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Equity Instruments: research on measurement Issues Paper

Objective

- 1 The objective of this agenda paper is to update the EFRAG Board on the proposed structure and key elements of the proposed EFRAG advice to the European Commission (the 'EC') request.

Introduction

- 2 EFRAG's reply to the EC will include a comparative assessment of alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments and appendices related to EFRAG work on the topic (e.g. EFRAG feedback statement).

Structure and key elements of EFRAG's reply to the European Commission

- 3 EFRAG's reply to the EC is expected to have 6 Chapters that address different topics.

Section	Description
Executive Summary	
Chapter 1 – Introduction	<p>This chapter summarises:</p> <ul style="list-style-type: none"> • the accounting treatment requirements for equity instruments in IFRS Standards; • EFRAG's endorsement advice on IFRS 9 <i>Financial Instruments</i>; • the request from the EC in 2017 and EFRAG's reply to the EC in 2018; • the request from the EC in 2018; • the objective of EFRAG's advice.
Chapter 2 – Summary of survey's results	This chapter is based on the executive summary of EFRAG's feedback Statement that is going to be published separately.
Chapter 3 – Base Case: IFRS 9 <i>Financial Instruments</i>	<p>This chapter discusses the approach followed in IFRS 9:</p> <ul style="list-style-type: none"> • the use of fair value in the statement of financial position;

	<ul style="list-style-type: none"> • the recognition of fair value changes in the statement of financial performance, including the pros and cons of: <ul style="list-style-type: none"> ○ the FVPL approach; ○ the FVOCI approach (without recycling) and • a comparison of IFRS with US GAAP
<p>Chapter 4 – Possible alternatives</p>	<p>Section 1 - General introduction</p> <p>The section discusses various aspects of the different models:</p> <ul style="list-style-type: none"> • the notion of sustainability, including reference to the limited evidence received on whether alternative accounting treatments to fair value would contribute to the objective of the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change; and • Lack of support for sustainability being an accounting feature; • preliminary high-level models do not necessarily reflect all possible requirements or aspects; • assumption that dividends will continue to be recognised through profit or loss; • dual meaning of impairment with reference to fair value models and cost models; and • unit of account issues, including the question around P*Q are not addressed. <p>Section 2 - Alternative accounting treatments</p> <p>This chapter considers some alternative models to fair value, including the pros and cons raised by EFRAG's constituents.</p> <p>Models based on existing IFRS measurement basis</p> <p><i>Valuation methods</i></p> <ul style="list-style-type: none"> • FVOCI with recycling, impairment and reversal • FVPL as the only approach (ie without FVOCI) <p><i>Cost models</i></p> <ul style="list-style-type: none"> • Historical cost less impairment; • Modified historical cost: a model similar to the equity method or a model where historical cost is adjusted for observable market conditions; <p>Theoretical models</p> <p><i>Valuation methods</i></p> <ul style="list-style-type: none"> • Fair value moving average: the use of a moving average of fair value to reduce the impact of market volatility;

	<ul style="list-style-type: none"> • Revaluation model: all declines in fair value below the acquisition cost would be recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI (recycled on disposal). <p>Other models mentioned by respondents</p> <p>This chapter also considers models proposed in the survey and not identified above include:</p> <ul style="list-style-type: none"> • Management orientation and strategy (Entity specific DCF) • Dedicated portfolio approach (ALM) • Strategic investments approach • Connection with variable fee approach <p>Section 3 - Alternative impairment approaches</p> <p>In addition, this chapter considers alternative impairment approaches (qualitative and quantitative) including those based on IFRS 9, IAS 39 and IAS 36 (including value in use - entity specific discounted cash flow model)</p>
<p>Chapter 5 – Equity-Type Instruments</p>	<p>If an alternative accounting treatment was also to be applied to ‘equity-type’ instruments, then ‘equity-type’ would need to be defined. This chapter considers possible definitions of ‘equity-type’ and whether the models identified in the report could be applied to such instruments.</p> <ul style="list-style-type: none"> • What are equity-type instruments? • Considerations in defining equity-type instruments <ul style="list-style-type: none"> ○ The nature of the units in an investment fund ○ IAS 32 puttable exceptions ○ Types of underlying assets (including possible test that ensures funds are mainly equity) ○ The sustainable nature of the activities invested in ○ Combined approach • Summary of results from survey • Treatment under IFRS 9 and US GAAP • What models could be applied to equity-type instruments? <ul style="list-style-type: none"> ○ Fair value models ○ Cost models
<p>Chapter 6 - Summary</p>	<p>This chapter includes a summary of the key characteristics of the different approaches identified in the report. The alternative accounting treatments are compared against some factors and criteria such as relevance, reliability and operability.</p>

Appendix 1 – Summary of Previous Research	This appendix provides a detailed summary of EFRAG's previous research on the classification of equity instruments.
Appendix 2 – Feedback Statement on EFRAG's public Consultation	This chapter will include EFRAG's feedback Statement that is going to be published separately.

Questions for EFRAG Board

- 4 Do EFRAG Board members have comments on the proposed structure and key elements of EFRAG reply to the European Commission request?