EFRAG

European Financial Reporting Advisory Group

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Equity team

EQUITY INSTRUMENTS – ALTERNATIVE MEASUREMENT APPROACHES

EFRAG

DISCUSSION PAPER

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EFRAG
European Financial Reporting Advisory Group

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European Financial Reporting Advisory Group ('EFRAG') issued this Discussion Paper.

Copies of the Discussion Paper are available from EFRAG's website.

EFRAG welcomes comments on proposals explored in this paper via the 'Questions to Constituents'. Such comments should be submitted through the EFRAG website by clicking here or should be sent by post to:

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Comments should arrive no later than xx xxxx 2019. EFRAG will place all comments received on the public record unless confidentiality is requested.

EFRAG
European Financial Reporting Advisory Group

EFRAG Research Activities in Europe

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin our research work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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Executive Summary

ES 1 International Financial Reporting Standard 9 ('IFRS 9') *Financial Instruments* is effective for annual periods beginning on or after 1 January 2018 except for entities undertaking insurance activities. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may however make an irrevocable election to present changes in the fair value in other comprehensive income ('OCI') on an instrument-by-instrument basis (the 'FVOCI election'). If an entity applies the FVOCI election, it does not assess these instruments for impairment and cannot reclassify in profit and loss gains or losses previously recognised in OCI on disposal of these instruments – also referred to as 'recycling'.

ES 2 In its endorsement advice on IFRS 9, EFRAG expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling might not properly reflect their performance.

ES 3 The European Commission ('the EC') requested EFRAG to consider alternative accounting treatments for equity and equity-type investments. The EC request is provided in Appendix 1. The request asks EFRAG to consider alternative accounting treatments to fair value that would properly reflect the performance and risks of long term investment business models. In particular, those that are related to those investments essential to achieve the UN Sustainable Development Goals and the Paris Agreement on climate change.

ES 4 The DP discusses the implications of including equity-type instruments in such measurement as well as possible approaches to defining long-term investment.

ES 5 The DP identifies a number of alternative measurement bases to depict the performance of long-term equity investments. Historical cost and averages fair value are the most established ones and are evaluated the alternatives against the technical criteria used for endorsement purposes and possible behavioural implications.

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this DP, particularly in relation to the questions set out below. Comments are more helpful if they:

a) address the question as stated;

b) indicate the specific paragraph reference to which the comments relate; and/or

c) describe any alternative approaches EFRAG should consider.

EFRAG should receive all comments by **xx XXXX 2019**.

EFRAG has not expressed a preliminary view on the issues explored in this DP. The objective of the DP is to obtain feedback from constituents that EFRAG will consider in developing its technical advice to the EC.

Question 1 – Scope of application

The DP discusses alternative measurement bases for equity instruments as defined in IAS 32 *Financial Instruments – Presentation* and units in certain investment funds, as discussed in paragraphs 2.3 to 2.9.

Q1.1 Do you think that the application of alternative measurement basis should be also extended to units in investment funds?

Q1.2 Do you think that the composition of the portfolio of the investment fund should be a factor in defining the scope of application?

Question 2 – Long-term investments

EFRAG has not reached a tentative position on whether a definition of 'long-term investments' is needed for the purpose of considering alternative measurement bases for such instruments, or what such definition could be.

Q2.1 Do you think that there should be an alternative measurement applied only to equity instruments that are held as 'long-term investments'?

Q2.2 If so, how would you define 'long-term investments'? How would you ensure that the definition is operational?

Question 3 – More than one measurement basis

EFRAG has focused on the reporting of performance and therefore the DP does not explore whether the alternative measurement would only be applied in profit or loss (with fair value used in the statement of financial position); or whether the alternative measurement would also be applied in the statement of financial position.

Q3.1 Would you support to maintain fair value in the statement of financial position and consider alternatives only in profit or loss?

Question 4 – More established alternatives

The DP considers whether historical cost or fair value averages could provide an improved basis for reporting the performance of entities that hold long-term portfolios of such instruments.

Q4.1 What are your views on either historical cost or fair value averages as a basis to report the performance of entities that hold long-term investments? Please explain your answer, including any alternatives you consider appropriate.

Chapter 1: Objective and background

The objective of the Discussion Paper

1.1 The main objective of this Discussion Paper ('the DP') is to gather constituents' views on possible ways of measuring equity and equity-type instruments as alternatives to the measurements required in IFRS 9 *Financial Instruments*. The DP considers whether these alternatives could provide an improved basis for reporting the performance of entities that hold such instruments as long-term investments.

1.2 The DP focuses mainly on measurement in profit or loss, which is widely considered to be the main indicator of financial performance. This is because the concerns expressed by European constituents on IFRS 9's requirements are, in EFRAG's experience, mainly in relation to the reporting of financial performance. EFRAG fully acknowledges that any comprehensive alternative accounting model would also need to include measurement in the statement of financial position.

The accounting requirements in IFRS 9 for equity instruments

1.3 The IASB issued IFRS 9 in July 2014. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. Entities undertaking insurance activities are permitted to apply IFRS 9 or on after 1 January 2021[1]. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('FVOCI'). This FVOCI election is available for all equity instruments, except those held for trading or contingent consideration recognised by an acquirer in a business combination. The entity may apply the FVOCI election on an instrument-by-instrument basis.

