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

Task Force on « Long Term Investment » of the Paris Marketplace

2. Country of operation

France

3. Job title

4. E-mail address

g.delamartiniere@yahoo.fr

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

Yes

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

Bringing together since 2010 the economic and financial operators of the Paris financial market involved in long-term investment (professional associations, various organisations, companies and think tanks), the LTI Task Force led by Gérard de la Martinière is an informal body for reflection and discussion which has contributed to the emergence of the LTI issue in France and at the European level.

Members: Association nationale des sociétés par actions (ANSA), France Invest (ex AFIC), Association Française des Investisseurs Institutionnels (AF2i), Association Française des Entreprises Privées (AFEP), Association Française de Gestion Financière (AFG), Bpifrance, Centre des professions financières (CPF), CNP, Confrontations Europe, Covéa, Groupe Caisse des Dépôts, EUROFI, Fédération Bancaire Française (FBF), Fédération Française de l'Assurance (FFA), Fédération Nationale des Travaux Publics (FNTP), Forum de l'Investissement Responsable (FIR), Mouvement des Entreprises de France (MEDEF), Paris Europlace.

The members of the Task Force are convinced of the merits of the following principles:

- Accounting standards must match with the reality of the LTI's business model to provide a useful and accurate picture of the risk/return and thus fit clearly into the perspective of the investment horizon;

- Accounting standards must respect the neutrality between the different asset classes in order to achieve the optimum allocation of resources from the point of view of both the investor and that of the economy as a whole;

- These standards should enable a relevant assessment of the adequacy of the investment strategy in line with the constraints of liabilities, on the one hand, the evolution of the economic environment on the other hand;

- Accounting standards must not only enable but promote long-term holding of shares, which is the main means of influencing business strategies in the sense of "sustainability".
In accordance with the holistic approach to long-term investment used in our last report, we are able to precise a "reversed" definition of LTI.

LTI is neither an asset class (even if certain assets are more "long-term" friendly than others) nor a single type of operator - rather a continuum - nor an investment horizon in the strictest sense. LTI is a bit of all these elements, a bundle of characteristics: the essence of LTI resides in the implementation of an assets/liabilities management model that capitalizes on the stable characteristics of liabilities.

On the basis of an holistic approach to LTI, we proposed the following definition in our last report ("Betting on the Long-Term: Rebuilding Investment for the Europe of Tomorrow", 2018) :

"Long-term investment is the financial investment strategy deployed by any operator holding stable resources which at the same time allows for and requires asset allocation able to generate an economic return over time" (report, page 43).

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

Yes

8. How do you define sustainable activities?

As explained in point 6, LTI is not the monopoly or the sole prerogative of a single category of operators, but rather a business model shared by many types of operators.

In practice, it concerns operators able to invest over the long term in variable proportions and in diverse forms, thereby constituting a continuum ranging from 'pure' short-termist operators (trading funds) to long-termist operators by their very nature (National Promotional Banks and Institutions, or NPBIs), with all the categories of financial operators in between whose activities may be at least partially structured over the long term.
Sustainable activities satisfy 3 types of resilience:
- Financial resilience: if the economical ecosystem does not allow a certain level of profitability the actors will not be able to fulfil their economic mission;
- Economic resilience: for a corporate, sustainability implies a long-term vision & decision-making process. The structure of the balance sheet should materialize this reality with a proper balance between equity and debts. This long-term vision more and more implies a proper balance between financial and extra financial (ESG) decision making tools. It appears that sustainability / risks factors are corelated to ESG factors;
- Environmental resilience: climate change and scarce resources are major long-term risks that will impact our societies. The long-term investors must have a specific role as risk intermediaries. They should structure their services / products in a way to increase the awareness of final investors and corporates concerning ESG factors.

