ICAEW
REPRESENTATION 76/19

EQUITY INSTRUMENTS - RESEARCH ON MEASUREMENT

Issued 29 July 2019

ICAEW welcomes the opportunity to comment on *Equity Instruments - Research on Measurement* published by EFRAG in May 2019, a copy of which is available from this link.

We do not believe that changes to IFRS 9 *Financial Instruments* are necessary to reflect the performance and risks attached to equity and equity-type investments in long-term business models in order to encourage greater financing for sustainable projects. In our view, IFRS 9 does not pose an obstacle to broader policy objectives such as sustainability and long-term investment.

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KEY POINTS

FOCUS ON INVESTOR NEEDS

1. We believe that the receipt of transparent, faithfully represented financial information by capital providers is fundamental to their investment decisions and as such can be seen to underpin the efficient operation of financial markets. Accounting solutions should be determined principally on their merits in achieving the objective of meeting the information needs of investors - the primary users of annual financial statements under the IASB's Framework – not according to other social or economic policy objectives.
2. In our view, using financial reporting as a mechanism for achieving other social or economic policy objectives risks undermining the usefulness of financial statements and might, over time, have an adverse effect on companies. For example, lower levels of inward investment may follow if financial statements provide less decision-useful information for investors.
3. It is within this context that we have considered the questions posed in EFRAG's questionnaire.

IFRS 9 AND SUSTAINABILITY OBJECTIVES NOT MUTUALLY EXCLUSIVE

4. The questionnaire appears to assume that changes to IFRS 9 *Financial Instruments* are necessary to reflect the performance and risks attached to equity and equity-type investments in long-term business models in order to encourage greater financing for sustainable projects. We do not believe that IFRS 9 poses an obstacle to broader policy objectives such as sustainability and long-term investment.
5. Notwithstanding this position, we agree that it is important for the implementation of new standards to be reviewed at an appropriate juncture. However, there has been insufficient time for reporting entities to gain practical experience of implementing IFRS 9 and for evidence to be gathered to establish whether or not there are in fact any reporting or business concerns regarding equity instruments.

MAINTAINING A COMMON ACCOUNTING LANGUAGE

6. We also take this opportunity to reiterate the importance, in our view, of maintaining a common accounting language for capital markets.
7. In 2015, ICAEW issued the report *Moving to IFRS reporting: seven lessons learned from the European experience*. This report was produced largely as a consequence of the extensive consultation and research carried out by ICAEW in preparation for its response to the European Commission's 2014 study into the costs and benefits of applying IFRS. Both the EC's study and the ICAEW report concluded that IFRS had been successful in creating a common accounting language for capital markets and that preparers had mostly found the application of IFRS to be positive, with the benefits outweighing the costs. Importantly, investors also supported IFRS, identifying improvements in transparency and comparability of financial statements.
8. In our view, a move in the direction of developing European standards risks undermining investor confidence and damaging Europe's capital markets. We believe it is important for the EU to continue exercising leadership in the adoption of IFRS around the globe.

ANSWERS TO SPECIFIC QUESTIONS

GENERAL INFORMATION

How do you define long-term investment business model?

9. As discussed below, we do not believe it is necessary to define an accounting treatment alternative to IFRS 9 for equity instruments held in a 'long-term investment business model'

and, accordingly, do not believe it is necessary to define a 'long-term investment business model' for the purpose of this questionnaire.

Are you currently engaging in investment of sustainable activities?

10. Not applicable.

How do you define sustainable activities?

11. Following on from our response above regarding 'long-term investment business model', we do not discuss the definition of sustainable activities for the purpose of this questionnaire.

SPECIFIC QUESTIONS

Question 1

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

[ ] The actual holding period

[ ] The long-term nature of the liabilities that fund the assets

[x] Other

If you have indicated "Other" please provide details

12. We do not believe it is necessary to define an accounting treatment alternative to IFRS 9 for equity instruments held in a 'long-term investment business model' and, accordingly, do not believe it is necessary to define a 'long-term investment business model' for this purpose. Please see our response to question 3 for further detail.

Question 2

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 (x) No

Question 3

Explain the reasons for your reply to question 2, including the key operational challenges in developing a different accounting treatment to IFRS 9 requirements.

13. As noted in the questionnaire, investments in equity instruments within the scope of IFRS 9 are either measured at FVTPL or at FVOCI. If the FVOCI election is taken, only dividend income is recognised in profit or loss, and any gains or losses previously recognised in OCI are not reclassified to profit or loss when the asset is disposed of.

14. We understand that the IASB intended the FVOCI treatment to apply to equity investments held for 'strategic' reasons, that is, primarily for non-contractual benefits rather than for increases in value. We are able to support the FVOCI classification for such equity investments since the objective of holding them is not to generate gains or losses.

