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Dear Jean-Paul

EFRAG Consultation on Equity Instruments – Research on Measurement

This letter sets out the high-level comments of the UK Financial Reporting Council (FRC) on EFRAG's consultation on the measurement of equity instruments. Our detailed comments to the questions raised in the questionnaire have been submitted via your website but are appended to this letter for ease of reference.

The FRC recognises that climate change and its implications are one of the defining issues of our time. It poses far-reaching financial risks, which can be minimised by an orderly transition to a carbon neutral economy. In that regard, in 2017 we welcomed the recommendations by the EU High-Level Expert Group on Sustainable Finance to embed sustainability factors more widely and effectively within the EU financial framework. On 2 July 2019, the UK Government launched its first Green Finance Strategy and the FRC, together with other UK financial regulators, will play its part in supporting this important initiative.

The FRC has already commenced a major project on the Future of Corporate Reporting with the objective of developing proposals to address current reporting challenges. This includes, but is not limited to, the provision of adequate information on issues of sustainability.

The primary objective of the financial statements of an entity is to provide information about the reporting entity that is useful to stakeholders. Historical views about who is a legitimate stakeholder are being challenged and we acknowledge that corporate reporting has to address these challenges to remain relevant. Nevertheless, as identified in the *Conceptual Framework for Financial Reporting*, relevance and faithful representation remain the fundamental qualitative characteristics of useful financial statements. All EU incorporated entities with shares listed on an EU regulated market are required to prepare financial statements in accordance with IFRS as endorsed in the EU. IFRS's are developed in accordance with the IASB's Conceptual Framework. Accordingly, attempts to prioritise certain public policy goals over the fundamental objective of financial statements, might be to the detriment of the intended users of financial statements. Whilst there are merits in reconsidering the purpose of corporate reporting more widely, we do not believe that this can be done through this specific aspect of financial reporting. Furthermore, we are unconvinced that a change to the measurement requirements would further the European Commission's goal to support long-term investment in sustainable activities.

We have the following key observations regarding the specific questions raised by EFRAG:

- The existing evidence whether IFRS 9 would or would not have an impact on investment decisions is inconclusive. Time is needed for IFRS 9 to be embedded in financial reporting.

- The questionnaire raises points that some of our constituents have concerns about, for example measurement of unlisted equity investments at fair value or measurement of investments in funds at fair value through profit and loss. However, these concerns could be addressed by expanding the scope of the existing measurement bases, rather than introducing an alternative approach, and should only be considered after IFRS 9 has been implemented long enough to assess its impacts. The IASB should analyse these and other application issues as part of its Post-implementation Review (PiR) process.

- We are unconvinced that the alternative measurement approaches considered in the Background Paper, including fair value through other comprehensive income with recycling, are preferable to those currently available. We reject the adjusted cost and adjusted or average fair value approaches as viable alternatives, because they provide less relevant and reliable information.

If you would like to discuss our comments, please contact me or Anthony Appleton on a.appleton@frc.org.uk.

Yours sincerely

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Appendix 1

Question 1

7. 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

FRC response:

IFRS 9 has only been effective since the beginning of 2018 and some insurance firms will not apply IFRS 9 until 2021, or later if the proposed deferral of IFRS 9 is approved. EFRAG gathered evidence in 2018 on the impact of IFRS 9 as part of the Equity Instrument – Impairment and Recycling project. We note that the evidence was inconclusive on whether IFRS 9 would or would not have an impact on investment decisions.

IFRS 9 will be subject to a Post-implementation Review (PiR) by the IASB. The PiR timetable allows for IFRS 9 reporting to bed down and for a robust body of evidence to develop. Until and unless there is more comprehensive evidence, we remain unconvinced that a change to IFRS 9 would result in more useful information for investors. There is no evidence to suggest that a change to IFRS 9 would advance the goals of the European Commission to foster investment in sustainable activities.

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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

(x) No

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.