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

Sustainable activities satisfy 3 types of resilience:
- Financial resilience: if the economical ecosystem does not allow a certain level of profitability the actors will not be able to fulfil their economic mission;
- Economic resilience: for a corporate, sustainability implies a long-term vision & decision-making process. The structure of the balance sheet should materialize this reality with a proper balance between equity and debts. This long-term vision more and more implies a proper balance between financial and extra financial (ESG) decision making tools. It appears that sustainability / risks factors are corelated to ESG factors;
- Environmental resilience: climate change and scarce resources are major long-term risks that will impact our societies. The long-term investors must have a specific role as risk intermediaries. They should structure their services / products in a way to increase the awareness of final investors and corporates concerning ESG factors.

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

Indeed, a long-term strategy is a balance sheet management strategy, i.e. joint management of assets and liabilities, is based on an investment policy that is consistent with the strategy, and effectively assesses the long-term risks and returns of the various components of the balance sheet.
1) The reasons why alternative approaches should be developped
As underlined by the HLEG in 2018, it is key
"to ensure that EU accounting rules do not unduly discourage long-term investment."

With regard to the options currently available under IFRS 9, the investor must choose to recognize them as of the initial recognition date, instrument by instrument and irrevocably, either in a portfolio measured at fair value through profit or loss, a source of income volatility, or at fair value through OCI, the variations of which do not affect income but equity without recognizing capital gain or loss on sale (no recycling).

Accordingly, for equity instruments (shares) on the one hand, the use of fair value through profit or loss produces income volatility that does not reflect the economic reality of long-term investment, as the asset concerned is not immediately sold. On the other hand, the use of fair value through OCI does not allow for measurement of the performance of a long-term investment as the realized capital gains or losses on sale are never recognized in profit and loss, thereby clouding the performance measurement of such investments.

2) The challenges to developing such alternative approaches

Alternative approaches should satisfy the following principles:
-Transparency and comparability: this principle can be easily satisfied by publishing, in the appendices to the annual accounts, the market values of long-term portfolios with explanations of deviations from the values recorded in the accounts.
-Stability: the method should ensure that change in valuation are taken into account smoothly, in line with the management horizon in order to avoid reflecting short-term fluctuations that have no impact on the long-term strategy.
-Assessment of externalities: the method must make it possible to take externalities into account and to trace their impacts into the accounts in a precise and objective way.

Consequently, a system for measuring value adapted to long-term investment must adhere to the following principles:
• Asset recognition must be consistent with that of liabilities in order to adequately trace the matching of assets and liabilities - the key to long-term management.
• Assets should be approached on a portfolio basis rather than line by line; it is the entire constituted portfolio that must be set against the recorded liabilities, not any single line of securities taken in isolation.
• A uniform recognition method must apply to all asset classes included within the portfolio regarding the target allocation and the requirement to make adjustments over time.

The best approach for measuring the long-term performance potential will take into account the management horizon of the asset in question.

Therefore consequently, in the field of long-term investors' accounting, the Task Force on LTI of the Paris Marketplace would like the following principles to be considered:

• Homogeneity of the method of accounting for assets and liabilities in an ALM endorsement process
• Adopting a uniform accounting standard for all asset classes involved in LTI management
• Overall apprehension by portfolio of major components of the balance sheet
• Construction of a progressive performance recognition model over the life of the investment horizon
• Identifying deviations from projection assumptions included in the ALM strategy
• Taking into account possible corrective measures introduced in management in light of such discrepancies
• Taking into account an immediate depreciation only if the new projection reveals a lack of liability coverage by assets
• Reversibility of depreciation in response to a new change in projection parameters
• The recognition of the residual gain or loss when each portfolio's operations is terminated.

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 suggest to:
-Introduce the concept of long-term projected value for portfolios managed over the long-term by incorporating all forecast cash flows in accordance with analysis supporting the investment decision. Accounts using projected value can then be published alonside notes to the accounts using market value, in the interests of maintaining transparency ;
-Authorise, under IFRS9, recycling of the results of listed and unlisted equities recognised at fair value through OCI, to enable measurement of the results of a long-term investment strategy ;

-Reclassify the recognition of equity funds in accordance with the management orientation and the investor's management strategy, in order to ensure neutrality between direct investment and intermediated investment.

