Equity Instruments - Research on Measurement

Response ID:123 Data

1. Why is EFRAG consulting?

As part of its Action Plan on Sustainable Finance, the European Commission ("EC") announced it would ask EFRAG to explore potential alternative accounting treatments to ("FV") measurement for long- term investment portfolios of equity and equity-type instruments.

In June 2018, EFRAG received a request for advice from the EC in relation to the accounting requirements for investments in equity instruments.

The request for advice is part of the EC's initiatives to orient capital flows towards investment in sustainable activities.

The request for advice asks EFRAG to consider alternative accounting treatments to measurement at fair value through profit or loss (FVPL) for equity instruments.

According to the request for advice, such possible alternative accounting treatments should serve the following objectives:
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;
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.

2. The questionnaire

EFRAG has developed this questionnaire in order to gather views from constituents on alternative accounting treatments to IFRS 9 *Financial Instruments* requirements for equity and equity-type instruments held in a long-term investment business model. Such alternative treatments should serve the objectives mentioned above. Respondents are encouraged to read the EFRAG Secretariat background paper available here.

The EFRAG Secretariat background paper provides background information on the request for advice. It explains how the consultation relates to the EC's initiatives on sustainable growth, illustrates the accounting requirements in IFRS 9 and explores some possible alternative measurement approaches.

The possible alternatives in the background paper are to be considered as examples; respondents may suggest other measurement approaches that they consider appropriate.

Additionally, the background paper provides indications of how the concepts of 'long-term investment business model' and "equity-type instrument" may be considered in the context of the questionnaire.

In addition to submitting replies to the questionnaire, constituents can provide their input on the topic and ask questions about the survey by writing to:
Fredre Ferreira (*fredre.ferreira@efrag.org*), or Isabel Batista (*isabel.batista@efrag.org*).

Respondents are encouraged to respond to all questions but are not required to do so. EFRAG will still consider their answers.

EFRAG will disclose the responses, unless a respondent asks for confidentiality.

Please complete this survey by 5 July 2019

3. General information about the respondent

1. Name of the individual/ organisation

VERA PALEA

2. Country of operation

ITALY

3. Job title

ASSOCIATE PROFESSOR IN ACCOUNTING AND FINANCE AND INDIPENDENT DIRECTOR AT ERSEL ASSET MANAGEMENT

4. E-mail address

vera.palea@unito.it

5. Are you currently engaging in a long-term investment business model?

Yes

6. How do you define long-term investment business model?

Investors engaged in long-term investing, such as insurances, pension funds and some asset management companies, are less concerned about interim changes in asset prices, focused instead on long-term income growth and/or long-term capital appreciation (World Economic Forum, 2011). Long-term investment is an attitude toward investing rather than a type of liability, or a type of operator, or an asset class, or a specific underlying project (Palea, 2019). Long-term investing is a financial investment strategy deployed in order to generate an economic return over an extended period of time. Accordingly, the expected investment horizon becomes the key criterion to distinguish between short- and long-term investing. From a financial reporting perspective, this requires a numerical threshold according to which distinguishing between short-term and long-term equity investments. IAS 25 classification should be reconsidered for this purpose.

References:
- Palea, V. (2019). Accounting for sustainable finance: does fair value accounting fit for long-term investing in equity? Working Paper 12/2019. University of Torino, Department of Economics and Statistics "Cognetti de Martiis".
- World Economic Forum (2011). The future of long-term investing.

7. Are you currently engaging in investment of sustainable activities?

Yes

8. How do you define sustainable activities?

There is no single definition of sustainability. It is widely shared, however, that the concept of sustainability has three strictly linked dimensions: economic, social, and environmental (e.g., Kahn, 1995). Market practitioners, international organizations and supervisory authorities have operationalized sustainability by referring to the so-called "ESG" factors (e.g., ESMA, 2018). Despite this, there is no definitive list of which issues or factors are covered by the terms "ESG". The UN-backed Principles for Responsible Investment and the UNEP definitions have gained the most prominence in recent years. According to UNEP Inquiry (2016) and the UNPRI (2018), "ESG" factors can broadly be defined as follows: (i) Environmental (E) issues relate to the quality and functioning of the natural environment and natural systems; (ii) Social (S) issues relate to the rights, well-being and interests of people and communities; and (iii) Governance (G) issues relate to the governance of companies and other investee entities. Please, refer to the International Capital Market Association's (ICMA) guidelines for illustrative examples. A final report by the EU Commission on this topic is expected by the end of June 2019.