1.4 If the entity elects FVOCI, changes in fair value are presented in other comprehensive income ('OCI'). These changes are not reclassified into profit or loss ('recycled') on disposal and there is no requirement to assess these instruments for impairment. However, dividends that are a return on investment from the instruments are recognised directly in profit or loss.

1.5 It has been commented that FVPL is likely to become more frequent with the introduction of IFRS 9. This is partly due to the fact that some instruments previously classified as available-for-sale ('AFS') in accordance with the previous Standard (IAS 39 *Financial Instruments: Recognition Measurement)* will not be eligible for the FVOCI option. Furthermore, some entities may decide not elect the FVOCI option for eligible equity instruments because of the lack of recycling.

[1] The IASB tentatively agreed at its November 2018 meeting to defer the effective date of IFRS 17 *Insurance Contracts* with one year with a consequential amendment to the mandatory effective date of IFRS 9 for insurers.

What are we looking at, and why?

1.6 In its Endorsement Advice to the European Commission ('the EC') on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL might not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG also noted that the FVOCI election was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance. EFRAG had previously stressed the importance of profit or loss as a main indicator of financial performance.

1.7 If neither option in IFRS 9 is attractive to some long-term investors, there may be a disincentive for those investors to hold equity instruments on a long-term basis and there are concerns that ultimately, less financing may be made available to entities to invest in the real economy. In its endorsement advice, based on the limited evidence available at that time, EFRAG assessed that it was unlikely that long-term investors would change their investment strategy as a result of IFRS 9. EFRAG noted that broader economic considerations, such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders, are likely to outweigh any accounting concerns.

1.8 The EC completed the endorsement process of IFRS 9 with the adoption of Commission Regulation No 2016/2067 on 22 November 2016. During the endorsement process, the European Parliament and some Member States called for close monitoring of the impact of IFRS 9 to ensure that it serves the European Union's long-term investment strategy.

EFRAG's activities so far

1.9 In May 2017, EFRAG received a request from the EC for technical advice.. The request has two distinct phases:

a) in the first phase ('the assessment phase'), the EC requests EFRAG to investigate the significance of the equity portfolio for long-term investors under IAS 39 and whether the new requirements in IFRS 9 are expected to affect asset allocation decisions; and

b) in the second phase, the EC requests EFRAG to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is an important element in order to re-introduce recycling, then EFRAG should consider how the impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches. The EC also requests EFRAG to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements that could enable users to form a view about the performance of the equity investments.

1.10 EFRAG reported its findings from the assessment phase to the EC in January 2018 and presents a summary of the main findings in Appendix 2. The assessment phase has indicated that for some entities that consider themselves long-term investors, the aggregate amount/value of equity instruments classified as AFS under IAS 39 *Financial Instruments: Recognition and Measurement* is substantial. On the other hand, some other entities that also consider themselves as long-term

investors make little or no use of the AFS classification and as a result, they will not be affected by IFRS 9's requirements.

1.11 In terms of the impact of IFRS 9 on respondents' decisions to invest and hold equity instruments or other class of assets, most respondents indicated that a variety of factors, including business, economic and regulatory factors, affect such decisions. However, almost half of the respondents (mainly insurance entities) reported that they expect to modify their asset allocation decisions as a result of IFRS 9's requirements, although most did not specify to what extent.

1.12 EFRAG reported its technical advice for the second phase of the EC request in November 2018 on possible ways to improve the requirements of IFRS 9 on accounting for equity instruments from a long-term investing perspective. In EFRAG's view a robust impairment model is a necessary complement to any reintroduction of recycling for equity instruments carried at FVOCI. This is due to several reasons including: a desire for consistency with other IFRS Standards and categories of assets; to provide information for users to evaluate stewardship; to achieve comparability among financial statements, to provide an assessment of future cash flow prospects; to eliminate or reduce any accounting-related incentive to maintain loss-making equity investments for an indefinite period; and to avoid recognition of losses only upon realisation which would not be consistent with the notion of prudence.

1.13 EFRAG maintained that a degree of rigour in the use of the election or an impairment model would be essential to ensure comparability. It noted that the majority of respondents expressed a preference for a model similar to the IAS 39 model but, unlike IAS 39, the model should allow the reversal of impairment losses. However, there were different views on how else the model should be improved.

1.14 The High-Level Expert Group on Sustainable Finance final report to the EC on 31 January 2018 recommended, among other things, to investigate alternative accounting approaches to fair value/mark-to-market valuation for long-term investment portfolios of equity and equity-type instruments.

1.15 In June 2018, EFRAG received a new request for technical advice from the EC in relation to the accounting treatment of equity instruments. The EC request is provided in Appendix 1. The new request asks EFRAG to consider alternative accounting treatments to fair value. In the words of the request, 'possible accounting treatments should 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.'