In the light of the 2 impairment models mentioned by EFRAG when it published its technical advice to the EC in November 2018, the revaluation model does not appear satisfactory because it does not take into account the nature of the unrealised capital losses occurrence. It makes no distinction between temporary volatility that affects market prices on the one hand and a significant drop in prices linked to economic fundamentals on the other hand, which can have a lasting impact on the valuation of certain assets.
The definition of objective triggers inside an impairment model similar to IAS 39 appears to be an interesting approach if they can appropriately capture the "significant" and "prolonged" nature of the unrealised losses suffered by the investor.

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.

14. Please explain your answer

This treatment should apply to equity investments over the long term, but more generally to all long-term investments regardless of the support used.

The accounting treatment for financial investments must reflect the risk exposure and the way in which these investments are managed.
Current debates about determining a different accounting treatment for equity instruments are precisely motivated by the need to capture the economic return over time of long-term investment.
Conversely, in the case of an investor holding equities with a short management horizon (i.e. trading), changes in market prices finally appear to be a good indicator of the future disposal price, which may justify accounting these changes directly in P&L.

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

What makes LTI is not the support but the strategy. The equity funds accounting treatment should be in accordance with the management orientation and the investor's management strategy, in order to ensure neutrality in accounting treatment between direct investment and intermediated investment.

Otherwise, we will be confronted with "accounting arbitrations" harmful to the LTI. To gain importance and meet the huge needs, LTI, as a sustainable investment, will have to go necessarily also through indirect investment.

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
The nature of the assets invested in
Mutual funds

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.

In the regulatory framework, a key role is given to accounting rules as those rules are not only technicalities to produce financial reporting and serve the trading sphere but also feed a lot of various internal and external purposes. They have a link with prudential issues.

Increasing long-term investment requires the removal of numerous obstacles blocking the path of investors, notably those resulting from the unintended effects of prudential and accounting principles which combination entails a focus on short-term fluctuations of value.

The impact of market value measurement is all the greater for prudential regulations having themselves generalised its use within their calculations: For example, in force since 2016, Solvency II measures capital requirements according to assets and liabilities at market value ("market consistent value" or "fair value"). This has meant a significant change for insurance companies as the majority of them had previously used other more stable methods to value premiums and provisions recognised in their accounts, such as historic cost and depreciated or amortised cost, which are now prohibited by the regulator.

To put it in a nutshell, prudential and accounting standards should acknowledge that the long term does not entail greater risk, but simply presents a different risk profile, with a greater emphasis on long-term trends but a lesser one on short-term market fluctuations.

As underlined in our report, we believe it is possible to promote a favourable regulatory environment by applying a few simple principles:
1) First of all, LTI must be repositioned at the centre of public policies – while at the same time ceasing to consider it only in a somewhat accessory manner, as an afterthought, via ad hoc and exceptional mechanisms which only tackle one of its aspects at best, while ignoring all the rest.
2) Such refocusing of public policies on the specific features of LTI must first take the form of adequate measurement of the associated risks and returns, in order to break free from the dominant financial approach that always and by default favours the short term, market value, disintermediation and instantaneous liquidity.
3) Under this condition it becomes possible to draw on long term asset & liabilities management, which fully recognises the value of stable liabilities and the importance of a long-term management horizon in which the principle of business continuity prevails over immediate liquidity.
4) This new approach must be accompanied by measures that promote alignment of the interests of the various operators with long-term objectives – as LTI is ultimately everyone's business: from the saver to the investor via the entire intermediation chain, right up to the entrepreneur.

Adapting accounting methods to long-term business models is not the only answer, but it is clearly a major part of the answer.

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.

If yes, please explain why.

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

23. Which accounting treatments do you support?

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.

If yes, please explain why.

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

26. Which accounting treatments do you support?

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.

If yes, please explain why.

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

29. Which accounting treatments do you support?

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.

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.

If yes, please explain why.

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

32. Which accounting treatments do you support?

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.

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.

If yes, please explain why.

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

35. Which accounting treatments do you support?

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.

If yes, please explain why.

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

38. Which accounting treatments do you support?

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.