Response to public consultation

ESMA response to the EFRAG consultation on Equity Instruments – Research On Measurement Project

11 July 2019 | ESMA32-61-353

Question 1

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

[ ] The expected holding period

[ ] The actual holding period

[ ] The long-term nature of the liabilities that fund the assets

[X] Other

If you have indicated "Other" please provide details

1. As indicated in our 2018 response[1] to EFRAG's Discussion Paper *Equity Instruments – Impairment and Recycling* (hereinafter the '2018 Discussion Paper'), in ESMA's view "*the primary objective of endorsed accounting standards remains to promote transparency and better decision-making in financial markets and, therefore, they should be considered as neutral with respect to other public policy objectives. We believe that this approach is ultimately the most beneficial for the performance of capital markets, including their capacity to support long-term investments*".
2. We note that, in discussing the qualitative characteristics of useful financial information, and in particular in relation to faithful representation, paragraph 2.15 of the IASB's Conceptual Framework explains that "*a neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.*" The Conceptual Framework also clarifies that providing neutral information *"does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions*". Although the qualitative characteristics underpinning IFRS and referred to in the Conceptual Framework are not directly part of the IFRS adopted for use in the European Union, ESMA highlights that neutrality is one of the features that paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires to take into account when developing a specific accounting policy and, therefore, we believe that it should be taken into account when assessing any potential alternative accounting treatment.
3. In this respect, we note that the model set out in IFRS 9 already captures two fundamental components of the features that are suitable to properly and faithfully reflect economic reality when accounting for financial instruments across all investment horizons: (i) the business model; and (ii) the contractual cash flow characteristics. ESMA believes that both those characteristics are relevant when accounting for financial instruments, including equity instruments, over all investment horizons, including for the long-term.

[1] https://www.esma.europa.eu/sites/default/files/library/esma32-61-259_esma_response_to_efrag_dp_equity_instruments_-_impairment_and_recycling.pdf

4. For example, an equity instrument due to its economic characteristics would not be eligible for amortised cost even when it is held for the long-term. At the same time, we note that IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading.
5. Furthermore, as explained in response to question 2, while we do not believe that an accounting treatment alternative to IFRS 9 is needed at this stage, ESMA highlights that if any such solution was developed, it should be sufficiently specific and narrowly defined in order to capture all the relevant features of the financial instruments it purports to represent and not be prone to structuring opportunities.

Question 2

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

[X] No

Question 3

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

6. As stated in our letter in response to EFRAG's consultation on the 2018 Discussion Paper, ESMA acknowledges the relevance of the debate in relation to the role of accounting on long-term investment. We also believe that transparent and timely reporting of information on the performance and risks underlying financial instruments held by issuers remain key factors to promote investor protection and the efficient allocation of capital.
7. From this perspective, as explained in response to Question 1, ESMA believes that IFRS 9 seems to already cater for the reflection of the key features of equity investments over different time horizons.
8. In ESMA's view, a historical cost accounting basis as described in the EFRAG staff background paper for equity instruments would not provide useful information for users of financial statements as already explained in the basis for conclusions of IFRS 9, except for what concerns the limited circumstances already envisaged by paragraphs B5.2.3 and B5.2.5 of IFRS 9 (i.e. when insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range).
9. Particularly, both in a single and in a dual measurement approach, a cost accounting basis would necessarily require an impairment model and, as already stated in our above-mentioned response to EFRAG's 2018 Discussion Paper, ESMA has not seen currently robust models that can provide relevant and timely impairment information for equity instrument.
10. In addition, we note that the dual cost measurement approach, as explained in the EFRAG's staff background paper, seems to be a formally different formulation of the same approach that EFRAG has already consulted on in its 2018 Discussion Paper. We would therefore recommend that EFRAG

carefully considers the feedback received[2] on that occasion which did not enable it to conclude in its advice[3] to the European Commission that recycling for equity instruments should be re-introduced. We believe that based on the outcome of that consultation, there is no basis at this stage to further consider that the dual measurement cost approach could be regarded as a viable alternative to account for equity instruments.

11. Furthermore, as acknowledged by EFRAG in its previous advice to the European Commission on Impairment and Recycling, it is too early to be able to assess any effects of IFRS 9 on long-term investment decisions. ESMA notes that this aspect should be addressed as part of the IASB's post-implementation review of IFRS 9 which will take place after a few years of application of the standard.

12. For the time being, also based on previous EFRAG's consultation, ESMA is not aware that the application of IFRS 9 requirements has caused any obstacles or disincentives to long-term investment decisions. Therefore, in ESMA's view, elaborating an alternative accounting model for equity and equity-type instruments, in advance of having identified evidence of any concrete issues for long term-investment arising from application of IFRS 9, may result in a solution that may ultimately be not effective. In the context of future work of the IASB and EFRAG on the post implementation review of IFRS 9, ESMA stands ready to assess the evidence resulting from this exercise.

