Equity Instruments - Research on Measurement

Response ID:253 Data

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

BNP PARIBAS

2. Country of operation

BNP Paribas is a financial institution and Europe's leading provider of banking and financial services. It has four domestic retail banking markets in Europe, namely in Belgium, France, Italy and Luxembourg. It operates in 72 countries and holds key positions in its two main businesses which are Retail Banking and Services and Corporate and Institutional Banking ("CIB").

3. Job title

Head of Group Accounting Policies

4. E-mail address

francoise.goudal@bnpparibas.com

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

Yes

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

Long term investment business model is a business model which purpose is not to realise the value of investments through short term resales to take advantage of market opportunities but instead to serve other objectives among which:

- managing a portfolio of listed and unlisted industrial and commercial investments with a view to supporting clients and extracting value over the medium and long term. This can be done through investments in minority interests in listed companies but also through private equity minority investments whether performed directly or through funds. Such private equity investments may aim at providing support for transmission and development projects for unlisted companies or make strategic investments in Fintech innovating entities.

- Managing assets backing commitments towards policyholders through investments in equity and debt instruments with a rather long term expected holding period. This applies to Insurance activities with long term non participating liabilities.

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

Yes

8. How do you define sustainable activities?

Sustainable activities are those which have a positive social and environmental impact. Sustainable finance seeks to reconcile economic performance with positive social and environmental impact for example by financing or taking minority equity stakes in companies that actively contribute to sustainable development. This can be achieved in different ways among which integrating environmental, social and governance (known as "ESG") criteria into investment decisions.
BNP Paribas is engaged in sustainable Financing and Investments in several ways among which support for social businesses and entrepreneurship, funding renewable energies, micro finance, socially responsible investing (SRI) portfolios offered to enable customers to invest in companies active in specific social and environmental domains (through Asset Management funds, Wealth Management funds, Cardif investments…), greens bonds issuances or direct investments (100M direct investments in innovative energy-transition startups by 2020 for example).

4. Question 1

9. IFRS 9 allows an entity to account equity instruments either at FVPL or, if applicable, at fair value through other comprehensive income (FVOCI) without impairment and without reclassification ("recycling") to P&L upon disposal of valuation gains or losses previously recognized through OCI ("IFRS 9 requirements" for equity instruments).
When defining an accounting treatment alternative to IFRS 9 requirements for equity instruments held in a long-term investment business model, which characteristics would you require to identify a *long-term investment business model*?

The characteristics/ business model of the investor
Other

If you have indicated "Other" please provide details

The identification of a long term investment business model shall be based before all on the characteristics of the investor's business model.

Such business model could be for instance to realise the value of the investment through the collection of dividends and ultimately the sale of the investment. In such case the disinvestment decision is generally a key management decision. This is the case for private equity business model for example.

Another long term business model could be that of insurance companies which investments in equity instruments are expected to generate the cash flows required to settle their insurance liabilities, for instance when the duration of the liabilities is longer than that of debt instruments (for instance, annuities), or when sales may be required only in specific circumstances (payment of large unexpected claims).

Long term investment business models may have different purposes but their objective is never to realise short term profits as is the case in a trading business model.

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

The purpose of long term investment activities is to hold positions in order to create value in medium and long term. Realised gains and losses are therefore a key indicator of the performance of these activities.

By preventing recycling, IFRS 9 "Fair value through OCI" category for equity instruments does not adequately reflect the performance of long term investment activities which is assessed not only on dividends received but also on gains or losses realised on sales.
Similarly, the "fair value though P&L" category fails to reflect the actual business model of long term investments by introducing undue volatility.

We consider that the most appropriate measurement attribute to faithfully reflect the performance when the business model is to hold the investments for a long period is the historical cost simple measurement alternative with impairment when the intrinsic value (value in use as defined in IAS 36) is lower than cost. The uncertainty inherent to the long term investment business model further justifies prudence and the use of cost to avoid the recognition of unrealised gains while taking into account potential losses through impairment.

