

Quantitative impairment triggers.

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

Characteristics

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

3.82 However, some of the reasons for not to considering defined triggers include:

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

b) it is less principles-based; and

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

3.83 If quantitative triggers are applied there could be a presumption that no impairment should be applied under those limits. It may be necessary to recognise 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

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

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

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

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

d) requiring the entity to specify and disclose its quantitative impairment triggers.

CHAPTER 45: EQUITY-TYPE INSTRUMENTS

If an alternative accounting treatment were 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?

4.1 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 that have been paid.

4.2 Neither the EC request, nor the High-Level Expert Group on Sustainable Finance final report to the EC on 31 January 2018 defines the term 'equity-type instruments'.

4.3 Based on information received from EFRAG Working Groups, such as the Insurance Accounting Working Group (IAWG) and Financial Instrument Working Group (FIWG) responses to this and previous consultations on this topic, EFRAG understands that these relate to debt instruments (as the holder has a put feature) that do not meet the SPPI requirements in IFRS 9 and so need to be carried at FVPL and not at FVOIC. EFRAG understands that these 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.

Why do equity-type instruments require an alternative accounting treatment?

4.4 Under IFRS 9, interests in UCITS, ETFs and Alternative Investment Funds (AIFs) are neither eligible for amortised cost nor for the FVOCI election and must therefore be carried at FVPL. This is a significant change in accounting treatment compared to IAS 39 under which such holdings, other than those held for trading, were classified as AFS.

4.5 The main arguments for allowing an alternative accounting treatment for these instruments are that these are economically the same as investments in equity instruments and that holding equity instruments directly or indirectly should not result in different accounting. By this logic, the business model related to these equity-type instruments (including the business model applied by the fund to the underlying equity holdings) should then also be considered when determining the appropriate accounting. Furthermore, on the basis that holding equity instruments directly or indirectly should not result in different accounting means that the usefulness of the financial information when applying the models discussed in Chapter 4 to equity-type instruments would echo the discussion for equity instruments.

4.6 As for equity instruments, EFRAG received no evidence that was presented to confirm a link between the accounting treatment for equity-type instruments and investments in sustainable finance.

Considerations in defining equity-type instruments

4.7 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 equity instruments or whether all units in funds should be classified as equity-type instruments. The definition could focus on the following aspects:

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

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

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

d) the business model or the trading strategy in place of such a fund;

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

f) the sustainable nature of the activities invested in.

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

The nature of the units in an investment fund

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

4.10 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

4.11 Equity-type instruments could be limited to instruments that meet the puttable exception[10] in IAS 32. However, applying the IAS 32 puttable requirements may be difficult from a holder's perspective due to incomplete information. For example, it may be hard to determine whether the relevant instrument is the most subordinate and whether the instrument entitles the holder to a pro rata share of the fund's net assets. Furthermore, with further issuances, the status of the investment may change which would require a change in measurement.

Equity-type test

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

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

b) the underlying pool of assets solely includes:

[10] 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.

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

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

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

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

Business model or trading strategy

4.14 It is important to consider the impact of the trading strategy of the fund itself. For instance, an investment in a fund that has a trading strategy when managing its underlying assets, should not be eligible for FVOCI, as FVTPL would be the appropriate accounting treatment to reflect the strategy of the underlying fund. For example, a company owns units in a high frequency trading hedge fund. A high frequency trader could turn over its portfolio three times in a day and then at the end of the day all gains were realised especially if they invest in highly liquid instruments. In this scenario, to recognise the gains in OCI for a period of for example three years is not an appropriate presentation of the nature of the hedge fund.

Types of underlying assets

4.15 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

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

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

Working assumption

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

Summary of results from survey

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

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

Table 5. 1 - Should a different accounting treatment should be applied to equity-type instruments?

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

Category of respondent	Fund units & puttable exception	Nature[11] of the assets invested	Other	Mutual funds
Academic	1			1
Asset Management	2		1	
Banks and Conglomerates	4	1	1	
Corporates - Others	3	1		2
Insurances and Conglomerates	12	1		
Long term and institutional investors	2	2	1	1
Standard Setters	3	3		
Users	2	2	2	
Grand total	**29**	**10**	**5**	**4**

Table 5. 2 - Which types of instruments that should qualify for a different accounting treatment?

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

[11] This uses the wording in the survey and refers to the types of assets invested in by the fund.

Treatment under IFRS 9 and US GAAP

4.21 Under IFRS 9, interests in UCITS, ETFs and Alternative Investment Funds (AIFs) are neither eligible for amortised cost nor for the FVOCI election and must therefore be carried at FVPL. This is a significant change in accounting treatment compared to IAS 39 under which such holdings, other than those held for trading, were classified as AFS.

4.22 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.

4.23 The change to accounting treatment for equity-type instruments under IFRS 9 follows from the requirement that debt instruments should be classified as FVOCI should they meet the SPPI guidance. This in turn results from the fact that the SPPI guidance replaced the requirements around embedded derivatives.

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

4.25 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.

4.26 According to ASC 320-10-55-9, a mutual fund is considered an equity security even if it invests only in U.S. government debt securities. Consequently, investments in bond funds and fixed-income mutual funds are considered equity securities and must be accounted for at fair value through net income (FVTNI) under the Accounting Standards Update.

What models could be applied to equity-type instruments?

4.27 This section considers whether any of the alternative models described in Chapter 4 could 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.

4.28 The following section focuses on the applicability of the models described in Chapter 4 to equity-type instruments, with particular reference on the operability of the approaches. The quality of the financial information resulting and the characteristics of the different models, identified in Chapter 4 when applied to the direct holdings of equity instruments, are considered equally applicable to indirect holdings of equity.

Valuation methods

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

a) FVOCI with impairment, reversal of impairment and recycling; and

b) mandatory FVPL.

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

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

4.32 Impairment will be discussed separately below.

Cost models

4.33 The cost models described in chapter 4 were:

a) historical cost less impairment; and

b) modified historical cost.

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

Theoretical and other models

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

Impairment

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

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

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

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 *Impairment and Recycling*"). The EFRAG DP *Impairment and Recycling* (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 *Impairment and Recycling* (available here).

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

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

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

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

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

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

e) be consistent with the notion of prudence.

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

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

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

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

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

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

A15 EFRAG’s response to the EC highlighted that the majority of the respondents to EFRAG DP *Impairment and Recycling* 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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