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

Erste Group Bank AG

2. Country of operation

Austria + 6 CEE countries

3. Job title

4. E-mail address

martin.svitek@erstegroup.com

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

No

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

We do not consider our bank as a typical long-term equity investor. Long-term equity investments including what we could consider as investments in sustainable activities constitute only a small fraction of our assets. The long-term holding horizon is pursued for investments with business or strategic relations such as banking industry, insurance companies, payment transaction companies, project financing companies and work-out companies.
From this perspective we do not object to current IFRS 9 requirements for measurement of equity instruments. They do not affect our investment decisions. However, we also understand that the IFRS 9 requirements may not fit the business model of typical long-term equity investors. As a result, we have decided to contribute to this round of EFRAG consultations on equity instruments. However, we do not provide answers to all of the questions.

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

8. How do you define sustainable activities?

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

Ticking "Other" because our proposal for the FVOCI measurement with recycling and impairment which could address concerns of long-term equity investors does not have to necessarily apply only to long-term investment business model. In our comment letter on the 2018 EFRAG discussion paper we expressed preference for the model to be applied to non-trading equity investments. Or, as an alternative, it could be applied to non-trading equity investments on an optional basis.
If an alternative other than the FVOCI measurement (with recycling and impairment) was chosen we believe that it should be applied only to the long-term investment business model. Its identification should combine business model of the investor and the expected holding period back-tested by the actual holding period of similar investments. Identification of specific features would, however, be a very difficult task, in our view.

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

We consider that most of the concerns faced by long-term investors could be solved by introducing AFS-like measurement method for equity investments. As far as we know, long-term investors did not express serious concerns in respect of measurement methods applied for equity investments in the IAS 39 environment. As a result, we believe that the AFS-like measurement approach with improved impairment requirements could suit their needs.
In the comment letter on the EFRAG Discussion Paper: Equity Instruments – Impairment and Recycling in May 2018 we expressed support for the introduction of recycling accompanied by an improved impairment model. For details including mechanics of the impairment model we refer to the letter.
The FVOCI measurement method with recycling and impairment would reflect the long-terms business model by recognising dividends and impairment in profit or loss over the holding period of the investments. Unrealised gains and losses (except for impairment) would be recognised in OCI and reclassified to profit or loss upon disposal of the assets. We admit that the profit or loss could be impacted in the period of disposal by performance which has been generated over the entire holding period. We also acknowledge that recycling could lead to earnings management by selectively selling specific investments. The disinvestment decisions as such constitute critical events which warrant that the unrealised gains and losses are reclassified. Also, the recycling may provide a possibility how to recognise in profit or loss matching effects with expenses incurred on related long-term liabilities which are backed by the equity investments.
In our view, it would be difficult to find an appropriate method for allocating the performance in profit or loss over the life of a long-term investment. Fair value measurement may lead to excessive volatility not corresponding to the long-term nature of the instruments. We see some merits in the allocation approaches, however, they would use many subjective inputs and face other issues as discussed in the EFRAG Secretariat background paper. Adjusted cost approaches could result either in excessive volatility due to non-recurring adjustments upon occurrence of observable transactions or they may suffer from availability and delays of the necessary information when adjusting for the share of profit or loss of the investee. The approach of adjustments to the inputs in fair value measurement while smoothing the volatility lacks merits, in our view. We do not understand why the risk free-rate should be kept constant while other inputs would be adjusted based on market development. Further, we note that the approach could not be applied for comparable company valuation multiple models because they do not use discounting as an input. Average fair value approaches could address the end of year noise in the market prices but as such they hardly remove the volatility as also illustrated by figures in paragraph 2.16 of the paper.
When saying this we remind that current IFRS 9 requirements do not create particular issues for our accounting practice and do not affect our investment decisions. From our perspective the changes would be justified only if it could be proven that the current requirements do not suit long-term investors and do affect their investment decisions.

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?

Please refer to Erste Group comment letter from May 2018 on the EFRAG Discussion Paper Equity Instruments – Impairment and Recycling where we provided details on the impairment model.

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

If the measurement model was FVOCI with recycling and impairment it should not be restricted to equity instruments held in a long-term investment business model. In our comment letter on the 2018 EFRAG discussion paper we expressed preference for the model to be applied to non-trading equity investments. As an alternative, it should apply to non-trading equities on an optional basis.
If another measurement alternative was considered to be suitable to address issues faced by long-term equity investors it should be restricted to the respective types of investments.

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

As mentioned above, current IFRS 9 requirements do not create particular issues for our accounting practice and do not affect our investment decisions. Extending the alternative treatment to equity-type instruments would be warranted only if the current FVPL measurement did not suit long-term investors and did affect their investment decisions.

10. Question 7

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

Other

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

The primary distinguishing factor should be the 'puttable exception' in IAS 32. However, the type of assets factor should also play a role. The alternative non-FVPL treatment should be available for funds which invest in equity instruments without material derivative positions which could leverage the returns. However, if the measurement alternative was FVOCI with recycling and impairment, which as such could be suitable for all non-trading equity-type investments, we consider that the fund assets could also include debt instruments and non-financial assets without material leverage positions. As a result, mutual funds investing in simple debt instruments or real estate funds could also be measured at FVOCI.

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.

0

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.

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?

Existing requirements are appropriate

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.

The company does not seem to distribute its performance during the holding period. As a result, if FVOCI measurement option in IFRS 9 was used no portion of the performance would be recognised in profit or loss over the holding period. With the FVPL measurement the FV may be difficult to determine considering that it is an unlisted start-up company. Further, fair value fluctuations may not be representative of the real performance of the entity.

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.

Adjustment of the cost by profit or loss of the investee and allocation approaches may have certain merits for capturing the performance of the entity in this case. However, they have the drawbacks mentioned in the answer to question 3 and in the EFRAG Secretariat background paper.
We consider that the FVOCI measurement with recycling and impairment could be the most suitable method. The entity's ongoing performance would be captured through FV changes. As the FV changes are also significantly affected by market noise and subjective unobservable valuation inputs it would be more appropriate to recognise all the changes in OCI (unless the investment is impaired). Disposal of the investment would constitute a critical event upon which the cumulative performance would be recognised in profit or loss.

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.

The FVPL measurement under IFRS 9 with short-term price fluctuations in profit or loss does not capture the objective of generating long-term targeted returns to back the related liabilities.

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.

An allocation approach based on the expected duration of the related liability might be appropriate. However, considering multiple issues related to development of allocation approaches as also mentioned EFRAG Secretariat background paper we believe that the FVOCI method with recycling and impairment would be suitable. The recycling enables that matching effects with expenses incurred on related liabilities are recognised in profit or loss although for this to happen entities have to perform selective sales.

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.

We consider comments to scenario C also valid for scenario D.

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.

We consider comments to scenario C also valid for scenario D.

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?

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?

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.