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

Covestro AG

2. Country of operation

Germany

3. Job title

Head of Accounting Policies

4. E-mail address

mario.bremenkamp1@covestro.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 appreciate the initiative to respond, and acknowledge the efforts of the EFRAG Secretary and staff. We do not have a clear-set definition of what constitutes a "long-term investment business model". However, we believe the following may contribute to what we believe is, or will be, key in our industry, and provide some helpful background for the answers in this questionnaire:

We perceive that considerable innovations of yet non-mature enterprises and corresponding small to mid-size venture capital-type of investments are one option for companies of the broader industry. These investments may take the form of direct or indirect investments, and may go along with either long-term equity or debt financing, or a combination thereof. Since the challenges in the chemical sector are high and efforts are costly, the industry is initially exploring opportunities with cooperations and long-term strategic partnerships with non-listed companies, such as in the area of renewable or alternative energy sourcing. Likewise, many industry representatives may join forces on the journey to reduce fossil resources, in particular crude oil, and eventually progress collaborative R&D activities to foster overall resource efficiency vis à vis a growing footprint of a circular economy. Overall, long-term, innovative and/or strategic, sustainable and hence business-related investments of this kind are certainly a driving factor going forward in our industry.

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

No

8. How do you define sustainable activities?

See our answer under #6 above.

4. Question 1

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

The expected holding period
Other

If you have indicated "Other" please provide details

As it related to a corporate, non-financial service sector company, investments should, to qualify as a contribution to its long-term investment business, be linked to the primary business purpose of the entity. So the business relation should come as an addition to a long-term, e.g. three years-type of, investment. One example could be a strategic, equity-type of investment into a small, non-listed start-up enterprise directed towards joint R&D activities to explore more resource-efficient products or production processes. Conversely, if a corporate, non-financial service sector company strategically invested into a non-business related enterprise on a long-term basis, i.e. through equity financing with an exit clause (i.e., put right after three years), the expected holding period may not by itself represent an appropriate measure to constitute long-term investment. For the discussion of equity-type of investments, see our answer to #6.

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?

No

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

Generally, our view as a chemical industry constituent is that consistent financial reporting guidance should be established and enforced for like scenarios. Whilst the investment business model will be impacted by the regulatory environment or strategic footprint of the company, financial reporting should not drive decision around business models, or corresponding investment behaviour.

Consideration of an alternative accounting implies that IFRS 9 – which has been implemented with considerable efforts – does not provide an appropriate basis to portray the performance and risks of equity instruments held in a long-term investment business model. Whilst we assume a balanced and educated view around a "need" might only be obtained as part of the IASB's anticipated IFRS 9 post-implementation review (PIR) activities, in our view, an alternative accounting treatment which better reflects the nature of long-term investments will be appreciated in cases explained under Question 1. In those situations, a periodic reliable, auditable and enforceable measurement of the investment at fair value will continue facing challenges.

We preferred consideration of an alternative accounting model in particular in and for cases in which periodic (i.e., semi-annual) financial information is not available or not available in a timely manner without undue cost. Today, IFRS 9 mandates periodic fair value measurement for equity investments. The fact that certain strategic, i.e. start-up, innovative or even family-owned business enterprises are not generating periodic accounts (or, not in the manner and frequency of listed companies) does provide considerable challenges for an investor to adhere to some of the IFRS 9 requirements.

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?

Generally, we do neither support nor reject an alternative accounting model for equity instruments held on a long-term basis measured at FVOCI with P&L recycling upon disposal. Should the IASB, as part of a Standard Setter project and/or as a result of its anticipated IFRS 9 post-implementation review (PIR) activities, revert (back) to a model of measurement of equity instruments at FVOCI with reclassification to P&L upon disposal, the aforesaid challenge to determine fair value at certain points in time will not be resolved. Furthermore, we do not have enough evidence that the benefits of changing (back) to such a model would outweigh the costs to be incurred by the constituency to (re-) implement such an alternative model.

