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

FEDERATION BANCAIRE FRANCAISE

2. Country of operation

FRANCE

3. Job title

4. E-mail address

ihuard@fbf.fr

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

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

Please refer to question 1.

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

8. How do you define sustainable activities?

Please refer to question 1.

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 characteristics/ business model of the investor
Other

If you have indicated "Other" please provide details

The characteristics/ business model of the investor

The business model – why an entity holds an investment - should be the primary criterion when considering the performance model to apply. The segmentation of measurement methods and hence of instrument categories should be primarily based on how they are managed, and not on their characteristics as it is first assessed in IFRS 9.

Equity instruments held on a long-term horizon with no intention of selling in the foreseeable future, irrespective of their negotiability or which may be sold occasionally when the opportunity arises should not follow the same measurement model as equity held on a short-term horizon to profit from movements in the price of the assets.

A business model should apply to equity investments that are managed on portfolio basis or on a line by line basis.

As the genuine nature of all equity investments held on a long-term horizon encompass very different situations in practice, we believe it would be better to consider a definition of a long-term business model as other than a business model whose purpose would be to achieve short term profit taking.

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

Reasons to favour an alternative accounting treatment to IFRS 9 requirements.

Under current IFRS 9, equity instruments' measurement and classification follow a binary approach: the "fair value through OCI for equities" approach and the "fair value through P&L" approach. None of these two approaches faithfully reflect the long-term business model and thus, the performance of such activities. The former approach retains the gains and losses realised on sales in the financial position. The latter introduces undue volatility in the income statement as unrealised gains and losses are recognised immediately in P&L, while they cannot be considered similar to realised gains and losses.

Indeed, realised and unrealised gains and losses are of different nature. The realised gains and losses – dividends but also gains or losses on sales - are gains or losses that are certain and that result from completed transactions. They are a key indicator of performance of longer-term horizon activities as they give an important information of the disinvestment decisions of the entity. For such investments, unrealised gains or losses are not considered to be components of their management performance as they remain uncertain and result from changes in the value of financial instruments that have not yet been settled. They should be kept in the financial position and not in the income statement.

To provide the most meaningful information related to management of equity investments not held for trading but on a longer-term horizon, realised gains and losses – dividends and cumulative gains and losses realised on disposals - should be located directly in the income statement. Besides, it is worth to be noted that the Conceptual Framework considers that the income statement is the primary financial statement for reporting entity's performance.

7. Question 4

12. With reference to equity instruments held in a long-term investment business model, if you support measurement at FV through other comprehensive income with reclassification to P&L upon disposal of the valuation gains or losses previously recognized through OIC (so called “recycling”), which impairment model would you suggest and how it would work in practice?

For a relevant impairment model, we consider that the IAS 39 impairment model may be improved with additional guidance and disclosures on methodology, but most important is that it shall be complemented with an impairment reversal mechanism under the same conditions as the ones that lead to impairment.

As suggested in our 2018 comments letter, we would retain the concept of "value in use" to conduct the impairment tests but also as a reference value for the impairment amount to be recognised in the profit or loss account. The concept is already applied in IFRS standards – i.e. defined by IAS 36 - and commonly understood by preparers and users.

In our opinion, the concept of "value in use" could be extended to financial assets when the business model applied is to hold these assets for a period other than a short-term period
The value-in-use measure is an entity specific measure determined in accordance with "future cash flows that the entity expects to derive from the assets" (IAS 36.6) . It takes into account internal and external factors and notably, the intended holding horizon of the assets. Equity instruments would be accounted for at a minimum between their original costs and the value in use.

The impairment model should be complemented by a reversal mechanism. Reversal of the impairment would either be automatic for any subsequent increase in value above triggers to be defined or follow a symmetrical approach to the impairment model taking into account external and internal indicators that the impairment loss no longer exists or has decreased.

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

The different accounting treatment should apply to all equity instruments as well as all equity-type instruments except those held in a short-term or trading business model.

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 believe that a different accounting treatment as referred previously should not be limited to equity instruments as defined in IAS 32 Financial Instruments: Presentation, but it rather should be extended to all equity-type instruments.

