Equity Instruments - Research on Measurement

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

BASF SE

2. Country of operation

Worldwide

3. Job title

Albert Hasselmeyer - Head of Group Accounting and Reporting; Alexander Bantz - Senior Specialist Group Financial Statements

4. E-mail address

alexander.bantz@basf.com

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

Yes

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

Long-term investment business models aim on creating value in a sustainable manner without relying on short-term market fluctuations.

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

Yes

8. How do you define sustainable activities?

Sustainable activities contribute to BASF's success in the long term when our products, solutions and technologies add value to the environment, society and the economy.

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*?

Other

If you have indicated "Other" please provide details

The way the reporting entity intends to manage the equity instruments to realize cashflows should be the decisive factor for classifying an equity instrument as long-term investment. In particular, this is because the performance of equity instruments from the perspective of the reporting entity generally depends on the intended use of the asset: If the latter is to be sold within a short time-span, the current market price is a reliable indicator of the asset's future performance from the perspective of the reporting entity, while the dividends recognized in P/L are an adequate measure to reflect past performance. By contrast, if an equity instrument is not intended to be sold shortly, the current market price may not be suggestive for the expected future performance of the equity instrument (e.g. due market price fluctuations not realized by the reporting entity). This holds true for strategic investments that are generally held with the intention of realizing long-term benefits (e.g. by establishing a strategic partnership) rather than capitalizing on short-term market price fluctuations.

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

Measurement at fair value (irrespective of recognizing changes in fair value in P/L or OCI), does not faithfully represent the risk the reporting entity is exposed to in connection with the equity instrument. This is due to the reporting entity not being exposed to (short-term) market fluctuations resulting from market participants' expectations about the (amount, timing and riskiness) of expected future cashflows and changes therein. Instead, this risk is typically restricted to the initial purchase price of the equity instrument(s) minus any realized risk components (i.e. impairments).
Moreover, the current accounting approach stipulates recognizing changes in market participants' assumptions about (timing, amount and riskiness) of expected future cashflows as part of the performance of equity instruments. This performance component is recognized in comprehensive income, i.e. either in P/L or OCI, although changes in market participants' expectations are not necessarily linked to the performance of an equity instrument as expected by the reporting entity and most definitely not linked to the realized performance of an equity instrument.

Key operational challenges in developing an alternative accounting approach include defining a measurement concept that meets the requirements of recognizing the performance of the equity instrument without incorporating arbitrary (market-based) measurement parameters as well as reflecting the performance of the equity investment in an unbiased manner, e.g. by relying on realized performance.

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?

n/a

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

A restriction of an alternative accounting approach for equity instruments to long-term investments is considered adequate: The value of short-term investments in equity instruments for the reporting entity is affected by market participants' expectations about (amount, timing and riskiness of) future expected cashflows. This is, as short-term investments are sold at conditions prevailing at equity markets with the received price being affected by market participants' estimates. Therefore, fair value measurement (encompassing market participants' estimates) as currently required by IFRS 9 is adequate for those equity instruments.

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.

No

16. Please explain your answer

Adding another category of financial instruments increases complexity and the risk for accounting approaches that are subject to judgement, in turn decreasing the comparability of financial statement information. It is important to note that reduction of comparability generally has dysfunctional effects on capital markets.

10. Question 7

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

18. If you have indicated "Other" please provide details

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.

10

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.

Besides the representation of risk and performance (see Question 3), also the value of an equity instrument from the perspective of the reporting entity may not be represented faithfully, when applying fair value measurement: For instance, if the asset is to be sold within the near future, the current market price is a strong indicator of the equity instrument's value to the company. By contrast, the current market price does usually not reflect the value of an equity instrument held as a long-term investment, e.g. in the form of a strategic investment. Those investments usually result in economic benefits that are either not directly available to other market participants (e.g. due to competitive advantages) or not directly attributable to an investment on a stand-alone basis (e.g. due to synergies). Therefore, another accounting approach besides fair value measurement can be adequate.
This characteristic is especially important, as the IFRS aim at providing information that helps the users of financial statements to estimate the value of the reporting entity (Framework, OB7). Without representing the value of the assets held by the reporting entity, this goal will hardly be achievable.

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.