1.16 The DP is intended to complement previous EFRAG discussion and consultations on the accounting treatment for equity instruments, For this reason, the DP does not address or request views either on the two measurement bases in IFRS 9, nor on FVOCI with recycling, which was the object of the prior consultation document. Constituents' input from previous consultations will be duly considered by EFRAG in developing its technical advice to the European Commission. Other aspects of IFRS 9, such as impairment or hedging requirements, are also outside the scope of this project.

Structure of the DP

1.17 **Chapter 2** discusses the scope of the DP, i.e. the type of instruments the DP applies to.

1.18 **Chapter 3** discusses the alternative ways in which the equity instruments might be measured for performance purposes.

1.19 **Chapter 4** considers alternatives in the context of the endorsement technical criteria and potential impact on behaviour by preparers.

1.20 **Appendix 1** provides the EC request for technical advice.

1.21 **Appendix 2** provides further information on the less established alternatives not further considered in this DP.

Chapter 2: Scope of application

Intended scope of application

2.1 This DP explores possible ways of measuring equity and equity-type instruments as alternatives to the measurements required in IFRS 9 *Financial Instruments* (i.e. FVPL or FVOCI without recycling). The DP considers whether these alternatives could provide an improved basis for reporting the performance of entities that hold long-term investments.

2.2 The DP does not discuss a reintroduction of recycling into the FVOCI category because constituents' views on this topic were sought in EFRAG's March 2018 Discussion Paper *Equity Instruments - Impairment and Recycling* ('the March 2018 DP').

Equity instruments

2.3 The instruments under consideration for the DP are those that meet the definition of equity instruments in IAS 32 *Financial Instruments: Presentation* paragraph 11, i.e. "[a] contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".

Equity-type instruments

2.4 Neither the EC request, nor the High-Level Expert Group on Sustainable Finance final report to the EC on 31 January 2018 defines the term "equity-type investments". Based on information received from EFRAG Working Groups[2] and responses to our previous consultations on this topic, our understanding is that these relate to puttable instruments from the holder's perspective such as units in investment funds.

2.5 From the issuer's perspective, puttable instruments that meet the requirements in IAS 32 paragraphs 16 A-D are met are still classified as equity as an exception. However, the exception does not apply to the holder of such instruments and therefore, the puttable feature means that the instrument is classified as debt[3]. When these instruments are puttable at fair value, they fail the SPPI[4] test in IFRS 9 and have to be carried at FVPL regardless of whether the business model test has been met.

2.6 The last part of the March 2018 DP included a question about other aspects of IFRS 9's requirements on accounting for holdings of equity instruments, which could be relevant to the depiction of the financial performance of long-term investors.

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[2] Including the 2018 Case Study on IFRS 17 *Insurance Contracts.*

[3] As indirectly confirmed by the IFRIC November 2013 agenda decision: https://www.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ifrs-10-ias-32-classification-of-puttable-i-that-are-non-controlling-interests-november-2013.pdf

[4] The requirement that all cash flows for the instrument should relate solely to payments of principal and interest.

2.7 Some of the respondents to this question mentioned that long-term investment in equities is not limited to holding instruments defined as equity in IAS 32 directly. Long-term investment can also be through indirect holdings in equity in the form, for example, of interests in Undertakings for Collective Investment Transferable Securities (UCITS), Exchange Traded Funds (ETFs), Authorised Investments Funds (AIFs). Some respondents argue that a comprehensive analysis of the long term investment business model needs to consider both direct and indirect holdings.

2.8 Under IFRS 9, interests in UCITS, ETFs and AIFs are considered to be debt instruments and have to be accounted for at FVPL since these would normally not meet the "solely payments of principal and interest" (SPPI) criteria. This is a significant change in accounting treatment compared to IAS 39 under which such holdings, other than those held for trading, are classified as AFS. Some constituents argue that FVPL leads to volatility in the statement of profit and loss that is not consistent with the long-term investment perspective.

2.9 The first question that arises is whether these investments should be treated as equity instruments which would allow the application of an alternative measurement basis as explored in the DP. If this is considered appropriate, the scope and the portfolio composition of the fund for purposes of such an exception has to be thought through.

2.10 Firstly, the scope has to be determined to avoid the use of an alternative measurement basis for various other instruments that fail the SPPI test. A seemingly simple way would be to allow the exception in IAS 32 for puttable instruments to be applied by holders of these instruments as well. Therefore, in such a case, if the investment qualifies, it can be measured using the alternative measurement basis. However, applying the IAS 32 puttable requirements may be difficult from a holder's perspective due to incomplete information. For example it may be hard to determine whether the relevant instrument is the most subordinate and whether the instrument entitles the holder to a pro rata share of the fund's net assets. Therefore, a different scope for such an exception from the holder's perspective may need to be delineated.

2.11 As treating these investments as equity instruments would allow the use of an alternative measurement basis, the question is whether this would be appropriate in all cases or whether one has to consider the investment portfolio of the fund in order to determine whether the investment in the fund could qualify for use of an alternative measurement basis. For instance, consider an investment fund with some investments in equity instruments but also a material open position in derivatives for trading purposes. In such a case, some may consider that the instrument may have been established to avoid recognising gains and losses on trading derivatives in profit or loss and that an alternative measurement basis would not be appropriate. In such a case, a 'look-through' test may be necessary to be applied as well before such an instrument can be classified as an equity instrument.