FRC response:

In our view there are only two remotely viable alternative measurement methods for equity instruments: historical cost or FVOCI (with recycling), each with recognition of any impairment losses. These alternatives were debated by the IASB in the course of the development of IFRS 9. In our response to the exposure draft of IFRS 9, we acknowledged that for non-financial institutions that only hold few strategic non-listed investments, the cost of remeasurement at fair value may outstrip the benefits of this valuation method for investors. There is also a trade-off between relevance and reliability for unlisted investments when measuring these at fair value.

When responding to the IFRS 9 draft proposals, we concluded that, on balance, we supported fair value measurement for all equity instruments. In the absence of a comprehensive PiR, we continue to stand by this conclusion.

Our concern about a FVOCI (with recycling) approach is that it provides opportunities for management discretion over when gains or losses that arose during the holding period, especially those relating to equity investments traded in a liquid market that can be sold and repurchased easily, are recognised in profit or loss. The relevance of performance information reported on that basis is highly questionable. Furthermore, such an approach should not be permitted without a viable impairment approach. This is considered further in Question 4 of this questionnaire.

We note that the IASB introduced the FVOCI option (without recycling) for equity instruments that are not primarily held with the objective to generate an investment return. The IASB refers to such investments as ‘strategic investments’. Following consultation, the IASB could not find a workable definition to identify such investments and, as a consequence, made this option available to all equity investments. Entities must decide whether this option is suited to reporting the performance of their investments, given the FVPL category is designed for all equity investments held with the objective of generating an investment return.

We do not believe that the alternative measurement bases historical costs or FVOCI (with recycling) are superior to those permitted in IFRS 9 for equity instruments. All options, including those permitted in IFRS 9, have merits and disadvantages. Stakeholders preferences amongst the options will differ. The effects of the options permitted in IFRS 9 and whether these indicate a need for alternatives, should be assessed as part of the IFRS 9 PiR.

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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?

FRC response:

EFRAG's Discussion Paper Equity Instruments – Impairment and Recycling explored this question. The evidence gathered by EFRAG was inconclusive about the need for recycling. We responded to EFRAG with the view that a wider debate as part of a post-implementation review of IFRS 9 is necessary before committing to any changes. Our constituents hold different views on the need for impairment, some believe it is prerequisite in a FVOCI (with recycling) model, other are less convinced because of the limitation of any impairment model. Some even support an impairment test for instruments measured at FVOCI (without recycling).

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

[x] No

14. Please explain your answer

FRC response:

We have noted in our responses to Question 1 and Question 3 in this questionnaire our reservations about developing alternative accounting treatments. We noted in our response to Question 3 that there is no consensus between our constituents about whether there is a need for change and if so, what measurement basis would be preferable.

Developing an accounting model would require a definition of long-term investment business model, but we acknowledge EFRAG's difficulty in developing a principle-based definition that finds consensus among EFRAG's stakeholders.

The FRC's *Guidance on the Strategic Report* uses terminology such as 'long-term success of an entity' or 'long-term value generation. This guide supports the UK narrative reporting requirements. The meaning of 'long-term' is not defined for the purpose of the guidance.

We also caution against adding to the multiple measurement options for the same equity instrument, increasing complexity for users. A lesson learned from IAS 39 was that users generally prefer measurement consistency for the same instrument.

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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 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

16. Please explain your answer

FRC response:

Some constituents would prefer an expansion of the measurement options available to equity instruments to indirect investments in equity investments through funds. We believe this is an area that the PiR of IFRS 9 could explore. There needs to be more analysis and discussion of the impact of the current measurement approaches, the merits of potential changes and any required definitions of eligible instruments.

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

[ ] The nature of the assets invested in

[ ] Mutual funds

[x] Other

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

We believe the merits of any change and the applicable characteristics would need to be debated as part of the IFRS 9 PiR.

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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.

Not relevant at all [0] ______________________[__]________________ Most Relevant [100]

[0] – No persuasive evidence that there are detrimental effects

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 response to this question.