To reflect Entity A's risk resulting from the investment measurement at historical cost in accordance with paragraph 2.9a) of the background paper would be adequate. This is, because Entity A's maximum exposure to losses is restricted to the initial purchase price. Moreover, this approach would allow for reflecting the realized performance of the investment in P/L over its entire term via the recognition of dividends (and a potential disposal gain). By contrast, recognizing gains or losses from fair value measurement would not only reflect the (realized) performance of the investment, but also the outcome of other measurement components not attributable to the investment itself (e.g. changes in interest rates).
Enhancing investor's insight in the performance of the equity instrument will not be achieved by fair value measurement: Basing the measurement of Entity A's equity stake on fair value would require determining an exit price for the equity instrument in line with IFRS 13.9. This approach not only results in recognition of point-in-time market-based value changes (potentially being subject to "noise" in the market), but also contradicts Entity B's inability to sell the equity instrument during the term of the investment. Thus, enhancing investors' insight in the performance of the investment would not be achieved. Instead, the realized performance can be reflected in an unbiased manner by recognizing dividends in P/L.

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

1. The investor's inability to dispose of the shares
2. The definite useful life of the investee's operation
3. The sustainable nature of the investee's operation

23. Which accounting treatments do you support?

Historical cost

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.

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.

As for scenario A, Entity A's risk is limited to the initial purchase price of the equity instruments. As such, measurement at historical cost in accordance with paragraph 2.9a) of the background paper would be adequate to reflect Entity A's risk exposure. In analogy, the performance of the investment over its entire term would be reflected adequately by the recognition of dividends and a disposal gain. Instead, recognizing fair value measurement gains and losses in P/L can distort the recognition of the performance of the investment as outlined above.

Considering that fair value measurement is subject to factors other than operational performance of Entity B, fair value measurement would also not enhance investors' insights in the long-term performance of the investment. Instead, the realized performance can be reflected by recognizing the dividends in the P/L.

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

1. The fact that the investor does not have a put option
2. The fact that the shares are unlisted
3. The sustainable nature of the investee's operation

26. Which accounting treatments do you support?

Historical cost

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.

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.

An open portfolio of equity instruments should not be treated as if this portfolio was one single instrument. This is mainly due to the loss of informational value when aggregating information about different instruments (sharing different characteristics, such as risk profiles). Therefore, the accounting approach should be chosen specific to the individual instrument, depending on the intended use of this instrument.

If certain instruments of the entire portfolio are intended to be held for a longer time-span, the current accounting approach under IFRS 9 should not be selected for the reasoning outlined in scenario A and scenario B. The instruments of the portfolio that are held with the intention to capitalize on market fluctuations with a view to achieve target returns, should be measured at fair value as also outlined in scenario A and B.

Most importantly, the accounting approach for the equity instruments shall not be influenced by the intended use of the proceeds of the instrument. This is, as the use of the proceeds is not decisive for the value, the risk or the performance of the equity instrument.

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

1. The fact that the entity holds a portfolio of equity instruments
2. The fact that the shares are unlisted
3. 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.

The accounting treatment should depend on the intended use of the asset with some assets (that are held to be sold) being subject to the existing fair value measurement approach, while other assets (that are held with the intention of benefiting from the proceeds over a longer period) should be measured at cost. If all assets of the portfolio are potentially to be disposed, fair value measurement is adequate for all of the equity instruments. Otherwise, a "mixed measurement" model is proposed, provided that parts of the portfolio are held for disposal while others are held for long-term investment purposes.

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.

The response is analogous to the response provided for scenario C. The measurement approach taken should not be affected by the intended use of the proceeds of the equity instruments.

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

1. The fact that the entity holds a portfolio of equity instruments
2. The fact that the shares are unlisted
3. 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.

Please refer to our answer to question 29.

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.

No

If yes, please explain why.

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

1. The investor's ability to redeem or sell
2. The listed feature of the fund
3. The investor's assessment of the long-term nature of its investment

35. Which accounting treatments do you support?

Existing requirements are appropriate

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.

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.

No

If yes, please explain why.

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

1. The investor's ability to redeem or sell
2. The unlisted feature of the fund
3. The investor's assessment of the long-term nature of its investment

38. Which accounting treatments do you support?

Existing requirements are appropriate

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.

20. Thank You!

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