Long-term investment

2.12 The EC request refers to 'long-term investment portfolios' and the High-Level Expert Group to 'balance sheets of long-term investors such as non-financial corporations, insurance companies and banks'. There is however no definition of long-term in IFRS Standards.

2.13 IAS 1 *Presentation of Financial Statements* requires entities to classify assets and liabilities as current or non-current for presentation purposes in their statement of financial position. An asset is classified as current when:

a) The entity expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

b) The entity holds the asset primarily for the purpose of trading;

c) The entity expects to realise the asset within twelve months after the reporting period; or

d) The asset is cash or cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

2.14 IFRS 9 does not refer to short-term or long-term. IFRS 9 does not allow entities to use the FVOCI for equity instruments that are held for trading. A financial asset is held for trading when:

a) It is acquired…principally for the purpose of selling or repurchasing it in the near term;

b) On initial recognition, is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or

c) Is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

2.15 IFRS 9 illustrates a business model whose objective is to hold assets in order to collect contractual cash flows; a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and other business models. Paragraph B4.1.5 notes that a business model that results in measurement at FVPL is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets.

2.16 It is clear that the notions of 'held for trading' and 'short-term' overlap at least in part, but it cannot be concluded that any instrument not held for trading should automatically considered as 'long-term'.

2.17 There is no indication that the IASB intended to differentiate the treatment of equity instruments based on a notion of 'long-term holding'. In a blog[5], Sue Lloyd, Vice-chair of the IASB explained that the IASB considered in some unusual cases, the presentation of fair value changes in profit or loss may not be indicative of the investor's performance. However, the IASB envisaged investments that have a 'strategic' purpose, intended to strengthen business relationships or provide access to specific markets rather than being held for dividend receipts or capital appreciation.

2.18 Eventually, the IASB decided not to develop qualifying criteria for the use of the FVOCI election, mostly due to the definitional challenges this would pose.

[5] https://www.ifrs.org/news-and-events/2018/04/ifrs-9-and-equity-investments/

2.19 In general, measurement requirements under IFRS Standards are not dependent on a notion of expected duration. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* may go close to it, by changing the measurement requirements for non-current assets held for sale and using, as one of the qualifying criteria, the fact that the sale should be expected to be completed within one year from the date of classification.

2.20 Measurement requirements based on a notion of expected duration can only be traced back to before IAS 39 became effective in 2001. IAS 39 superseded the portions of IAS 25 *Accounting for Investments* that dealt with debt and equity instruments. Previously, IAS 25 required the measurement of marketable equity instruments classified as long-term assets at the lower of cost and market value determined on a portfolio basis.

2.21 EFRAG debated whether a definition of 'long-term' investments is needed for the purpose of considering alternative measurement bases for equity instruments, but did not reach a conclusion. It also debated how such a definition could be developed, but no consensus emerged as to what this would include.

2.22 If a definition was deemed necessary, the following characteristics could be used individually or in combination to develop it:

a) The expected or actual holding period – this would tie-in to the notion of long-term investment (rather than investor);

b) The characteristics/ business model of the investor – this would tie-in to the notion of long-term investor;

c) The long-term nature of the (underlying) liabilities - some constituents claimed that equities may be held with the view to meeting obligations under long-term liabilities, and this linkage should be reflected in the way the investments are accounted for.

The characteristics/ business model of the investor

2.23 The EC in its Green Paper Long-term financing of the European Economy issued in 2013 described the capacity of financial institutions to channel long-term finance as a business model in its investment portfolio.

2.24 The EC paper also described the financing process as a central issue to support structural economic reform and the return to the long-run trend of economic growth. Long-term financing is also needed throughout the whole lifecycle of a company, helping to start a business, allowing it to grow and then sustaining its growth. Long-term financing would support the transition of companies as they progress through this life cycle.

2.25 In July 2015, EFRAG issued a Bulletin *Profit or loss versus OCI,* which identified four groups of business models, one of which was the long-term investment business model. The business models used, for example, by banks and insurance entities would generally belong to this group, although banks may also undertake short-term trading activities.

2.26 In a long-term investment business model, entities acquire assets in order to generate a stream of revenue from period to period. Nevertheless, the ultimate cash inflow from the asset is often through sale in the market in which it was originally bought and, generally, in a similar 'condition' as when it was bought. Cash flows are

generated by holding the asset (e.g. in the form of dividends, or income from letting others use the asset) and from sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective.

2.27 Several frameworks have been proposed to categorise business models and could be used to refine the content of the EC paper and EFRAG bulletin mentioned above. However, a differentiation based on the nature of the business model would be inherently judgmental, especially for complex entities.

The expected or actual holding period

2.28 The expected or actual holding period would be more practical than a qualitative definition if it was defined using a numerical threshold. That would enhance comparability among companies when they categorise their investment portfolios.

2.29 However, a numerical threshold is arbitrary by nature, and it would have operational issues, such as the level of sales compatible with the long-term definition.