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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.

Illustrative example A - Wind farm with predetermined useful life

Scenario A - Wind farm with predetermined useful life

- Entity A holds a 10% non-controlling equity instrument in Entity B. Entity B does not qualify as an associate and, as a consequence, does not qualify for equity accounting.

- Entity B has been set up to build and operate a wind farm as part of a long-term renewable energy programme. At the end of the economic life of the wind farm (10 years) no residual value is expected, and Entity B could either seek additional financing to build a new asset or be put into liquidation.

- Entity A initially expects Entity B to generate a stable annual profit and distribute it to shareholders. Furthermore, given the business purpose of the equity instrument, the terms and conditions of investing in Entity B prohibit investors from selling their equity investment during the 10-year period. Entity A is therefore required to hold its investment in Entity B for the full economic 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

(x) No

If yes, please explain why.

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

- The sustainable nature of the investee's operation
- The definite useful life of the investee's operation
- The investor's inability to dispose of the shares

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22. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) Other

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.

Illustrative example B - Unlisted single equity instrument

Scenario B - Unlisted single equity instrument

- Entity A buys a 10% equity instrument in Entity B from Entity C for CU 1000. Entity B is an unlisted start-up company manufacturing electronic scooters to be used in the e-scooter sharing industry. Entity B does not qualify as an associate and, as a consequence, does not qualify for equity Accounting.
- Entity A intends to hold the equity instrument in Entity B for the purpose of creating value in the long term by generating a capital gain after a period of time during which Entity B is likely to have gone through a significant transformation.
- Entity A does not have a put option and there are no observable recurring transactions in the equity of Entity B. Due to these conditions, Entity A does not expect to dispose of its interest in Entity B in the near future.

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

(x) No

If yes, please explain why.

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

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

26. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) Other

27. 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.

Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability

Scenario C

- Entity A holds a portfolio of various financial instruments, including equity instruments that do not qualify as subsidiaries nor as associates, therefore do not quality for consolidation nor for equity accounting. The objective of entity A is to use the proceeds from the portfolio to serve the cash flows from a long-term obligation of issued insurance contracts.
- Entity A sets up a dedicated "asset base" to serve the long-term obligation which is expected to be settled over the next 30 years. The portfolio includes a significant portion of shares in unlisted corporates, although there is no legal constraint on the composition of the portfolio.
- Entity A regularly monitors the value changes in the portfolio and may occasionally sell part of it and reinvest the proceeds, with a view to achieve its target returns.

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

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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

(x) No

If yes, please explain why.

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

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

29. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability

Scenario D

Same fact pattern as Scenario C but the liability is an obligation or financial liability other than insurance contracts, for example a decommissioning liability per IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

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

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(x) No

If yes, please explain why.

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

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

32. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

Illustrative example E - Long-term investment held indirectly through a unit fund - listed

Scenario E

- Entity A acquires units in Exchange Traded Funds (ETF) as part of a larger investment portfolio.
- Each ETF invests in a diversified portfolio of financial and non-financial assets. Entity A does not have control over the investment decisions of the funds, which are managed independently.
- Entity A's past practice indicates that, on average, it will hold these units for approximately six months although the holding period varies considerably from one investment to another. When the units are redeemed or sold, Entity A expects to acquire another investment or investments.
- In its management report and other public statements, Entity A presents itself as a long-term investor whose strategy is to allocate assets so as to generate an economic return over time.

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- Under IFRS 9, Entity A will be required to classify the investment as FVPL. Refer to Equity-type instruments in Chapter 4 of the Secretariat background paper for more information.

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

(x) No

If yes, please explain why.

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

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

35. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

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

Same fact pattern as Scenario E above, except that the fund is unlisted.

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

(x) No

If yes, please explain why.

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

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

38. Which accounting treatments do you support?

( ) Historical cost

( ) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

(x) Existing requirements are appropriate

( ) 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.

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