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

AFRAC Working Group International Financial Reporting

2. Country of operation

Austria

3. Job title

4. E-mail address

katharina.van.bakel-auer@afrac.at

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

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

Investments by an entity that are held for the long term.
This does not necessarily imply that the underlying business of the investee are long-term.

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

8. How do you define sustainable activities?

Activities that contribute to a better living for society over generations without harm to nature and excessive consumption of resources.

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
The actual holding period
Other

If you have indicated "Other" please provide details

fungibility of investment (e.g., listing of the investment)

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

We are strongly against the current IFRS 9 option for FVOCI with no recycling. In addition to losing the clean surplus property for profit or loss, it treats dividends and holding gains/losses differently.

While some contend that FV (and FVPL specifically) is the most useful measurement basis for any purpose, we believe there is merit to other bases, particularly to reduce short-term P&L volatility that is expected to be irrelevant to the entity.

We believe that long-term investments should be measured differently from current IFRS requirements. A true and fair view on a long-term business model is not reflected properly by taking a snapshot of a volatile asset value and less volatile liabilities. If there are, say, 10 years to go in a long-term contract the relevance of daily volatility is of minor importance for the assessment of the value of the contract. If the assets are illiquid or not attractive to be sold, short-term business models are in trouble and the consequences of the upcoming realization of the net worth of activities and transactions should be included in the measurement. But to disclose it in the same way for long-term business models is not the proper presentation.

The OCI option in IFRS 9 lacks a proper matching of line items in the P&L and is therefore also not suitable for an accurate presentation. Furthermore, different pay-out ratios can distort the economic substance of an investment if the economic substance is finally realized when exiting.

This applies regardless whether long-term equity instruments are on listed or unlisted companies. In the absence of a directly observable market price and in the context of a business model that does not consider short-term volatility in the first place; the fair value as defined by IFRS 13 does not properly reflect the nature of the investments. Yet listing can be useful as an indicator of fungibility of the investment.
We do not see a relation to a sustainability motive in investing. Rather, it is the entity's (documented) intent to hold an investment in the long-term term. "Sustainability" is not itself a useful characteristic for a different accounting treatment.
We favor a principles-based approach rather than regulation of exemptions from principles to induce a specific desired behavior of entities. A principles-based approach is also necessary to avoid structuring of investments just for a desired accounting treatment.

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 suggest an adjusted cost measurement. One example of such an adjusted measurement is the equity method, as currently used for investments in associates. The advantage is that the carrying amount of the long-term investment is adjusted by equity changes of the investee.

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 we state in our answer to Question 6, equity-type instruments should also be eligible for the different accounting treatment.

On the other hand, long-term debt is measured at cost, so there is no need to consider an alternative accounting treatment.

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

The accounting treatment for long-term investments should be open for units of investment funds because they can be very close to equity (e.g., closed funds, restrictions on refund depending on liquidity, price and timeline). The variety of such funds in practice is large and the terms and restrictions around "being puttable" differ widely (e.g., private equity funds).

This does not imply that all investment funds should ideally qualify. But it would be difficult to find a conceptually sound and practical definition of the kind of investments that a qualifying investment fund can hold.

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.

30

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.

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 main reasons are the intent (or a factual restriction to sell) of the investor to hold the investment for in the long-term. In this case, a fair-value measurement is not decision-useful.

Moreover, the fact that the investment has a definite useful life is relevant because it moves the investment from its substance more into the direction of property, plant and equipment.

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

1. The definite useful life of the investee's operation

23. Which accounting treatments do you support?

Adjusted 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.

The main reasons are the intent (or a factual restriction to sell) of the investor to hold the investment for in the long-term. In this case, a fair-value measurement is not decision-useful.

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

1. The fact that the shares are unlisted

26. Which accounting treatments do you support?

Adjusted 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.

Overall an asset-liability-mismatch should be avoided when IFRS 17 becomes applicable from 2022 onwards. (For that reason, insurers are still not applying IFRS 9 so far.)

Yet we do not think that linking the measurement of long-term investments with any long-term liability is conceptually sound. We would prefer considering an extension of hedge accounting rules to capture such linked items.

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?

Adjusted 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.

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 in Example C. The only difference is the higher predictability of the cash flows compared to the insurance case.

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?

Adjusted 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.

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

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

No

If yes, please explain why.

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

1. The listed feature of the fund

35. Which accounting treatments do you support?

Existing requirements are appropriate

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.

Yes

If yes, please explain why.

Depending on the facts and circumstances, this example is suggestive that the fund is not fungible, thus indicating that the entity intends to hold the fund for the long term.

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
2. The unlisted feature of the fund

38. Which accounting treatments do you support?

Adjusted 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.

20. Thank You!

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