The long-term nature of the (underlying) liabilities

2.30 Some IFRS Standards allow the use of accounting mechanisms to reflect a linkage between assets and liabilities. Paragraph 6.58 of the Conceptual Framework for Financial Reporting recognises that, in some circumstances, when assets and liabilities are related in some way, using the same measurement basis for the related assets and liabilities contributes to the usefulness of information.

2.31 During the prior EFRAG consultation, some constituents claimed that equities may be held with the view to meeting obligations under long-term liabilities, and this linkage should be reflected in the way the investments are accounted for.

2.32 For instance, insurance companies invest in equities and other assets to generate cash inflows used to settle their insurance liabilities. Energy companies may invest in equities to generate cash inflows to settle their obligations in relation to decommissioning of nuclear plants.

2.33 However, a differentiation based on this criterion gives rise to a number of conceptual and operational challenges. Firstly, there would be a need to determine if simply entering into long-term liabilities would be sufficient to qualify for long-term investing or a more stringent link between the liabilities and the investments in concern would be needed.

2.34 Secondly, and subject to the above, the range of qualifying liabilities could include items that are measured differently (amortised cost, fulfilment cost, best estimate of the settlement amount). In that case, the accounting mechanism would need to be articulated differently based on the measurement feature of the liability, or the measurement of the qualifying liabilities would have to be modified.

2.35 Given the concerns mentioned in the EC request, another relevant characteristic could be the nature of the investee and its activities. The regulation on European long-term investment funds[6] (ELTIF) has been developed with the objective to raise and channel capital towards European long-term investments in the real economy, in line with the EU objective of smart, sustainable and inclusive growth.

[6] Regulation 2015/760

2.36 The regulation does not define ‘long-term’ but instead provides stringent criteria around the eligible investments in terms of both the nature of the direct assets (infrastructure, public buildings, social infrastructure, transport, sustainable energy and communications infrastructure) and the issuers whose instruments ELTIF are allowed to hold (unlisted entities and listed entities with a market capitalisation below a specified threshold).

2.37 Specific questions on the scope of application and definition of long-term are included in the Questions to Constituents.

Chapter 3: More established alternatives

3.1 The basic measurement choices established in both IFRS Standards and most other accounting frameworks can be characterised as historical cost and current value. Before IFRS 9 became effective, IAS 39 required fair value for equity instruments with the changes recognised either in profit or loss (for instruments classified as held-for-trading) or OCI (for AFS instruments). Only instruments without a quoted price on an active market and whose fair value could not be reliably measured were carried at cost. For equity instruments classified as AFS, the amounts recognised in OCI were recycled to profit or loss upon disposal or impairment.

3.2 IAS 27 *Separate Financial Statements* allows entities to measure investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 or using the equity method.

3.3 This DP firstly explores historical cost and fair value averages as possible alternatives in the short term given that they more established and well known. EFRAG has considered other alternatives that are described in Appendix 2. These alternatives are less established and would need to be further developed before being considered for standard-setting purposes.

3.4 The DP focuses on measurement in profit or loss. Some of the approaches explored in the DP could be also be used in the statement for financial position. For instance:

a) Historical cost could be used as a measurement basis in the statement of financial position. In that case an entity would not recognise remeasurement gains or losses and only recognise gains or losses in profit or loss to recognise an impairment loss or when the equity instrument is derecognised;

b) Fair value could be used as a measurement basis in the statement of financial position and historical cost to measure the performance in profit or loss. In that case, an entity would recognise remeasurement gains or losses on the equity instrument in OCI, and only recognise gains or losses in profit or loss to recognise an impairment loss or when the equity instrument is derecognised.

3.5 As explained in paragraph 1.2 EFRAG has focused its discussion on the measurement of the performance in profit or loss. For this reason, the DP does not consider in detail whether the approaches explored could or should also be used as a measurement bases in the statement of financial position.

3.6 EFRAG notes that the use of fair value to measure equity instruments is well established in IFRS Standards and provides relevant information about the entity's financial position. However, some raise concern about the verifiability of fair value for equity instruments for which no market price is available.

Historical cost

3.7 Accounting was founded on the concept of historical cost and it has been used for a long period also for equity instruments. IAS 39 allowed cost to be used in limited circumstances and IFRS 9 permits that in a small number of cases cost could be a proxy for fair value – although not for quoted instruments.

3.8 Given the familiarity with the concept, this DP explores whether historical cost as measurement basis could reflect the performance and risk in a long-term

investment business model. Historical cost recognises the holding gain or loss (apart from impairment) once the final realisation is confirmed on disposal although that may have been earned over a period.

3.9 Historical cost is often viewed as simpler than other measurement bases such as fair value, but complex issues may arise in open portfolios. For example, the determination of cost on partial realisation where shares have been bought at different points in time, should FIFO, weighted average basis or another basis be used? Another complex issue is the determining of the occurrence and amount of impairment to be recognised in profit or loss.

3.10 The treatment of acquisition costs is not covered in the DP. Furthermore, the DP assumes that dividends will be recognised in profit or loss in accordance with IFRS 15 *Revenue from Contracts with Customers* however, it may be necessary to consider the interaction between recognition of dividends in profit or loss and the cost of the investment.