In investment situations referenced under questions 1 and 2, we would rather prefer a cost model, in particular in cases in which periodic financial statement information is not available. This cost model should go along with an impairment model, the features of which to be further defined. Certainly, the IASB as the Standard Setter would need to revisit and eventually reevaluate its own prior concerns around the criteria underlying the guidance for impairment / "impairment triggers" under IAS 39.

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

Clearly, as laid out in the EFRAG Secretary's Background Paper, equity instruments which are solely or primarily held for trading purposes or to primarily generate capital gains ("fair value arbitrage") should remain subjected to FVPL measurement. Conversely, in our view, consistently defining a long-term investment holding ("holding period") appears to be one of the most challenging efforts. We rather emphasize our preference to consider exemptions from mandatory periodic fair value measurement (FVOCI or FVPL), in cases where appropriate, timely and/or reliable financial information is not available; see our answer under question 4.

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 explained above, we believe preparers will encounter issues to timely and reliably measure instruments at fair value. These issues are one the same for any instruments defined in IAS 32.11 et sequ. that do not meet the criteria to qualify as equity instruments (see question 7). However, some of these instruments bring along the same set of owner-type rights and obligations (see EFRAG Secretary's Background Paper) as do instruments meeting the IFRS definition of equity instruments.

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.

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.

No. See our answer to questions 4 and 6.

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.

NOTE: We opted for "Existing requirements are appropriate" and "Other".

Generally, we assume no need for a different accounting treatment, for the reasons, and apart from the exceptions noted in the previous answers. At the same time, we do not have enough evidence that any potential accounting change will support in achieving the UN Sustainable Development Goals or the goals of the Paris Agreement on Climate Change. This is because we lack robust evidence that financial statement presentation and disclosure is driving general strategic business and / or investment model-type of decisions.

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?

1. The fact that the shares are unlisted

26. Which accounting treatments do you support?

Other

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

NOTE: We opted for "Existing requirements are appropriate" and "Other".

We believe the scenarios within Illustrative Example 1 (Windfarm) represent examples which demonstrate the challenge to determine fair value estimates periodically. In these cases, we believe historical cost (including Impairment) would be an appropriate measurement model should the IASB decide to revisit its existing approach in the codified IFRS 9 standard. However, we do not see a "need" for the reasons provided above.

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.

NOTE: We opted for "Existing requirements are appropriate" and "Other".

In the illustrative example, the portfolio apparently comprises equity and non-equity investments ("various financial instruments, including equity instruments"). More information on individual facts and circumstances would be needed. However, whilst we acknowledge that there are challenges for the periodic determination of fair value for an unlisted investment (portfolio), we believe existing guidance under IFRS 9 represents an appropriate measurement basis in the scenario given.

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?

1. The fact that the entity holds a portfolio of equity instruments

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.

NOTE: We opted for "Existing requirements are appropriate" and "Other".

We refer to our answer under #29 for the illustrative example in Scenario C.

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 listed feature of the fund
2. The investor's ability to redeem or sell

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.

NOTE: We opted for "Existing requirements are appropriate" and "Other".

We do believe existing guidance under IFRS 9 represents an appropriate measurement basis in the scenario given, in particular, since there is past practise of redemption / disposales of the listed investment unit in combination with rather short-term, though varying holding periods. We refer to our answer under #29 for the illustrative example in Scenario C and under #32 for the illustrative example in Scenario C.

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

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.

NOTE: We opted for "Existing requirements are appropriate" and "Other".

We acknowledge the challenge to determine periodic fair value estimates if the fund is not listed (see above). However, we believe preparers investing in these types of asset portfolios may have some financial information to assess, in particular against the background of a practise not hold on a long-term (e.g., 6 months, though varying) and a practise to redeem or sell. We refer to our answer under #35 for the illustrative example in Scenario E.

20. Thank You!

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