Alternatively, the use of historical cost dual measurement alternative (ie FV through OCI with impairment and recycling) to reflect on the face of the balance sheet the fair value of the investment could be considered depending on the characteristics of the investment (quoted or not…) and whether its fair value is meaningful and could be monetized or not.

We see no major operational challenges in developing an accounting treatment different from those proposed by IFRS 9 for long term equity investments. As for impairment of debt instruments, a model can be developed for equity instruments with some backstops to limit differences in the application of the model between preparers.

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?

Should the historical cost dual measurement alternative (ie FV through OCI with impairment and recycling) be favoured, the impairment model should lead to the recognition of an impairment loss on each time there is a prolonged decline in the value of the investment compared to its initial recognition cost. Such impairment shall be reversed when there is a prolonged valuation of the investment at a level equal or above its initial recognition cost.

The value of the investment for impairment purposes could be either its fair value or its « value in use » as defined by IAS 36, depending on the characteristics of the equity investment. For strategic investments or investments expected to be held over a long period of time, "value in use" may be an appropriate indicator for impairment.

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

The different accounting treatment should be applicable to all equity investments which purpose is not to realise the value of investments through short term resales to take advantage of market opportunities (ie not held with a trading intent).

Such accounting treatment should also apply to indirect equity investments as units of investment funds or units of collective undertakings as long as their underlying assets are equity investments (or equity investments and hedging derivatives) managed within an investment business model as defined above. This is because investments in equity can be made in several ways either directly or indirectly through funds and there is no rationale to treat both instruments (equity and equity-type) differently if they achieve the same economic outcome.

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

Please, see above answer to question 5.

10. Question 7

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

Other

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

We believe that units of funds meeting the "puttable exception' in IAS 32 whatever their nature should be eligible to the same accounting treatment as equity instruments as long as their underlying instruments are equity instruments and the funds have an investment strategy and not a trading one.

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.

100

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.

For an equity investment in a windfarm that cannot be sold to a third party and that has a predetermined useful life, IFRS 9 FV through OCI with no impairment would not be an appropriate accounting treatment as fair value measurement would not provide useful information. Furthermore, if the investment fails to meet the targeted performance no impairment would be recognised in profit and loss. Underperformance would only be reflected over time in profit and loss through reduced "dividends" and investment losses would not be reflected at all.
Applying IFRS 9 fait value through profit and loss would not be an appropriate measure either as it would introduce a volatility that it would not be possible to monetise through a sale of the investment.

In the absence of possibility to monetise fair value changes, historical cost with single measurement alternative would be the most appropriate approach.

This example seems rather theoretical as in practice the sale of an investment is rarely if never prohibited.

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

23. Which accounting treatments do you support?

Historical 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.

Because the ultimate purpose of entity A is to dispose of its investment to realise its value, IFRS 9 FV through OCI with no impairment and recycling would not adequately reflect the performance of the investment. Similarly, IFRS 9 FV through profit & loss accounting treatment would generate volatility in profit and loss due to fair value changes with limited possibilities to monetise these fair value changes in the absence of a liquid market.

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?

Other

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.

Historical cost with a single measurement alternative and impairment would be a more appropriate accounting treatment than fair value measurement for an investment in an unlisted start-up company with limited possibilities to sell the investment in the near future and realise fair value changes.

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.

Applying IFRS 9 FV through OCI with no impairment and recycling and therefore no recognition of realised profit and loss would lead to an accounting mismatch in profit and loss as not aligned with the accounting treatment of insurance liabilities. Similarly, IFRS 9 FV through profit & loss accounting treatment would generate a meaningless volatility in profit and loss due to changes in the fair value of investments. A different accounting treatment from those proposed by IFRS 9 is therefore needed when an investment in equity instruments is used to serve long term insurance liabilities cash flows.