References:
- ICMA (2018) Sustainability bond guidelines.
- ICMA (2018) Social bond principles.
- ICMA (2018) Green bond principles.
- ESMA (2018). Consultation Paper on integrating sustainability risks and factors in MiFID II
- Kahn, M. (1995). Concepts, definitions, and key issues in sustainable development: the outlook for the future. Proceedings of the 1995 International Sustainable Development Research Conference, Manchester, England, Mar. 27 - 28, Keynote Paper, 2-13.
- United Nations Environment Programme (2016), "UNEP Inquiry, Definitions and Concepts, Background Note 2016".
- United Nations Principles for Responsible Investing (2018), "What is responsible investment?".

4. Question 1

9. IFRS 9 allows an entity to account equity instruments either at FVPL or, if applicable, at fair value through other comprehensive income (FVOCI) without impairment and without reclassification ("recycling") to P&L upon disposal of valuation gains or losses previously recognized through OCI ("IFRS 9 requirements" for equity instruments).
When defining an accounting treatment alternative to IFRS 9 requirements for equity instruments held in a long-term investment business model, which characteristics would you require to identify a *long-term investment business model*?

The expected holding period

5. Question 2

10. In your view, is an alternative accounting treatment to IFRS 9 requirements needed to properly portray the performance and risks of equity instruments held in a long-term investment business model?

Yes

6. Question 3

11. Explain the reasons for your reply to question 2, including the key operational challenges in developing a different accounting treatment to IFRS 9 requirements

Under the IFRS, fair value is an exit price and the firm's intention to hold the asset is irrelevant. The exit price is a market-based, not an entity-specific measurement. It is a liquidation value.

Research suggests that fair value accounting loses significance, and is even worse than other accounting treatments, for long-term investments (e.g., Allen & Carletti, 2008; Plantin et al., 2008). Long-term equity investments, which are usually held for the collection of cash flows in the form of dividends, may even be considered closer to subordinated debt than equity ownership. Accordingly, European Regulation 575/2013 on prudential requirements for credit institutions and investment firms treats equity investments, even the public one, that are not held for trading as credit exposure, allowing banks to use either a simple risk weight approach or a probability of default/loss given default approach (PD/LGD).

Furthermore, long term investments often consists of unlisted equities, which are evaluated according to market-based techniques. As important research shows, private equities' performance is relatively different from publicly traded companies (e.g., Cochrane, 2005; Liungqvist & Richardson, 2003; Moskowitz & Vissing-Jorgensen, 2002; Quigley & Woodward, 2002). Moreover, market-based techniques fail to consider firm-specific risk factors, which are key for long-term investment. Palea & Maino (2013) and Migliavacca et al. (2019), among others, report that market and transaction multiples, which are corroborated by observable market data and are thus considered to be highly unbiased, introduce great estimation errors in financial reporting and increase fair value prociclycality (also Barth, 2004; Persaud, 2008; Plantin et al., 2008). As a result, mark-to-model estimates fail to provide a faithful representation of the real strategy underlying long-term equity investments.

Evidence also indicates that fair value accounting have affected investment behaviour and prevented institutional investors, such as pension funds and insurances, from taking long-term positions in equity. Such investors have adjusted their investment behaviour to mitigate the impacts of accounting rules on the volatility of equity book value. (Greenwood & Vayanos, 2010; World Economic Forum, 2011; OECD, 2012; Bank of England, 2014; Aubry, 2017).

Because equity does a better job than debt of sharing risk between borrowers and lenders and because it is better able to support long-term investment projects (as it is perpetual), a structural shift away from equity holding by institutional investors leaves the system as a whole with poorer risk-sharing and weaker long-term investment (Bank of England, 2014). Given their long-term liabilities, institutional investors could provide important long-term finance to the economy in the form of equity investment in infrastructure and other productive assets. Moreover, by being better placed to look through short-term market volatility than many other types of investors, they can exert a stabilizing influence on the financial system. Therefore, they can play a crucial role in supporting both long-term economic growth and financial stability, which are two key elements of sustainability (e.g., Palea, 2018).

For a proposal of an alternative measurement system, please see the answers to your illustrative examples.

References:

- Allen, F., & Carletti, E. (2008). Mark-to-market accounting and liquidity pricing. Journal of Accounting and Economics, 45(2), 358-378.
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- World Economic Forum (2011). The future of long-term investing.