13. Finally, we also note that the request for advice from the European Commission as summarised in the EFRAG staff background paper asks EFRAG to investigate potential alternatives to fair value for equity instruments that can "*properly portray the performance and risk of long term investment business models*". In this respect, ESMA believes that at this stage there seem to be no obvious alternatives to the requirements currently provided for in IFRS 9 that have the potential to properly reflect performance and risks of equity instruments, for the reasons developed hereafter.

14. On the one hand, the adoption of a historical cost measurement basis in the form of a dual measurement approach (i.e. fair value through other comprehensive income with recycling), as mentioned in our response to the 2018 Discussion Paper, "*may introduce in some cases, and especially for financial institutions, short-term accounting incentives to put in place opportunistic profit-taking disposal policies, thus sustaining earnings management practices, which would be contrary to the objective of encouraging long-term investments*".

15. On the other hand, the use of a fair value average, either in a single or in a dual measurement approach, would address the objective of smoothening the reported performance from the equity investments. In ESMA's view, an approach that tries to identify a 'rule' for determining the appropriate target period over which the average fair value is to be determined, would necessarily result in an arbitrary choice that may result in confusing users of financial statements without resulting in more transparent and useful information to financial markets.

Question 4

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

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[2] EFRAG's Feedback statement on the 2018 Discussion paper is available here: https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1802121143235063%2F05-04%20EFRAG%20Research%20project%20Equity%20Instruments%20-%20Impairment%20and%20Recycling%20-%20Summary%20of%20replies%20-%20Board%2018-08-22.pdf

[3] Available here: https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520Technical%2520advice%2520to%2520the%2520European%2520Commission%2520on%2520Equity%2520Instruments.pdf

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?

16. In line with our response to question 2, we do not specifically address this question. However, we would like to reiterate that any accounting model that is alternative to the current requirements in IFRS 9 would necessarily require a robust impairment model that can provide relevant and timely information on the impairment of equity instruments. To this end, ESMA notes that the existing models complying with the requirements in IAS 39 *Financial Instruments: Recognition and Measurement* have not proven to be particularly effective.

<u>Question 5</u>

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
[X] No

Please explain your answer

17. In line with our response to question 2, we do not believe that there is a need at this stage for an alternative accounting treatment for equity and equity-type instruments.

18. However, we would like to reiterate our concerns on the 2018 Discussion Paper regarding the proposal to potentially restrict an alternative accounting solution to long-term investments: "*in order to prevent the risk that entities may use the recycling option for short-term opportunistic profit taking strategies, in principle […] [the use of fair value through OCI as alternative treatment] should be made available only to the population of equity instruments to which an issuer publicly commits to put in place long-term investing strategies that should be clearly defined by the standard. However, we acknowledge that in practice creating a sub-category of equities reflecting the objective of a long-term investment strategy is highly difficult and, in the past, the IASB tried to define the sub-portfolio of strategic investments, but concluded that such definition would be impracticable. In our view, this is consistent with the fact that entities providing feedback to EFRAG's Report were not able to explain how they identify which equities are held for the long-term. If the subcategory is not properly defined, it may result in structuring opportunities or in limitations that may not ultimately reflect the objective of a long-term investment strategy, for example when issuers put in place a genuine portfolio rebalancing or asset-liability management policy*. *Consequently, if recycling would be re-introduced, ESMA believes that an impairment model should apply to all equity instruments carried under the FVOCI election*".

<u>Question 6</u>

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 measure 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
[X] No

Please explain your answer

19. In line with our response to Question 2, we are not in favour of an alternative accounting treatment for 'equity-type' instruments as defined in the EFRAG's background document and in the text of this question.

20. From the perspective of transparency of financial information, we would like to stress that units in investments funds may be significantly different from 'plain vanilla' equity instruments from the point of view of their risk and return profile. Therefore, we would be concerned that any considerations on equity instruments are applied almost *by analogy* directly to units of investment funds, as this may result in a distorted depiction the nature and evolution of risks undertaken by issuers when investing in those instruments.

21. Particularly, in the European context, investment funds that qualify as alternative investment funds (AIF) are allowed to invest in any type of assets which may include derivatives as well as structured products. Reflecting the risks and performance of these assets with an alternative solution to the current fair value through profit or loss model would require a *look-through* approach which might make the accounting complex and burdensome, namely considering the implications for these instruments of developing and implementing an impairment solution that is applicable to them.

22. Finally, we note that similar considerations may apply to investment funds that qualify as undertakings for collective investment in transferable securities (UCITS) which, subject to the existing legal limitations on the eligible assets, may also include complex instruments such as structured products and derivatives.