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?

Other

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.

We believe that FV through OCI with impairment and recycling would be the most appropriate accounting treatment in this case.

The fair value measurement of investments on balance sheet is necessary to be aligned with
the current fulfilment measurement of insurance liabilities as defined by IFRS 17 and the Asset-Liability Management (ALM) practices of insurers. However, only realised gains or losses on financial instruments should affect profit & loss. Unrealised fair value changes which are not caused by impairment as well as changes due to

variations in the discount rate (on insurance liabilities) are irrelevant for the purpose of performance reporting in periods before disposal of the financial instrument and should consequently be considered as "market noise". Therefore, the two-sided (for IFRS 9 and IFRS 17) OCI option is the preferred one.

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.

As for scenario D, applying IFRS 9 FV through OCI with no impairment and recycling would lead to an accounting mismatch in profit and loss in the absence of alignment with the accounting treatment of the liability. Similarly, IFRS 9 FV through profit & loss accounting treatment would generate a meaningless volatility in profit and loss.

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?

Other

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.

FV through OCI with impairment and recycling would be the most appropriate accounting treatment in this scenario as more aligned with the accounting treatment of liabilities.

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.

Yes

If yes, please explain why.

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

1. The investor's assessment of the long-term nature of its investment

35. Which accounting treatments do you support?

Other

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.

FV through OCI with impairment and recycling would be the most appropriate accounting treatment for this investment activity as long as the ETF underlying assets are equity instruments.

19. Illustrative example F - Long-term investment held indirectly through a unit fund – non listed

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

Yes

If yes, please explain why.

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

1. The investor's assessment of the long-term nature of its investment

38. Which accounting treatments do you support?

Other

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.

Same as for example E.

20. Thank You!

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

Confirmatory email

Jul 05, 2019 10:32:16 Success: Email Sent to: francoise.goudal@bnpparibas.com

New response email

Jul 05, 2019 10:32:16 Success: Email Sent to: Isabel.Batista@EFRAG.ORG,fredre.ferreira@efrag.org,almudena.alcala@efrag.org

Response ID: 253

Survey Submitted:	Jul 5, 2019 2:32 pm
IP Address:	159.50.16.171
Language:	English (UK) (fr-FR)
User Agent:	Mozilla/5.0 (Windows NT 6.1; Trident/7.0; rv:11.0) like Gecko
Http Referrer:	http://www.efrag.org/News/Public-183/New-EFRAG-consultation-on-Equity-Instruments--Research-on-Measurement
Page Path:	1 : Why is EFRAG consulting? (SKU: 1) 2 : The questionnaire (SKU: 3) 3 : General information about the respondent (SKU: 9) 4 : Question 1 (SKU: 7) 5 : Question 2 (SKU: 24) 6 : Question 3 (SKU: 10) 7 : Question 4 (SKU: 25) 8 : Question 5 (SKU: 11) 9 : Question 6 (SKU: 4) 8 : Question 5 (SKU: 11) 9 : Question 6 (SKU: 4) 10 : Question 7 (SKU: 12) 11 : Question 8 (SKU: 26) 12 : Question 9 (SKU: 13) 13 : (untitled) (SKU: 27) 14 : Illustrative example A - Wind farm with predetermined useful life (SKU: 14) 15 : Illustrative example B - Unlisted single equity instrument (SKU: 15) 16 : Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability (SKU: 17) 17 : Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability (SKU: 16) 18 : Illustrative example E - Long-term investment held indirectly through a unit fund - listed (SKU: 22) 19 : Illustrative example F - Long-term investment held indirectly through a unit fund – non listed (SKU: 23) 20 : Thank You! (SKU: 2)

SessionID:	1562335689_5d1f59c9ee0bb9.22018216

Response Location

Country:	France
Region:	A8
City:	Paris
Postal Code:	75008
Long & Lat:	Lat: 48.854301452637, Long:2.3526999950409