7. Question 4

12. With reference to equity instruments held in a long-term investment business model, if you support measurement at FV through other comprehensive income with reclassification to P&L upon disposal of the valuation gains or losses previously recognized through OIC (so called "recycling"), which impairment model would you suggest and how it would work in practice?

8. Question 5

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

For more detail, please refer to paragraphs 4.3 to 4.29 of the Background paper.

Yes

14. Please explain your answer

Research suggests that fair value accounting is appropriate for trading assets, whereas it loses significance, and is even worse than other accounting treatments, for longer holding periods (e.g., Allen & Carletti, 2008; Plantin et al., 2008). For liquid securities traded in active markets that are held for trading, fair value accounting can reflect the gains and losses associated with the investment in a timely manner, thus enhancing transparency and facilitating market discipline. This is not true for long-term investment. For long-term equity investments, which are usually held for the collection of cash flows in the form of dividends, or consist of illiquid assets, fair value accounting does not provide a faithful representation of the real-world phenomena it purports to represent (e.g., Allen & Carletti, 2008; Plantin et al., 2008; Palea & Maino 2013; Migliavacca et al., 2019; Barth, 2004; Persaud, 2008). Such investments may even be considered closer to subordinated debt than equity ownership. In fact, European Regulation 575/2013 on prudential requirements for credit institutions and investment firms treats equity investments, even the public one, that are not held for trading as credit exposure, allowing banks to use either a simple risk weight approach or a probability of default/loss given default approach (PD/LGD).

References:
- Allen, F., & Carletti, E. (2008). Mark-to-market accounting and liquidity pricing. Journal of Accounting and Economics, 45(2), 358-378.

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9. Question 6

15. As per IFRS 9, equity-type of instruments, such as units of investment funds, do not meet the definition of equity instrument of IAS 32 Financial Instruments: Presentation, therefore are not eligible for the option to mesure them at fair value through comprehensive income ("FVOCI"). At the same time, they are not eligible for measurement at amortised cost (as they have contractual cash flows that are not Solely Payments of Principal and Interest, "SPPI" instruments). As such, IFRS 9 requires to account for them at FVPL; no FVOCI option is granted ("IFRS 9 requirements for equity-type instruments").

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

For more detail please refer to paragraph 4.30 to 4.39 of the Background paper.

Yes

16. Please explain your answer

Let us consider the case of European long-term investment funds (ELTIFs), which has been established by Regulation 760/2015. ELTIFs are alternative investment funds that can be operated cross-border in the EU, with authorization by one Member State being effective in all other EU Member States. The purpose of Regulation 760/2015 is to raise and channel capital toward long-term investments in the EU's real economy, supporting sustainable development, which is one of the founding objective of the EU as set out by the Lisbon Treaty. ELTIFs are also vehicles through which the European Investment Bank can channel its European infrastructure and SME financing. On the demand side, ELTIFs can provide a steady income stream for pension funds and insurance companies, which face regular and recurrent liabilities and are seeking long-term returns within well-regulated structures.
The list of eligible investments includes participations, debt instruments and loans provided to infrastructure or non-financial companies, unlisted or listed, with a market capitalization of no more than EUR 500 million, established in a EU Member State or, under certain restrictions, in a third country. In order to reach their goals, ELTIFs can also invest in other funds. There is no significant difference between providing finance to sustainable activities directly or through these vehicles. Accordingly, there is no reason to differentiate between equity and such quasi-equity investments when discussing alternative accounting treatments to fair value accounting.

10. Question 7

17. If so, which characteristics would you require to define the "equity-type" instruments?

Units of funds and other instruments that meet the 'puttable exception' in IAS 32

Mutual funds

11. Question 8

19. With reference to equity and equity-type instruments held in a long term investment business model, please rate how relevant a different accounting treatment is to the objective of reducing or preventing detrimental effects on investment in sustainable activities in Europe.

80

12. Question 9

20. Are there other characteristics that would justify an accounting treatment different than IFRS 9 requirements for equity instruments and equity-type instruments held in a long-term investment business model? Please provide examples.

Generally speaking, fair value accounting increases prociclycality – i.e. the tendency to contribute to asset price volatility and to exacerbate financial market movements, including through asset price feedback loops (Bank of England, 2014). By encouraging pro-cyclical behaviour, fair value accounting increases systemic market risk (IMF, 2016; Jaggi et al., 2010; Laux & Rauter, 2016; Novoa et al., 2009; Plantin et al., 2008). A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).
As the Bank of England (2014) points out, a combination of factors, including fair value accounting, has driven asset allocation of institutional investors to suboptimal outcomes from the perspective of financial stability, through procyclicality, and long-term investment and economic growth, through the unwillingness to bear risk and de-risking strategies. Financial stability and economic growth are two fundamental characteristics against which IFRSs must be tested during the endorsement process (Palea, 2019). This being the case, there are good reasons to consider alternatives to fair value accounting for long-term investing in equities.