Therefore, changes in fair value are arguably never of primary relevance to the presentation of their financial performance, whether unrealised or realised on disposal.

15. For other types of equity securities, we believe that measurement at FVTPL provides the most relevant and reliable information. We would not support the introduction of a third category of equity securities, for example for equity instruments ‘held in a long-term investment model’, or amendments to the existing categories. In our view, this would introduce unnecessary complexity.

Question 4

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 OCI (so called “recycling”), which impairment model would you suggest and how it would work in practice?

16. In general, we believe total comprehensive income to be the most relevant measure when considering overall performance. Measures of profit or loss are however widely used, providing important additional information. It is essential, therefore, that measures of profit and loss provide information that is as useful as possible.

17. For this reason, some gains and losses are recognised in OCI rather than in profit or loss, usually because the gain or loss in question is not properly regarded as part of ‘performance’ during the period. Such amounts, if included in profit or loss, would lead to a measure of profit or loss that is less useful, when used in conjunction with other relevant information, either in judging performance during the period or in helping to make forecasts of future performance. As explained below, we believe that the effect of recycling will usually be to produce a less useful figure of profit or loss for the year, as it would include items that do not have any predictive value and that are only weakly connected with the company’s performance in the year in which they are recycled.

18. With this in mind, we continue to hold the view that it would not be appropriate to introduce recycling (and impairment) for genuine ‘strategic’ investments in equity instruments which are classified as FVOCI. Even if the FVOCI classification were applied to a wider group of investments, for example equity instruments held in a ‘long-term business model’, we do not agree that recycling and impairment would be appropriate.

19. This is because we do not consider that presenting accumulated fair value changes for investments in equity or equity-like instruments in profit or loss in a single period on disposal reflects the investor’s periodic performance. The gains or losses may have arisen over a number of periods and should be recognised only once, as they arose, in OCI. In our view, therefore, the information resulting from recycling can be potentially confusing and unhelpful for investors.

20. Further, we consider that recycling accumulated fair value changes in respect of individual investments can obscure an entity’s performance across a portfolio as a whole and could lead to opportunities for manipulation of profit or loss ie, selective disposals can be made to enhance reported profit; this can occur even when fair values both for the specific investments disposed of and for the portfolio as a whole have declined in the period. In our view, the fact that recycling can create an accounting-related incentive to dispose of equity investments at certain times suggests it would not in fact be conducive to long-term investing.

21. Introducing recycling for FVOCI equity instruments would, in our view, cause significant additional complexity which would outweigh any perceived benefits. A major element of this complexity would relate to the impairment model, which would need to be introduced if recycling were applied.

Question 5

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.

[ ] Yes [x] No

Please explain your answer.

22. As discussed under question 4, we do not believe that a different accounting treatment should be introduced for equity instruments held in a 'long-term investment business model.'

Question 6

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 measure 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 [x] No

Please explain your answer.

23. We do not believe that a different accounting treatment should be introduced for equity instruments or 'equity-type' instruments held in a 'long-term investment business model.' Please see our response to question 4 for further detail.

Question 7

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

[ ] Mutual funds

[ ] Other

If you have indicated "Other" please provide details.

24. Not applicable.

Question 8

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. Not relevant at all

[0] ____________________[_0_]______________Most Relevant [100]

25. We do not believe that changes to IFRS 9 are necessary to reflect the performance and risks attached to equity and equity-type investments in long-term business models in order to encourage greater financing for sustainable projects. That is, in our view, IFRS 9 does not pose an obstacle to broader policy objectives such as sustainability and long-term investment.

26. Furthermore, while we agree that it is important for the implementation of new standards to be reviewed at an appropriate juncture, we believe there has been insufficient time for reporting entities to gain practical experience of implementing IFRS 9 and for evidence to

be gathered on whether or not there are in fact any reporting or business concerns regarding equity instruments.

Question 9

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.

27. No. Please see our response to question 3.

ILLUSTRATIVE EXAMPLES

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.

Illustrative example A - Wind farm with predetermined useful life

• Entity A holds a 10% non-controlling equity instrument in Entity B. Entity B does not qualify as an associate and, as a consequence, does not qualify for equity accounting.

• Entity B has been set up to build and operate a wind farm as part of a long-term renewable energy programme. At the end of the economic life of the wind farm (10 years) no residual value is expected, and Entity B could either seek additional financing to build a new asset or be put into liquidation.

