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

Marianna Sorrente/ AIAF

2. Country of operation

Italy

3. Job title

Financial Controller Corporate

4. E-mail address

m.sorrente@gmail.com

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

Yes

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

Entity acquires assets in order to generate a stream of revenue from period to period (e.g. in the form of dividends or income from letting others use the assets).

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

No

8. How do you define sustainable activities?

activities that contribute to mitigating and adapting climate change, which have environmental and social objectives such as investments in sustainable infrastructures in order to reduce gas emissions

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 expected holding period

If you have indicated "Other" please provide details

5. Question 2

10. In your view, is an alternative accounting treatment to IFRS 9 requirements needed to properly portray the performance and risks of equity instruments held in a long-term investment business model?

Yes

6. Question 3

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

I think for those equity instruments that are not held for trading or contingent consideration recognized in a business combination it is useful a separate presentation in other comprehensive income of gains and losses as it would allow the users and stakeholders to identify easily and value accordingly the fair value changes. Taking into account the equity instruments are long term investment it is necessary to have an assessment (impairment test) to ensure that the carrying amount is consistent with the economic reality. An impairment model would provide relevant information to users if it provides insight into whether a decline in fair value is more or less likely to reverse in the future. The informational value of impairment with respect to assessing future cash flows would be important regardless of whether or not recycling occurs. In a long-term investment business model 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. Both dividend receipts (which are included in profit or loss) and gains on disposal from the sale of equity instruments represent a form of realization of the fair value the instruments. Therefore both events should be presented in the same way. The prohibition on recycling of cumulative gains or losses at the time of disposal may limit the relevance of reported profit or loss. In fact gains and losses reported in profit or loss on disposal are indicative of the performance of the investor. In consideration of the above arguments the FVOCI could be adapted in FVOCI with recycling including the impairment assessments.

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?

The objective of an impairment model should be to distinguish declines in the fair value of an equity instrument below its purchase price that reflect objectively identifiable, adverse changes in the issuer's economic condition from declines that reflect temporary market fluctuations.
The impairment model could be similar to the IAS 39 Model but with additional guidance to reduce subjectivity. As a matter of fact IAS 39 could be made less subjective if thresholds for "significant or prolonged" were defined.
A "significant" decline could be defined as a specific percentage decline from the acquisition cost and "prolonged" as a specific time period where the fair value has been below the acquisition cost.
IFRS Standard could specifically define quantitative thresholds for both terms and reporting entities could select a threshold within the limit.

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.

Yes

14. Please explain your answer

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 alternative accounting treatment could be applied to those "Equity-type" instruments that qualify for the puttable exception, but with the additional requirement that the assets held by the fund do not include material items that under IFRS 9 need to be carried at FVPL or could be subject to significant credit losses.

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

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.

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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.

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.

I agree a separate presentation in other comprehensive income of gains and losses is useful and
taking into account the equity instrument is a long term one (10 -year period) it would be necessary to have an assessment (impairment test) to ensure that the carrying amount is consistent with the economic reality, moreover both dividend receipts and gains on disposal from the sale of equity instrument should be included in profit or loss as they represent a form of realization of the fair value the instruments.

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

1. The investor's inability to dispose of the shares
2. The sustainable nature of the investee's operation
3. The definite useful life of the investee's operation

23. Which accounting treatments do you support?

Allocation-based approaches

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.

I believe that as the equity instrument is not held for trading or contingent consideration (Entity A intends to hold the Equity Instrument in Entity B for a period of time during which Entity B is likely to have gone through a significant transformation)) it is useful a separate presentation in other comprehensive income of gains and losses
The capital gain that Entity A intends to generate should be included in profit or loss as it represents a form of realization of the fair value the instrument
Furthermore taking into account the equity instrument is a long term one it would be necessary to have an assessment (impairment test) to ensure that the carrying amount is consistent with the economic reality

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

1. The fact that the investor does not have a put option
2. The sustainable nature of the investee's operation
3. The fact that the shares are unlisted

26. Which accounting treatments do you support?

Allocation-based approaches

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.

No

If yes, please explain why.

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

1. The fact that the entity holds a portfolio of equity instruments
2. The link to a long-term obligation (insurance contracts)
3. The fact that the shares are unlisted

29. Which accounting treatments do you support?

Allocation-based approaches

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.

No

If yes, please explain why.

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

1. The link to a long-term obligation
2. The fact that the entity holds a portfolio of equity instruments
3. The fact that the shares are unlisted

32. Which accounting treatments do you support?

Allocation-based approaches

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 investor's ability to redeem or sell
2. The listed feature of the fund
3. The investor's assessment of the long-term nature of its investment

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.

If yes, please explain why.

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

38. Which accounting treatments do you support?

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.