References:
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- Schwarz, C., Karakitsos, P., Merriman, N., & Studener, W. (2015). Why accounting matters: a Central Bank perspective. Accounting, Economics and Law, 5(1), 1-42.

13. (untitled)

The following pages include 7 illustrative examples of long term investment. For each scenario, you are invited to answer the questions on the page which follows.

Please consider that for Scenario A, B, C and D IFRS 9 requires to either measure the investment at FVTPL or to elect the option for measurement at FV through other comprehensive income, without reclassification to P&L, upon disposal, of the valuation gains or losses previously recognized through OCI, and without impairment.

14. Illustrative example A - Wind farm with predetermined useful life

21. For scenario A - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

This kind of investment is closer to subordinated debt than equity ownership. Accordingly, European Regulation 575/2013 on prudential requirements for credit institutions and investment firms treats equity investments, even the public one, that are not held for trading as credit exposure, allowing banks to use either a simple risk weight approach or a probability of default/loss given default approach (PD/LGD).

22. Which element in the scenario is more relevant for your reply?

1. The investor's inability to dispose of the shares

23. Which accounting treatments do you support?

Other

In case you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have selected "Other", please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and

users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.
As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).
As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in unlisted equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).
According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.
Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the disclosure notes in order to mitigate its potential adverse effects.
From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.
A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

References:
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15. Illustrative example B - Unlisted single equity instrument

24. For scenario B - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

Because of their illiquidity, unlisted equities are naturally suited for long-term investing. The holding periods for such illiquid assets are generally very broad, ranging from 10 to 50 years (European Commission, 2013b). Research shows that fair value accounting performs very poorly for unlisted equities, failing to provide a faithful representation of the real economic phenomena it purports to represent (e.g., Migliavacca et al., 2019; Palea & Maino, 2013).

References:
- European Commission (2013b). Commission staff working document impact assessment. Accompanying the document Proposal for a regulation of the European parliament and of the council on European long-term investment funds. Brussels, 26.6.2013. SWD(2013) 230 final.
- Migliavacca A., Palea, V., & Rainero, C. (2019). Fair value measurement under level 2 inputs: do market and transaction multiples catch firm-specific risk factors? In P. De Vincentiis, F. Culasso, & S. Cerrato (Eds.), The future of risk management, volume II: Perspectives on financial and corporate strategies. Cham, Switzerland: Palgrave.
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25. Which element in the scenario is more relevant for your reply?

1. The fact that the shares are unlisted

26. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.

As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).

As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in unlisted equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).

According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.

Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the disclosure notes in order to mitigate its potential adverse effects.

From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.

A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

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16. Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability

27. For scenario C - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

According to the asset and liability management theory, insurers and pensions funds are, in principle, long-term investors. Because of the long-term maturities of most of their liabilities, these investors can behave as "patient investors".Life insurance companies, as major providers of annuities and similar retirement products, have long-term liabilities. Non-life insurers can also hold long-term equity portfolios although their policies are renewed on a yearly basis. Formally, non-life insurance policies are a short-term liability, yet they are renewed via tacit approval and their total amount remains globally stable over time. Therefore, it can be used to finance long-term investments.

28. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation (insurance contracts)

29. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other",

please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.

As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. Furthermore, during financial crises the historical cost regime has prevented asset fire sales, whereas fair value accounting has increased market turmoil (Ellul et al., 2015; Lepore et al., 2018).

Important research has showed that during financial crises, fair values reflect the amount of liquidity available on the market rather than the asset's future cash flows, i.e. fundamental values (Allen and Carletti 2008; Shleifer and Vishny 2011). A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).

As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).

According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.

Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the disclosure notes in order to mitigate its potential adverse effects.

From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.

A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

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17. Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability

30. For scenario D - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

Long-term investing is not just a prerogative of financial intermediaries. Industrial firms may invest in strategic equities to exploit business opportunities or commercial/entrepreneurial relationships, with no expectation of capital gain. Several carmakers, including BMW, have made significant forward-looking and sustainability-oriented strategic investments to develop electric cars and revolutionary materials. Some energy companies (e.g., EDF) are investing in equities to generate the cash inflows needed to settle long-term obligations for the decommissioning of nuclear plants. These investments will be hold for a very long period.

31. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation

32. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.

As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. Furthermore, during financial crises the historical cost regime has prevented asset fire sales, whereas fair value accounting has increased market turmoil (Ellul et al., 2015; Lepore et al., 2018).

Important research has showed that during financial crises, fair values reflect the amount of liquidity available on the market rather than the asset's future cash flows, i.e. fundamental values (Allen and Carletti 2008; Shleifer and Vishny 2011). A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).

As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).

According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.

Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the disclosure notes in order to mitigate its potential adverse effects.

From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.

A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

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18. Illustrative example E - Long-term investment held indirectly through a unit fund - listed

33. For scenario E - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

Long-term investment is an attitude toward investing rather than a type of liability, or a type of operator, or an asset class, or a specific underlying project (Palea, 2019). Long-term investing is a financial investment strategy deployed by any operator in order to generate an economic return over an extended period of time. Accordingly, the expected investment horizon becomes the key criterion to distinguish between short- and long-term investing. From a financial reporting perspective, this requires a numerical threshold according to which distinguishing between short-term and long-term equity investments. IAS 25 classification should be reconsidered for this purpose.

Of course, differentiating between short- and long-term investments and allowing different accounting treatments for them could give rise to opportunistic behavior and classificatory manipulation. Hence, effective corporate governance becomes crucial in such a context. The corporate governance literature shows that strong internal corporate governance improves the monitoring of managerial discretion over accounting choices (e.g., Zalata & Roberts, 2016). Specifically, high-quality internal governance, in terms of the overall quality of boards and audit committees, has been proven to mitigate classification shifting, acting as a substitute for strict accounting standards. The European Commission is aware that long-term investing and strategies needs consistent corporate governance mechanisms. For this reason, the Action Plan on Sustainable Finance includes among its objectives that of strengthening the disclosure of strategies and rules according to which directors act in the company's long-term interest (European Commission, 2018a). Accordingly, the basis for equity classification as a long-term investment should be documented and subject to specific monitoring and controlling by an investment committee overseeing equity allocation to long-term investments. Disclosure notes should include all the information financial report users require to understand long-term investing by the reporting entity. For example, a complete depiction of long-term investments should include, at a minimum, a description of the equities in the group indicating whether they are listed or unlisted, a classification by sector and region, a numerical depiction of the equities in the group, a classification according to their expected holding period, and an explanation of significant changes in the holding period that might affect their long-term investment quality and their risk management practices. The reporting entity should also demonstrate the existence of a clear, decisive strategy for holding the assets over a long period and the consistency of this strategy with its main policies. Such increased disclosure would allow for a more faithful representation of the investment strategies of the entities while providing incentives to pursue sustainable business practices (Schoenmaker & Schramade, 2019).

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34. Which element in the scenario is more relevant for your reply?

1. The investor's assessment of the long-term nature of its investment

35. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.

As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. Furthermore, during financial crises the historical cost regime has prevented asset fire sales, whereas fair value accounting has increased market turmoil (Ellul et al., 2015; Lepore et al., 2018).

Important research has showed that during financial crises, fair values reflect the amount of liquidity available on the market rather than the asset's future cash flows, i.e. fundamental values (Allen and Carletti 2008; Shleifer and Vishny 2011). A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).

As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).

According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.

Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the

disclosure notes in order to mitigate its potential adverse effects.
From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.
A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

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19. Illustrative example F - Long-term investment held indirectly through a unit fund – non listed

36. For scenario F - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable

Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) 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.

Yes

If yes, please explain why.

Illiquid asset classes should be classified by default as long-term investments, consistent with the difficulty of exiting such investments within a short period of time. Because of their illiquidity, private equities are naturally suited for long-term investing. Research shows that fair value accounting performs very poorly for unlisted instruments (e.g., Migliavacca et al., 2019; Palea & Maino, 2013).

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37. Which element in the scenario is more relevant for your reply?