Average fair value

3.11 A component of the fluctuations observed in fair value possibly relates to it being a point in time value as well as the frequency of measurement (i.e. every reporting period compared . A way to reduce the perceived volatility of a point in time value could be to use the average of fair value estimates rather than the value at the reporting date.

3.12 There are a number of ways in which an average of fair value could be determined. It could be based on quarterly estimates or even daily estimates for the month or week around the reporting date.

3.13 Another point to consider is whether such a measurement basis would require an impairment test or whether this is considered to be superfluous.

3.14 Specific questions on the measurement basis in the statement of financial position and preferred alternative measurement basis are included in the Questions to Constituents.

Chapter 4: Evaluating the alternatives

Introduction

4.1 Chapter 3 presents possible basic measurement methods for equity and equity-type instruments to portray performance. The central issue of this DP is determining whether these alternatives could provide an improved basis for reporting the performance of entities that hold long-term portfolios of such instruments.

4.2 A good starting point for the discussion about the measurement of equity instruments may be to consider the portrayal of a reporting entity's performance with respect to its investment over time. Setting aside the recognition of dividends which is recognised on an accrual basis, most agree that for investments held for trading, the depiction of performance should include current changes in fair value. This is due to the nature of the business model, which achieves its objective by short-term profit taking.

4.3 This DP aims to address the performance of investments in equity instruments that are part of a long-term investment portfolio. As noted above, there is no broad consensus on how to portray the performance of such a business model. Some argue that whilst the business model may be different, it should not change how performance is reported. Others disagree and note that entities should be able to select a different way to report their investment performance based on their business model.

4.4 An issue with IFRS 9, for some, is that one of the choices of measuring performance does not reflect gains or losses in that performance. Realisation or the conversion of an equity instrument into cash may be an important event which necessitates recognition in profit or loss even if this may refer to an increase in value attained over a number of years.

4.5 For others, the gain or loss realised in the conversion into cash accrued in earlier periods should be reflected in those periods when it 'accrued'.

4.6 In this chapter, EFRAG considers aspects of the two alternative methods described in Chapter 3 in terms of technical criteria and whether the alternatives may have any potential effects on behaviour.

4.7 EFRAG notes that each alternative may need to be accompanied by specific disclosure requirements; that have not been considered in detail for the purpose of this DP.

Relevance

4.8 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

4.9 EFRAG's endorsement advice on IFRS 9 pointed out that the standard's FVOCI option for equity instruments that does not permit gains or losses from ever impacting profit or loss. In EFRAG's view, this may limit the relevance of the information as profit and loss is the primary indicator of performance.

4.10 Compared to the FVOCI option in IFRS 9, historical cost described in the prior chapter would result in recognition of gains on disposal, that may provide confirmatory value of the gains and therefore of stewardship.

4.11 Some are concerned that historical cost loses its relevance over time. However, others argue that this is no bigger a problem than irrelevant price fluctuations. Furthermore, IFRS 7 disclosures about the investment including the fair value of the instrument and price risk thereof could supplement management explanations as to the entity's performance.

4.12 Fair value based approaches, such as IFRS 9's FVPL treatment of equity instruments, are often considered to provide users with the most relevant information for most business models. Management generally has the ability to purchase, hold or dispose of individual investments in equity instruments each reporting period. On that basis, recognising average fair value for investments in equity instruments provide users with valuable insight to assess the stewardship of the entity's investment decisions on an ongoing basis.

4.13 On the other hand, it is noted that fair value changes based on average fair value at the reporting date may not be more relevant for long-term investments because the fair value changes may reverse before the entity actually disposes the investment.

Reliability

4.14 Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

4.15 Some consider that performance based on historical cost reflects realised results and is not impacted by short-term fluctuations in value – where average fair value may show an investment in an unfavourable light at a specific point in time when overall, with some patience, real value could be unlocked.

4.16 It may be argued that historical cost is more reliable than a fair value measurement, especially for equity instruments for which there is no market price available. However, assessing impairment losses for assets measured at cost involves the use of various judgements including whether such a loss should be recognised as well as the amount of such loss which may depend on estimates. Those impairment judgements could also be biased. As a result, the impact on reliability of each alternative other than those based on a Level 1 fair value measurement appears to be fairly similar to one another.

4.17 It may also be argued that recognition of fair value changes even if based on average fair value provides a faithful representation of the characteristics of equity instruments that do not have contractual cash flows or redemption amount.

4.18 However, average fair value may be more viable for highly liquid instruments, because daily fair values would not be available for unquoted instruments. To ensure comparability between entities, the accounting standard could select a specific average period.

4.19 The selection of a specific average would be necessarily arbitrary, and some may argue that it should be adjusted to the expected holding period. This discussion

would in substance replicate the debate about defining the ‘significant’ and ‘prolonged’ threshold in relation to the impairment model.

4.20 Furthermore, whilst such averaging may smooth the period end value, it does not mean that the change between two such averages would necessarily be less significant than the change between two fair values, thereby not necessarily reducing volatility in the balance sheet.

