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

Assuralia

2. Country of operation

Belgium

3. Job title

Professional Union of Belgian Insurance companies

4. E-mail address

marco.debeerdelaer@assuralia.be

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

Yes

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

A long-term investment business model is a model in which the company acquires assets in order to generate a stream of revenues on the long run, often in order to match long-term insurance related liabilities.
Belgian insurers, and more generally European insurers, are in the business of providing protection for risks and long-term savings products. Insurance liabilities result in predictable cash outflows, on the long-term for both life and non-life activities.
Through an efficient asset-liability management, insurers are able to match the long-term profile of their investments with long-term liabilities. The aim is to have investments that replicate the duration of related liabilities. Insurance companies are thus by definition long-term investors and they play a very important role in financing the real economy.

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

Yes

8. How do you define sustainable activities?

Sustainable activities generally refers to activities taking into account environmental, social and governance considerations aiming at having a positive impact on society in the long-term.
Environmental, social and governance (ESG) factors:
[Reference is made to the European Commission proposal "on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341", in Article 2(o) "sustainable investments".]
Environmental: factors that contribute to an environmental objective. Such objectives include climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, waste prevention and recycling, pollution prevention and control and protection of healthy ecosystems. [See Article 5, Commission Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, COM(2018) 353 final.]
Social: factors that contribute to a social objective, and in particular to tackling inequality, an investment fostering social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities;
Governance: factors that contribute to good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance;

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 sector supports the fact that IFRS 9 classification rules are based on the business model of companies but question whether investments are held for trading or not. This allows many Belgian insurers to classify their equity instruments under the FVOCI method as these instruments are not held for trading. The FVOCI classification approach is suitable for both shorter term and long term, life and non-life activities. As such, there is no real need to make a distinction between a short term and a long-term investment business model for equity instruments. However, the proposed treatment of equity under the FVOCI method hampers investments in equity by insurance companies.

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

A general improvement of the current accounting treatment of equity instruments classified at FVOCI is needed rather than to introduce a new accounting treatment for long-term investment in equity instruments. The reintroduction of recycling is necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Just as dividends, gains and losses realised on disposal of equity instruments measured at FVOCI are an integral part of the company performances and should be shown in the results. As such, there is no conceptual reason to make a distinction between these different sources of profits and losses. Reporting consistently all the components of the performance of equity instruments in profit and loss will provide complete and appropriate information to users about the performance of the related investments. This will also ensure consistency with the accounting treatment of debt instruments accounted for at FVOCI for which interests payments as well as gains and losses upon realization are recognised in profit and loss.

Many users of financial statements are interested in additional information that distinguishes between realised and unrealised gains and losses. Recognising gains and losses when equity instruments at FVOCI are sold in profit and loss would give a clearer information to users about the disinvestment decision taken by the company. As such, users will be in a better position to assess the performance of the company.

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?

We fully support measurement at FVOCI with reclassification to profit and loss unpon disposal of the valuation gains or losses previously recognized through OCI (i.e. recycling) for all equity instruments which are not held for trading. However, we recognize the need for an impairment model if equity instruments were to be accounted for at FVOCI with recycling.

We acknowledge that some of the negative fair value changes can have a permanent nature and that it would be appropriate and in line with the principle of prudence of the Conceptual Framework for Financial Reporting to reflect such fair value changes in profit or loss. A robust impairment model also increases the relevance of the profit or loss statement as primary source of information of a company's performance.

An improved version of the IAS 39 impairment model could be used as a way forward. An improvement is needed in order to overcome inconsistencies caused by the unclear notions of 'prolonged' and 'significant' and by the excessive notion of 'once impaired always impaired'.
Concerning the unclear notions of 'prolonged' and 'significant', additional guidance on the meaning of those notions" could be provided by the standard. Moreover, additional requirements concerning the disclosure of the applied valuation rules, including the quantitative impairment triggers, in the notes of financial statement could also be included in the standard.

Concerning the unclear notions of 'prolonged' and 'significant', we propose the introduction of quantitative triggers to define what is a significant or prolonged decline in fair value. This could be done by defining a specific percentage decline from the acquisition cost and a specific time period over which the fair value has been below acquisition cost. However, these quantitative triggers should be rebuttable to take into consideration certain facts and circumstances.

Concerning the excessive notion of 'once impaired always impaired', we suggest to include in the standard an option to book reversal of impairments using symmetric quantitative rebuttable thresholds.

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.

No

14. Please explain your answer

Cfr. Question 1

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

We support the extension of the proposed accounting treatments in the answers under questions 3 and 4 to equity-type of instruments since we do not support those alternative accounting treatments.
Insurers do not invest only directly in equity instruments; they also invest indirectly, for example through units or notes in investment funds. It is important not to create a competitive disadvantage because the same assets are hold through different mechanisms. Therefore, to provide relevant information for the performance of long-term investors such as insurers, we believe that the accounting treatment of "equity-type" instruments such as UCITs should also be eligible to the FVOCI category under IFRS 9.

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

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.

75

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.

We are convinced that an adaptation of the accounting treatment under IFRS 9 for equity and equity-type instruments is necessary. However, a dedicated accounting treatment limited to long term investment business model is not appropriate for insurance companies. The FVOCI model is a suitable accounting model for both long-term and shorter-term investments as long as changes in fair value recorded in OCI are reclassified ('recycled') to profit or loss on disposal and as long as a robust impairment model as described under Question 4 is foreseen.
There is no need to try to differentiate long-term investments from shorter-term investments as companies already distinguish long-term investments by accounting for them at FVOCI instead of FVPL. This choice is made based on the nature of the underlying liabilities, as part of the ALM strategy.

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.

No

If yes, please explain why.

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

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

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.

No

If yes, please explain why.

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

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

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.

No

If yes, please explain why.

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

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

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.

No

If yes, please explain why.

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

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

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?

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

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?

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.

No alternative accounting treatment for the long-term investment business model is needed to properly portray the performance and risks of equity instruments.
The reintroduction of recycling is however necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Gains and losses when equity instruments measured at FVOCI are sold are an integral part of the investor's performance as dividend on these instruments. Since capital gains can be considered as accumulated non-distributed dividends, we see no conceptual reason to present them differently.
We also support the introduction of an impairment model if equity instruments were to be accounted for at FVOCI with recycling. As stated under Question 4, we suggest the introduction of an impairment model similar to that of IAS 39 with the introduction of reversal of impairments and of additional guidances on the meaning of the notions of 'significant' and 'prolonged'.

20. Thank You!

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