1. The unlisted feature of the fund

38. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Historical cost and fair value accounting serve different purposes, hence they should not be viewed as competitors. A dual measurement system (Palea, 2014) with historical cost recognized on the balance sheet and fair value accounting in the disclosure notes would reconcile the needs of both financial statement preparers and users. From the preparers' perspective, historical cost accounting as a measurement system would create conditions more favourable for long-term investing in equities, consistent with the EU's objectives of supporting sustainable development.
As detailed in previous answers, research indicates that insurers and pension funds subject to fair value accounting have moved away from equity investments adopting "de-risking" strategies (e.g., Bank of England, 2014; OECD, 2013). This is less evident for investors subject to historical cost accounting. Furthermore, during financial crises the historical cost regime has prevented asset fire sales, whereas fair value accounting has increased market turmoil (Ellul et al., 2015; Lepore et al., 2018). A number of studies provide evidence that fair value procyclicality is exacerbated for level 2 and 3 assets by measurement errors that are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Palea & Maino, 2013; Persaud, 2008; Plantin et al., 2008; Schwarz et al., 2015).
As a result, historical cost accounting seems to better suit the objective of facilitating long-term investing in equities. On the other hand, it has also been noted that historical cost accounting could cause insurers to hold on to downgraded assets in the hope of resurrection, while fair value accounting could serve to deter excessive risk taking (e.g., Lepore et al., 2018).
According to a dual measurement system, the carrying amount on the balance sheet would be at the historical cost less impairment. Fair values reported in the disclosure notes would instead act as a discipline mechanism against excessive risk taking and would reveal managers' private information. Fair value is also needed to rank and

sort out competing investment strategies. Fair value could be either an exit price or a value in use depending on the liquidity of the financial assets.
Importantly, research finds a lower value-relevance for disclosed (versus recognized) amounts in the body of financial statements (e.g., Davis-Friday et al., 2004; Müller et al., 2015). This suggests that recognition and disclosure are not perfect substitutes, which is consistent with the purpose of providing information on fair value in the disclosure notes in order to mitigate its potential adverse effects.
From the users' perspective, historical cost accounting would provide the cost of an investment, while fair value would provide a measurement of what management expects to get in return for it. Users need to know the cost of the investment (i.e., the amount paid to obtain that fair value) to effectively evaluate stewardship, which is a major objective of financial reporting. A given asset owned by two different entities will have the same fair value at any given time, but fair value does not inform users that the entities may have paid a different price for it. The effective evaluation of stewardship requires knowledge of both historical cost and fair value. Comparing expected events (i.e., fair values) with past events (i.e., historical costs) would improve the ability of financial statement users to evaluate past performance, thus fulfilling a stewardship objective, and to predict future performance, thus fulfilling a decision-usefulness objective.
A dual measurement system would smooth out some of the extremes of the two regimes, yielding higher total social surplus (financial statement users plus preparers' surplus) and leading to welfare-enhancing asset allocation. The adoption of a dual measurement and reporting system should therefore be considered and discussed at a standards-setting level. In line with the Lisbon Treaty (2007), financial reporting standards-setting must consider the interests of the individual users of financial reporting without endangering financial stability and economic growth. Therefore, there is a need to balance these objectives.

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20. Thank You!

Thank you for taking our survey. Your response is very important to us.

Response ID: 123

Survey Submitted:	Jun 4, 2019 7:57 am
IP Address:	151.32.113.52
Language:	English (UK) (it-IT,it;q=0.9,en-US;q=0.8,en;q=0.7)
User Agent:	Mozilla/5.0 (Windows NT 6.1; Win64; x64) AppleWebKit/537.36 (KHTML, like Gecko) Chrome/74.0.3729.169 Safari/537.36
Http Referrer:	http://www.efrag.org/News/Public-183/New-EFRAG-consultation-on-Equity-Instruments--Research-on-Measurement
Page Path:	1 : Why is EFRAG consulting? (SKU: 1) 2 : The questionnaire (SKU: 3) 3 : General information about the respondent (SKU: 9) 4 : Question 1 (SKU: 7) 5 : Question 2 (SKU: 24) 6 : Question 3 (SKU: 10) 7 : Question 4 (SKU: 25) 8 : Question 5 (SKU: 11) 9 : Question 6 (SKU: 4) 10 : Question 7 (SKU: 12) 11 : Question 8 (SKU: 26) 12 : Question 9 (SKU: 13) 13 : (untitled) (SKU: 27) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17)

	17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 19 : Illustrative example F - Long-term investment held indirectly through a unit fund – non listed (SKU: 23) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 19 : Illustrative example F - Long-term investment held indirectly through a unit fund – non listed (SKU: 23) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 19 : Illustrative example F - Long-term investment held indirectly through a unit fund – non listed (SKU: 23) 20 : Thank You! (SKU: 2)
SessionID:	1559631221_5cf6157527a178.38857944

Response Location

Country:	Italy
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City:	Turin
Postal Code:	10152
Long & Lat:	Lat: 45.072498321533, Long:7.6876997947693