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

ESBG

2. Country of operation

3. Job title

4. E-mail address

tsvetomira.vanassche@wsbi-esbg.org

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

Yes

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

A long-term investment business model could be understood as one whose objective is the formation of long-term capital assets and, therefore, capital appreciation is not the main reason to either hold or realize the asset. In this sense, in addition to equities, it could also consider the inclusion of certain tangible and intangible assets (as per the "Green Paper on the long-term financing of the European economy").

In our opinion, the concept of a long-term investment business model could be related and interplay a role with "Sustainable Activities", since long-term investment decisions may re-quire considering sustainability risks and opportunities. For some entities, when they invest in "Sustainable Activities", they are taking into account a long-term investment horizon most of the times. However, we acknowledge that not all the investments held in a long-term investment business model may meet the definition of "Sustainable Activities". Considering that there is no two-way relationship between both definitions of "Sustainable Activities" and "Long-term investment business model" answering some questions of this questionnaire is challenging.

In the particular case of the insurance business, the generic definition detailed above re-garding a "long-term investment business model" is further complemented with a view of considering the nature of the liabilities combined with liquidity and other aspects of asset liability management which enables or requires a long-term investment strategy.

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

Yes

8. How do you define sustainable activities?

It should be noted that a definition of sustainable activities has not been developed by the IASB nor the European Commission for the purpose of the EU endorsement of IFRS stand-ards.

In our view, the definition of "Sustainable Activities" for any accounting purposes should be consequently determined by each company (entity-specific definition) according to its own criteria and consistently with its mission and strategic plan. In this regard, the definitions es-tablished in the Regulation on Taxonomy could act as a maximum to define its scope. That is, companies could have a more restrictive definition if their own criteria set narrower bounda-ries on the type of investments that could be considered "Sustainable Activities". The taxon-omy would therefore be the basis that would determine the maximum scope of this account-ing category of equity investments and provide discipline in the accounting arena, given that as detailed in Question 3 we are in favour of having a specific different accounting treatment for this category of investments.

Taxonomy considers criteria for the generation of impact and establishment of long-term objectives. Although the Taxonomy on its current state does not yet include all sustainable sides, our expectation is that any new accounting requirement will progress in consistency with the path in which the Taxonomy is developed to include not only green investments but also social ones. In this sense, as established in the final provisions of the draft of the Regu-lation, it should be expected that the scope will be extended to cover other sustainable objec-tives, in particular, social objectives.

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
The expected holding period
Other

If you have indicated "Other" please provide details

These characteristics have been answered based on our response to identify "Sustainable activities" as a separate category. Please see our answer in Question 3 regarding "Long-term investment business model" for insurance activities.

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

In the context of this questionnaire, ESBG members may be engaged in different kinds of business models. It could be considered that one business model relates to the insurance activities in the long-term life business, whereas the other model relates to investments in "Sustainable Activities", engaged directly from the bank or from any of its subsidiaries, etc.

Regarding the insurance activities, those ESBG members which are financial-conglomerates support the position taken by the insurance sector and their Associations and representative groups, oriented towards a FVOCI model with recycling and impairment, for all types of in-vestments in equities and comparable instruments, without making differentiations because they are investments in sustainable activities. . Although we have only appointed insurances activities, this FVOCI model should also be open to other long term investment business model that a company can identify. However, a reintroduction of recycling and impairment for equity instruments should not limit the possibility for companies to continue measuring equity instruments at Fair value through profit or loss (FVPL) where this provides the ap-propriate representation of their performance.

For the investments carried at the bank group level, ESBG supports a different accounting treatment to IFRS 9 requirements in equity instruments held in a long-term investment business model, but only for those investments in sustainable activities as it has been de-fined before. In line with the commitment of the European Commission to enhance the fi-nancing of sustainable development, ESBG believes that in order to favour investments in sustainable activities, these investments should be allowed to be accounted for at cost less impairment losses.

The cost measurement would avoid issues with fair value measurement which would often be largely based on unobservable inputs. Moreover, the regulatory capital of banks would not be impacted by fair value fluctuation as it would be with FVOCI measurement.

Due to the characteristics of these investments, they may require a period of maturity, in which there will be cash inflows, but without a business plan in place. During this initial time, we propose not to carry out an impairment test as it can be an essential moment of the project in which investment is needed without profit, and an impairment test would discour-age investment in these early phases.

Once there is already an initial business plan, we envisage an impairment model based on this initial business plan, where entities should define the principal KPIs that they follow and the methodology to set quantitative thresholds used to assess whether there is an impair-ment. At initial recognition and at each reporting date (considering the materiality of the equity), entities would make a transparent disclosure in the annual report of the quantitative thresholds set and used and include a statement on whether they have been reached or not. Entities should disclose the rationale behind not impairing an instrument when the trig-gers are met (rebuttable presumption).

In this way, entities would avoid fluctuations in their income statements that could arise if the default requirements in IFRS 9 were applied, and they would recognize the return on the investment once the investment is realized in the statement of Profit and Loss, and there-fore, this type of investment would be encouraged.

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?

As referred above, the accounting measurement we propose for the "Sustainable Activities" would not be based on recycling although would need of some type of impairment criteria as explained. See previous question.

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

As explained in question 3, we consider that the FVOCI measurement with recycling and im-pairment should be available to long term investment business model that a company can identify. Further, we believe that a new accounting category of cost measurement could be envisaged for equities considered as "Sustainable Activities".

However, we would suggest the European Commission to pay attention to other kind of in-vestments that may want to incentivize, for example, green loans. Currently under IFRS 9 the origination of these type of loans may be discouraged due to accounting treatment as they need to pass the SPPI test. To determine whether such loans satisfy the SPPI test, the contractual terms that determine variability in cash flows as a result of the Green Measures should be carefully assessed. If the magnitude of the change in the interest rate driven by the sustainability variability has the consequence of not complying with the SPPI test, it may discourage these investments as they will be compulsory measured at FV-PL.

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

Given that the objective is to promote "Sustainable Activities", for reasons of comparability and consistency the same model of measurement at cost less impairment should apply to all equity-type investments. We expect the attractiveness of these types of investments to de-crease if they don't have the same treatment. However, the underlying assets of these in-struments have to meet the same requirements of sustainable activities as equities.

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

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.

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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.

Yes

If yes, please explain why.

As explained in question 3, we believe that a differentiated accounting treatment for invest-ments in sustainable activities is important to promote them.

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

1. The sustainable nature of the investee's operation

23. Which accounting treatments do you support?

Historical cost

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.

As explained in question 3, we believe that a differentiated accounting treatment for invest-ments in sustainable activities is important to promote them.

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

1. The sustainable nature of the investee's operation

26. Which accounting treatments do you support?

Historical cost

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.

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)

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.

As explained in question 3, we would support a FVOCI with recycling accounting treatment for these portfolios in the terms proposed by the insurance industry. However, a reintroduction of recycling and impairment for equity instruments should not limit the possibility for companies to continue measuring equity instruments at Fair value through profit or loss (FVPL) where this provides the appropriate representation of their performance.

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

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.

As long as the company holds that this investment is part of a long term investment busi-ness model, we believe that the example could be similar to example C because the port-folio of equity instruments held with a view to service a long-term liability. As a result, the FVOCI measurement with impairment and recycling could also be suitable here.

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?

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?

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.