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

European Fund and Asset Management Association (EFAMA)

2. Country of operation

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3. Job title

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4. E-mail address

info@efama.org

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

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

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*?

The characteristics/ business model of the investor

If you have indicated "Other" please provide details

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

Under IFRS 9, fair value (mark-to-market) gains on equity investments (other than those held for trading) cannot be converted into P&L. This makes investments in long term equity investments less attractive when compared to the previous IAS 39 regime where such gains would have been converted into P&L on disposal. We would propose that recycling is re-introduced together with one robust impairment model, mitigating any concerns of "earnings' management".

7. Question 4

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

We would propose a principles based impairment model that can be applied at portfolio level – Please refer to EFAMA comments on EFRAG's discussion paper "Equity Instruments – Impairment and Recycling", dated March 2018.

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

We propose that any different accounting treatment for equity instruments held in a long-term investment business model is also made available for equity-type instruments as referred to paragraphs 4.30 to 4.39 of the Background paper (puttable instruments from the holders' perspective such as units in investment funds) and Debt instruments with equity-like features (eg profit linked notes) that fail the SPPI test. Please refer to EFAMA's comments on IASB's discussion paper "Financial Instruments with Characteristics of Equity", dated June 2018, especially to the following suggestions:

- "IFRS 9 should be amended in order to classify investments in investment funds as FVOCI (by amending IFRS 9.5.7.5) in order to include the new asset category "Investment Entity" holdings as defined in IFRS 10.

- Alternatively, EFAMA would suggest to introduce a 'look through' approach in IAS 32.11 for classifying holdings in "Investment Entities". This look-through approach would result in a debt classification for instruments passing the IFRS 9 SPPI test and an equity classification for anything else. Subsequent changes will also be required to IFRS 9 to recognise this revised approach."

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

See above response to Q5 (14)

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
Other

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

Debt instruments with equity-like features (eg profit linked notes) that fail the SPPI test. Please refer to our previous comments.

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.

We would propose that this is linked with the relevant entity's business model for a group of assets. Specifically, would suggest that the current IFRS 9 business model assessment framework is expanded to factor in considerations for portfolio of assets which are acquired and held to meet a pre-determined long-term investment risk / return objective.

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.

The primary concern here relates to accounting for any residual gains/losses on disposal of the end of the investment's economic life. Within the current IFRS 9 accounting framework, such residual gain/losses will never be recycled to the P&L where all other returns from this investment would have been recognised in profit or loss during this 10-year period.

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.

Other – The existing requirement of using reporting end date fair value for balance sheet measurement should be retained, while a different framework should be applied for reporting gains/losses in the P&L, ideally supported by a robust impairment framework. The proposed "Adjusted cost – reflecting the share of profit or loss of the investee" could also be a good alternative, however there will be practical challenges in obtaining the underlying investee financial information on a timely basis. Other suggested alternatives such as the "Average of fair value" or "Adjusted cost – reflecting observable market transactions" are also not practical when considering that long term investments are often unquoted and with limited observable market transactions – The only exception where this approach may work is for long-term investments held through an ETF as per Example C further below.

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 primary concern here relates to accounting for fair value (mark-to-market) gains/losses arising from holding such investment. Within the current IFRS 9 accounting framework, any mark-to-market capital gains will never be recycled to the P&L, those making such investments less attractive when compared to the previous IAS 39 regime where such gains would have been converted into P&L on disposal.

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.

See above responses to example A (22/23)

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 concern here relates to accounting for both periodic fair value (mark-to-market) gains/losses arising from holding such an investment and residual gains/losses on disposal. Within the current IFRS 9 accounting framework, any periodic mark-to-market or residual gain/losses will never be recycled to the P&L, those making such investments less attractive when compared to the previous IAS 39 regime where any gains would have been converted into P&L on disposal.

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.

See above responses to example A (22/23)

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.

Same as Example C.

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

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.

Same as Example 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.

Yes

If yes, please explain why.

The primary concern here is that Entity A needs to measure such ETF holding at fair value through profit or loss ("P&L") and book any resulting gains/losses in P&L, potentially resulting in unintended P&L volatility for Entity A which may arise due to wider market volatility at the reporting year end date. This example together with example F are the most relevant examples for the industry.

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.

See above response to example A (23)

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.

Same as Example E.

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.

Same as Example E.

20. Thank You!

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