Comparability

4.21 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

4.22 IFRS 9 included an option to account for equity instruments in two different ways that results in outcomes that cannot be easily compared. Based on the election, an entity would report changes in fair value either in profit or loss or in OCI. Paragraph 82A of IAS 1 *Presentation of Financial Statements* would require an entity using the FVOCI election to present line items for items of OCI classified by nature.

4.23 Historical cost would be similar from a performance reporting perspective to FVOCI without recycling during the holding period, although there would be significant differences in the periods that investments are realised. Using averages for fair values would not greatly impact comparability on the assumption that the averaging occurs over the same period.

Understandability

4.24 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

4.25 Historical cost as well as the existing measurement approaches contained in IFRS 9 are well understood measurement approaches as these have been used for many years.

4.26 The averaging approaches discussed in this DP are systematic methods that provide a smoothing mechanism to fair value changes. If these approaches were adopted in IFRS it is unlikely understandability would be compromised as the methodology can be easily and clearly explained.

Prudence

4.27 For the purpose of this DP, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

4.28 Proponents of cost are likely to argue that fair value based measurements are not prudent and would prefer to recognise gains possibly only on realisation. However, prudent accounting for assets measured at cost would require timely recognition of impairment losses, which in turn would require a robust impairment model. The previous EFRAG consultation showed that there is no consensus on how to develop a robust impairment model for equity instruments.

Effects on behaviour

4.29 The use of fair value as measurement basis for equity instruments necessarily increases reported volatility during the holding period compared to cost. Many preparers have expressed concern that specifically volatility in profit or loss could impact the attractiveness of their issued equity instruments. In support, preparers point to sudden decreases in market prices of their issued equity instruments in response to lower than expected performance.

4.30 The concern is that such volatility in the price of its issued equities could have implications for future capital raising ventures. Others counter that the market response is due to unexpected outcomes and a lack of clear communication rather than volatility in performance *per se.* This is especially relevant where the volatility could be modelled, for example due to general volatility in market prices of equity instruments. The concerns around volatility could also lead to entities disinvesting when markets are experiencing losses, thus increasing a financial market downturn.

4.31 It is also suggested that the use of fair value can have pro-cyclical effects where capital regulations draw heavily on the accounting. The argument is that, if a bank has to write down its assets to reflect a decrease in market prices, the bank's regulatory capital may be depleted, which can negatively affect the availability of financing for the real economy. Others do not consider this a significant impact given the differences between capital regulations and accounting.

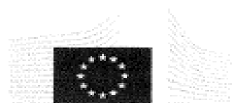
4.32 On the other side, it has been noted that the use of cost provides opportunity for selective profit-taking. In this way, the entity is able to decide the period in which a holding gain is recognised, although the gain has been accruing in other periods.

4.33 Others would instead consider that recognition of profit should be driven by cash realisation, as the sale changes the risk exposure of the holder of the assets.

Chapter 5: Other aspects

5.1 TO BE COMPLETED – In this chapter, the DP may consider suggestions on other metrics entities may use to communicate their investment strategy and performance.

Appendix 1 – EC request



EUROPEAN COMMISSION
Directorate General Financial Stability, Financial Services and Capital Markets Union

INVESTMENT AND COMPANY REPORTING
Accounting and financial reporting
Head of Unit

Brussels, 1 June 2018
FISMA B3/EVDP/fv/Ares(2018)3110211

Jean-Paul Gauzès
President
EFRAG
Square de Meeûs 35 B-1000 Brussels
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Subject: Request for technical advice on possible alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity type instruments

Dear Mr Gauzes,

As part of its Action Plan on Sustainable Finance[1], the Commission announced it would ask EFRAG to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.

Under IFRS 9 equity instruments can be measured either as fair value through profit or loss (FVPL) or, as an irrevocable choice at initial recognition, at fair value through other comprehensive income (FVOCI). However, in case of FVOCI measurement IFRS does not allow gains or losses realized upon the disposal of the financial asset to be recognized as profit or loss (no "recycling" through P&L).

The Commission has already asked EFRAG to assess the FVOCI treatment for equity instruments in an earlier call for advice[2]. The Commission asked to assess in two phases: 1) the significance of the equity instruments portfolios measured at FVOCI and the possible impact on long-term investments, and 2) to explore possible alternative accounting treatments. The Commission notes that EFRAG's work is well under way for this call for technical advice.

This request for technical advice asks EFRAG to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should 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.

Alternative accounting treatments for long term equity investments should preferably enhance investors' insight in the long term performance of investments as opposed to recognizing point in time market based value changes in reported profit or loss during the duration of the equity investment.

[1] COM/2018/097 final : http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

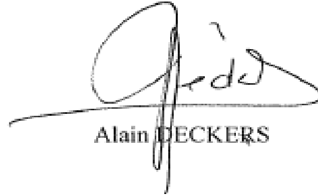
[2] https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1606211130208837%2F06.02%20-%20Request%20from%20EC%20-%20Equity%20Instruments.pdf

We would be grateful if EFRAG could provide us with the outcome of its work by the second quarter of 2019.

We thank you in advance for your cooperation and would be happy to provide any clarification required on this letter to EFRAG representatives.

Should you have any questions, please contact Erik van der Plaats (Telephone: +32 2 29 55565).