• Entity A initially expects Entity B to generate a stable annual profit and distribute it to shareholders. Furthermore, given the business purpose of the equity instrument, the terms and conditions of investing in Entity B prohibit investors from selling their equity investment during the 10-year period. Entity A is therefore required to hold its investment in Entity B for the full economic 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 (x) No

If yes, please explain why.

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

________The sustainable nature of the investee's operation

________The definite useful life of the investee's operation

________The investor's inability to dispose of the shares

Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

Illustrative example B - Unlisted single equity instrument

• Entity A buys a 10% equity instrument in Entity B from Entity C for CU 1000. Entity B is an unlisted start-up company manufacturing electronic scooters to be used in the e-scooter sharing industry. Entity B does not qualify as an associate and, as a consequence, does not qualify for equity Accounting.

• Entity A intends to hold the equity instrument in Entity B for the purpose of creating value in the long term by generating a capital gain after a period of time during which Entity B is likely to have gone through a significant transformation.

• Entity A does not have a put option and there are no observable recurring transactions in the equity of Entity B. Due to these conditions, Entity A does not expect to dispose of its interest in Entity B in the near future. 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 (x) No

If yes, please explain why.

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

________***The fact that the shares are unlisted***

________***The fact that the investor does not have a put option***

________***The sustainable nature of the investee's operation***

Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability Scenario C

• Entity A holds a portfolio of various financial instruments, including equity instruments that do not qualify as subsidiaries nor as associates, therefore do not quality for consolidation nor for equity accounting. The objective of entity A is to use the proceeds from the portfolio to serve the cash flows from a long-term obligation of issued insurance contracts.

• Entity A sets up a dedicated "asset base" to serve the long-term obligation which is expected to be settled over the next 30 years. The portfolio includes a significant portion of shares in unlisted corporates, although there is no legal constraint on the composition of the portfolio.

• Entity A regularly monitors the value changes in the portfolio and may occasionally sell part of it and reinvest the proceeds, with a view to achieve its target returns

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 (x) No

If yes, please explain why.

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

________The link to a long-term obligation (insurance contracts)

________The fact that the entity holds a portfolio of equity instruments

________The fact that the shares are unlisted

Which accounting treatments do you support?
( ) Historical cost
( ) Average fair value
( ) Adjusted cost
( ) Adjusted fair value
( ) Allocation-based approaches
(x) Existing requirements are appropriate
( ) 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.

Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability

Same fact pattern as Scenario C but the liability is an obligation or financial liability other than insurance contracts, for example a decommissioning liability per IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

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 (x) No
If yes, please explain why.

Which element in the scenario is more relevant for your reply?
________The link to a long-term obligation
________The fact that the entity holds a portfolio of equity instruments
________The fact that the shares are unlisted

Which accounting treatments do you support?
( ) Historical cost
( ) Average fair value
( ) Adjusted cost
( ) Adjusted fair value
( ) Allocation-based approaches
(x) Existing requirements are appropriate
( ) 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.

Illustrative example E - Long-term investment held indirectly through a unit fund - listed

• Entity A acquires units in Exchange Traded Funds (ETF) as part of a larger investment portfolio.
• Each ETF invests in a diversified portfolio of financial and non-financial assets. Entity A does not have control over the investment decisions of the funds, which are managed independently.
• Entity A's past practice indicates that, on average, it will hold these units for approximately six months although the holding period varies considerably from one investment to another. When the units are redeemed or sold, Entity A expects to acquire another investment or investments.
• In its management report and other public statements, Entity A presents itself as a long-term investor whose strategy is to allocate assets so as to generate an economic return over time.
• Under IFRS 9, Entity A will be required to classify the investment as FVPL. Refer to Equity-type instruments in Chapter 4 of the Secretariat background paper for more information. 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 (x) No
If yes, please explain why.

Which element in the scenario is more relevant for your reply?
________The investor's assessment of the long-term nature of its investment
________The listed feature of the fund
________The investor's ability to redeem or sell

Which accounting treatments do you support?
( ) Historical cost
( ) Average fair value
( ) Adjusted cost
( ) Adjusted fair value
( ) Allocation-based approaches
(x) Existing requirements are appropriate
( ) 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.

Illustrative example F - Long-term investment held indirectly through a unit fund - non-listed

Same fact pattern as Scenario E above, except that the fund is unlisted.

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 (x) No
If yes, please explain why.

Which element in the scenario is more relevant for your reply?
________The investor's assessment of the long-term nature of its investment
________The unlisted feature of the fund
________The investor's ability to redeem or sell

Which accounting treatments do you support?
( ) Historical cost
( ) Average fair value
( ) Adjusted cost
( ) Adjusted fair value
( ) Allocation-based approaches
(x) Existing requirements are appropriate
( ) 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.