Differentiating the accounting treatment on the basis of the holding mechanism – direct vs indirect - would create economic competitive disadvantage between same types of assets – equity instruments vs equity-type instruments.

Accordingly, the same accounting treatment should apply to equity instruments irrespective of whether they are held directly or indirectly through investments vehicles (such as investment funds). Indeed, excluding instruments equivalent to equity instruments from the alternative accounting treatment would not appropriately reflect the management strategy of the funds.

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

Could be included in the scope instruments that meet the puttable exceptions of IAS 32.

To define the « equity-type" instrument, we believe that an approach similar to the contractually linked instruments approach under IFRS 9 should apply. Under such an approach, it would be necessary to look through the underlying pools of assets held by the fund to determine the characteristics of the pool.

The underlying pool could include one or more of the following instruments: equity instruments or equity-type instruments (that are looked through), instruments that reduce the cash flow variability, cash or cash instrument used to meet liquidity constraints.

If the characteristics are met, then the fund would be treated as an equity-type instrument and the adequate accounting treatment would apply depending on the business model retained.

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.

100

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 further comments.

13. (untitled)

The following pages include 7 illustrative examples of long term investment. For each scenario, you are invited to answer the questions on the page which follows.

Please consider that for Scenario A, B, C and D IFRS 9 requires to either measure the investment at FVTPL or to elect the option for measurement at FV through other comprehensive income, without reclassification to P&L, upon disposal, of the valuation gains or losses previously recognized through OCI, and without impairment.

14. Illustrative example A - Wind farm with predetermined useful life

21. For scenario A - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Under FVPL accounting, the fair value would not provide useful information as changes in fair value cannot be monetised. FVOCI accounting according to IFRS 9 would not be appropriate as it would not capture any potential decline in value in profit and loss.

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

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

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.

Based on the two assumptions on residual value at the end of the economic life of the asset and prohibition of selling, we believe that historical cost with an impairment test is the most appropriate accounting treatment.

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.

FVPL accounting implies a "fair value" assessment that does not accurately portray the long-term objectives of the investment strategy.
FVOCI accounting according to IFRS 9 does not permit recycling whereas the performance of the investment is expected to be generated on disposal.

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

1. The fact that the investor does not have a put option

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.

For the reasons mentioned above, we believe that historical cost with an impairment test is the most appropriate accounting treatment.

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.

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

1. The link to a long-term obligation (insurance contracts)
2. The fact that the entity holds a portfolio of equity instruments

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.

Both examples C & D address similar issues.
None of the IFRS 9 requirements would accurately portray the performance of the investments as FVPL introduces volatility in P&L and as FVOCI retains earnings upon disposals in OCI.
For the reasons mentioned above, a FVOCI measurement with recycling upon disposals, impairment test and reversal of impairment is the most appropriate accounting treatment.

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.

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

1. The link to a long-term obligation
2. 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.

Both examples C & D address similar issues.
None of the IFRS 9 requirements would accurately portray the performance of the investments as FVPL introduces volatility in P&L and as FVOCI retains earnings upon disposals in OCI.
For the reasons mentioned above, a FVOCI measurement with recycling upon disposals, impairment test and reversal of impairment is the most appropriate accounting treatment.

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.

Yes

If yes, please explain why.

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

1. The investor's assessment of the long-term nature of its investment

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.

Both examples E & F address similar issues.
The accounting treatment to apply does not rely on the unlisted (or listed) feature of the fund. The same accounting treatment should apply to equity-type instruments as that applied to equity instruments, depending on the management strategy of the fund. A FVOCI measurement with recycling upon disposals, impairment test and reversal of impairment is the most appropriate accounting treatment

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.

Yes

If yes, please explain why.

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

1. The investor's assessment of the long-term nature of its investment

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.

Both examples E & F address similar issues.
The accounting treatment to apply does not rely on the unlisted (or listed) feature of the fund. The same accounting treatment should apply to equity-type instruments as that applied to equity instruments, depending on the management strategy of the fund. A FVOCI measurement with recycling upon disposals, impairment test and reversal of impairment is the most appropriate accounting treatment

20. Thank You!

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