Yours sincerely,



Alain DECKERS

cc.: A. Watchman, (EFRAG TEG Chairman)

Appendix 2 – Less established alternatives

1. EFRAG debated other alternatives. These alternatives are less established and raise some operational issues that would need to be further examined before they are considered for standard-setting activities.

Alternatives based on adjusted cost

2. One criticism of historical cost is that it does not provide timely information about changes in value, and therefore it may lack predictive value and not depict the full effect of the entity's exposure to risk arising from holding the asset. To mitigate this, historical cost could be adjusted to reflect events that have occurred since the purchase of the equity instrument.

Adjustments for the share of profit or loss of the investee

3. The entity could be required to recognise its share of profit or loss of the investee. This adjustment would reflect the underlying performance of the investee, in a way similar to the equity method but without the need to apply all the consolidation procedures required in IAS 28 *Investments in Associates and Joint Venture.*

4. This adjustment would reduce the incentive to make selective disposals, because gains would be recognised regardless of dividend distribution or selling of the equity instrument. Recognition of the share of loss would also mitigate the risk that impairment losses are not recognised timely.

5. An entity would be required to obtain access to financial information on the investee. This could be often possible, but there may be issues with the timing of the availability of the financial statements and the fact that the investees may not be reporting under IFRS Standards or a comparable GAAP. This may also not be practicable for large, open investment portfolios.

Adjusting for observable market transactions

6. The entity could be required to reflect observable price changes on the basis of orderly transactions for the identical or a similar investment of the same issuer. A similar approach is used in US GAAP for unquoted instruments where the fair value is not readily determinable.

7. This adjustment would periodically align the historical cost to a current value, thus reducing the loss of relevance of historical cost over time. However, these adjustments would only be non-recurring and based on observable, external transactions that may happen at random.

8. An entity would be required the investor to monitor if observable transactions are occurring on their investment. EFRAG notes that this would be feasible for an entity with a limited number of equity investments, but burdensome for an entity with a very high number of small investments.

9. EFRAG notes that the carrying amount of listed equity instruments is continuously adjusted based on observable market transaction. This alternative would result substantially in a FVPL measurement for listed equity instruments.

10. Compared to FVPL, the first adjustment could be more or less volatile. The second adjustment could result in less frequent but bigger changes, to the extent that observable market transactions on unquoted entities do not occur frequently.

Alternatives based on adjusted fair value

11. Paragraph 15 of IFRS 13 *Fair Value Measurement* indicates that a fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions

12. One criticism of fair value is that the holder of the instruments is exposed to the volatility caused by market changes that may not reflect positive or adverse changes to the issuer's prospects for future cash flows. Fair value measurement in the statement of financial position could be modified to reduce the reliance on current market conditions at the measurement date.

Adjustments to the input

13. For instance, the entity could be required to maintain constant the original risk-free rate and update only the risk premium specific to the issuer. In this way, investment performance would not be affected by general market price changes. This would be similar to using the interest rate at inception for amortised cost irrespective of subsequent changes in market rates.

14. Compared to FVPL, this alternative would not recognise in profit or loss some of the fair value changes and may decrease volatility in profit or loss.

Allocation-based approaches

15. The FVOCI election in IFRS 9 results in the entity never recognising any gains or loss in profit or loss, while historical cost and FVOCI with recycling instead results in recognition only when events like impairment or disposals occur.

16. An alternative would be to use a systemic allocation of the estimated investment gain over the term that reflects the investment perspective. This systemic allocation could be articulated in different ways but in all cases there would be need to identify a relevant period and allocation pattern.

17. One variant would use the anticipated holding period when the equity instrument was acquired and apply an expected return rate over this period to compute the return in profit or loss.

18. Another variant would use the expected duration of a designated (linked) liability. The entity would need designation mechanism to associate equity instruments with liabilities held by the entity. The allocation pattern could be based on either the rate applied to the liability (assuming the liability is measured at amortised cost); or include in profit or loss expenses or income that exactly match the income or expenses included in profit or loss for the linked liability.

19. The systematic allocation over a relevant period has the advantage that it reduces exposure to short-term value changes that critics of a fair value based measurement approach do not consider part of a long-term investment performance. It also takes away the concerns about entities' ability to manage earnings by selectively selling specific instruments.

20. However, the allocation-based approach is heavily reliant on management assumptions. An allocation based on an expected return rate would raise the question on how the rate should be reassessed and how to adjust for any differences between the expected and actual rate.

21. An allocation based on a designated (linked) liability would raise issues about the eligibility criteria for designation and designation mechanism.

22. Formal documentation and designation are familiar to most reporting entities for hedge accounting treatment and doing the same would be simple for reporting entities with a limited number of liabilities. However, other reporting entities are likely to have numerous liabilities which may make it impracticable to designate an investment in an equity instrument to a specific liability on a 1:1 level. For these, the duration of the liabilities may form a basis for designation, but this is on the assumption of a static portfolio. The issue as to whether the pool or portfolio could be subsequently modified over time would need to be addressed.

23. Moreover, an allocation based on a designated (linked) liability would raise issues on the implications of the underlying liability being settled early or transferred.

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