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

Serge Pattyn

2. Country of operation

België

3. Job title

Independent Financial Analyst and Business Consultant

4. E-mail address

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

No

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

A long-term investment business model is in my view characterised by the average holding period of the investments (5-7-9 years ... although the exact average duration should not be decisive). This does not mean that the investor would not sell or cannot sell any of its equity investments as time goes by (e.g. because of an updated assessment of the risks taken, a rebalancing of the portfolio that is needed, because it is simply decided to sell a particular investment, strategic reasons...) but the initial idea should always be that the investor intends to hold on to its investment for the longer term.

As a consequence of this, a long-term investor would not directly take into account the short-term price/value fluctuations to measure the performance of the portfolio. Although it is reasonable to assume that the investor will take a look at the current "price" or the assumed "value" when assessing a particular investment, the idea should nonetheless be that the dividend (and other income) stream is relatively more important.

The business model can be long-term for different reasons and from different perspectives :
- Insurers - but also banks - that manage large equity portfolio's to cover their long term liabilities ;
- Investment entities (e.g. private equity…) that hold on to certain investments to help the companies to develop further (3-5-7-… years) ;
- Infrastructure funds that manage long term participations (meaning : a long construction phase with significant cash needs, a somewhat long start-up phase with significant cash drains, a relatively long period during which the investments are operational with hopefully increasing cash flows – and dividends - that guarantee a certain return on investment…).
In this case of often non-listed entities it needs to be said that to measure the fair value on an annual basis, especially in the early years, is quite difficult. Of course the theory with regard to valuation is well-developed (as mentioned in one of the papers) but that does not mean that the result of the calculations is always a certainty (knowing the number of parameters that need to be assessed and their more then significant impact on the outcome).
- Real estate groups that buy, develop further, keep... investment properties for the longer term (cashing in rental and other income and, admittedly, capital gains from time to time - at least that is the idea)
- ...

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

No

8. How do you define sustainable activities?

This is a difficult one.
I picked this from the web : something is sustainable if it meets the needs of the present without compromising the ability of future generations to meet theirs.
What does that mean in terms of financial reporting, measurement bases, IFRS 9... ?
Clearly sustainable is about the long term, about climate-energy-infrastructure-people-waste-nature-... and similar kind of investments/things that we need to do in order not to endanger the environment in which future generations will have to live.

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
Other

If you have indicated "Other" please provide details

I have also indicated "Other" to be able to stress that the idea should also be : short-term price or value is not the main driver to assess the performance (e.g. an insurance company does not intend to sell its entire equity portfolio because markets were significantly up last year, the insurer may rebalance its portfolio's and/or take other actions (--> stewardship !) based on a new assessment of the markets... but the idea is nonetheless to stay in equities ... for the longer term).

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

If we agree about the characteristics of a long-term business model - whereby short-term price and/or value fluctuations are less relevant to assess the performance of the entity - we should come to the conclusion that FVPL is not always the most relevant way to report on these investments.
This may also be the case because fair value is not always meaningful (e.g. entity with long-term investments in infrastructure/energy/... projects).
From a risk perspective it remains meaningful to have the fair values somewhere (e.g OCI). It gives the user insights in the current (financial) position and it sometimes allows the user to assess stewardship (e.g. when did the insure bring down its exposure to equity markets and vice versa...).

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?

I do support a FVOCI model with recycling because FVOCI gives at a certain moment in tome information about the financial position while the price/value fluctuations are not part of profit or loss (where the analysts look at to assess performance). That said, the price/value fluctuations become performance upon disposal ... and need to be captured in profit or loss then.

But if an entity is allowed to portray its successes in profir or loss, we also need to find a way to portray the mistakes in profit or loss because it cannot be so that the lower price or fair value is systematically captured in OCI ... and is never transferred to profit or loss.

The impairment model should be based on : based on everything we know and a new assessment of the situation, the entity does not expect that it will be able to recover the capital invested. In other words : the drop in price/value is more or less "definite".

Examples :
- Equity portfolio (large caps, liquid stocks...) of an insurance company is down 8% on last year; no need to book impairments because it cannot be excluded that the value of the portfolio is again up 15% next year ;
- Long term energy project : cost and time overruns, higher financing needs, future cash inflows have been revised downwards ... there may be a need to recognise an impairment loss in profit or loss (as it cannot be justified that the fair value - worst case scenario - is reduced to zero in OCI ... without telling users that in profit or loss).

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

Because my reasoning can also be applied when an entity does not have a long-term business model.

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

I am not familiar enough with the kind of products also described in the Background paper but the philosophy we are trying to develop is quite clear I think. And therefore, this philosophy should become applicable when the instruments are "equity-type".
Then we should find a principles-based way to integrate the approach in IFRS 9.

10. Question 7

17. If so, which characteristics would you require to define the "equity-type" instruments?

The nature of the assets invested in
Other

18. If you have indicated "Other" please provide details

I have indicated "Other" just to add that : the nature/characteristics of the assets should be taken into account to assess the proper measurement basis (FVOCI with recycling and robust impairment model).

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.

No possibility to assess the fair value at a certain moment in time.
E.g. long term waste projects, infrastructure projects, energy projects ...
Very often the fair values of these long term investments are terribly subjective and entirely dependent upon the parameters used that have an enormous influence on the outcome.
The only reasonable reference then is : "are we on track, or not?"

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.

This is a very particular case as after 10 years "no residual value is expeced" and A cannot sell the shares in B. Hence, the stable annual profit that is distributed is to cover : a certain return (e.g. 8%) ánd repayment of the money initially invested (assuming that A analysed the file correctly before stepping in and was convinced that this was possible).
Therefore the stable annual profit that is distributed to the shareholders has to be combined with an impairment charge that reflects the reimbursement of the capital invested because note that after 10 years the fair value of the investment will be zero (unless liquidation allows B to pay out a certain amount of money). In any case, it cannot be that the investment in B is still in the books for xxx euro after 10 years and then has to be written off completely. That has to be anticipated to properly reflect the performance (which is only the dividend received to keep it simple).

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

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

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.

A is kind of Investment Entity that hopes to transform B and make something out of it.
B is clearly a long-term investment. I understand it as : this will take years.
A part from the fact that the fair value of B is highly subjective (because of the uncertainties) ... it is clear that the outcome of the subjective calculations cannot be used to asses the performance of A.
The only question that makes sense here : is A on trach with regard to the development/transformation of B.
I would prefer a cost model at first here ... but admittedly fair value will at a certain moment in time become more relevant (if B is successful) and/or an impairment model has also to be taken into account (if B is not successful).

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?

Historical 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.

See all that has been said before : the short-term value fluctations have no meaning when trying to portray the performance of A. The value fluctuations are relevant (to assess the way the portfolio has developed over the past 12 months and over the years but only from a "financial position" perspective).
That said : recycling is needed because the user needs to be able over time to assess : the kind of projects A invested in, the way these were managed, when they were sold (capital gain or loss?)...

The link with the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change is not clear to me in this case.

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?

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.

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.

See Illutrative Example C.

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?

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.

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.

No

If yes, please explain why.

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

1. The unlisted feature of the fund

38. 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.

20. Thank You!

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