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Survey on collection of evidence on undue short-term pressure from the financial sector on corporations

Section IV: the role of fair value in better investment decision-making

In this section of the questionnaire, ESMA seeks to collect further information related to the following statement from the report[1] of the High Level Expert Group (hereafter 'HLEG'): "there is considerable disagreement among interested parties on the appropriate accounting treatment for long-term investments, in particular on whether long-term assets on investors' balance sheets should be valued based on the currently prevailing (daily) market prices – also known as 'mark-to-market' valuation or 'fair value' accounting […] The debate is mainly around equity, equity-type and listed credit instruments on the balance sheets of long-term investors, such as non-financial corporations, insurance companies and banks."

The section contains questions on whether and how fair value may impact the capacity of financial reporting to provide relevant and reliable information on equity instruments held for long-term investment purposes. Responses in this area will help ESMA to assess how the measurement and disclosure of fair value may impact the selection of a short- or long-term horizon, as well as to assess whether the transparency benefits arising from the use of fair value for financial instruments, particularly equity instruments, outweigh the intrinsic potential volatility of fair value. Furthermore, whilst Level 1 fair value measurement is based on quoted prices in active markets and, as such, it has a high degree of reliability, ESMA is also interested in exploring the usefulness of Level 2 and Level 3 fair value measurements[2] and the extent to which investors are willing to take these fair value measurements into consideration in their long-term investment decisions.

The European Commission has issued two requests for advice to the European Financial Reporting Advisory Group (EFRAG) to assess the impact of IFRS 9 Financial Instruments on equity investments and to investigate potential alternatives to fair value accounting for equity and equity-type instruments held for the long-term. ESMA closely monitors and contributes to EFRAG's work in this area[3]. In section IV of the questionnaire ESMA investigates more specifically the reasons underlying any connection between fair value accounting and the emergence of short-term pressures in the investment practice of issuers.

The questions in this section are primarily addressed to institutional and retail investors that make use of information in issuers' financial statements in their investment decisions, as well as to issuers that prepare financial statements.

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[1] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf
[2] Inputs to Level 2 fair value measurements are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Inputs to Level 3 fair value measurements are unobservable inputs for the asset or liability.
[3] http://www.efrag.org/News/Public-183/New-EFRAG-consultation-on-Equity-Instruments--Research-on-Measurement

MINISTÈRE DE L'ÉCONOMIE ET DES FINANCES MINISTÈRE DE L'ACTION ET DES COMPTES PUBLICS

Questionnaire

22. Based on your experience, please indicate to which extent you agree with the following statement:
"For the purpose of undertaking an **internal** assessment of the performance of long-term investments held in equity instruments, fair value provides a company's management with relevant information in order to better understand the short-term and the long-term consequences of the investments held"
1: Totally disagree
2: Mostly disagree
3: Partially disagree and partially agree
4: Mostly agree
5: Totally agree
* Please explain your response and provide evidence, where available
1400 character(s) maximum

1 Acknowledging that fair value might provide useful information, ANC does not think that it reflect the "performance" in all cases. Measuring financial instruments at fair value through profit or loss (FVPL) particularly fits a trading/ held for sale business model. Conversely, by definition, long-term investment (LTI) is not supposed to be shortly disposed of. As a result it cannot be presumed that FVPL measurement fits LTI. On the whole, there is a consensus among our stakeholders that "trading" corresponds to a defined business model whereas LTI encompasses situations other than trading (reversed definition), i.e. corresponds to the default method for measurement.

2 In addition, the relevance of the use of fair value (as detailed in answer to Q26) in certain level 2 and level 3 measurements is questionable. As a consequence, ANC is convinced that fair value in itself is not sufficient to provide a company's management with relevant information in order to better understand the short-term and the long-term consequences of the investment held.

23. Based on your experience, please indicate to which extent you agree with the following statement:
"For the purpose of enabling an **external** analyst or investor to assess the performance of long-term investments held in equity instruments by a company, fair value provides relevant information in order to better understand the short-term and the long-term consequences of the investments"
1: Totally disagree
2: Mostly disagree
3: Partially disagree and partially agree
4: Mostly agree
5: Totally agree
* Please explain your response and provide evidence, where available
1400 character(s) maximum

3 In addition to the answer to Q22, which applies also for external analysis, the following points can be added: for equity instruments other than trading, applying a FVPL measurement will generally not properly reflect the performance in the P&L. As many users and academics do, ANC considers that the ability to identify realised vs. unrealised gains or losses is fundamental and highly relevant to assess internal management's performance since a gain, or a loss, is certain only upon the sale of the underlying instrument.

4 Reflecting in the P&L each change in the market value leads to over-represent into the entity's performance its ability to immediately dispose of an asset, as compared with other features (risks and performance drivers). This focus is addressed by Jacques de Larosière[4] when he stresses the limits of relying on mere market mechanisms to raise money from the financial markets, since "Financial institutions' risks are not market risks, even when their assets are acquired or sold on organised markets. Prudential and accounting standards should rather acknowledge that the long term does not entail greater risk, but simply presents a different risk profile."

5 In that specific context, historical cost measurement in the P&L may also provide relevant information on non-trading transactions without adding a temporary immediate volatility.

6 As a consequence, fair value accounting does not provide systematically all the relevant information. In certain circumstances, further disclosures may be useful to better understand all the assumptions made for each measurement and to better understand the long-term perspective of the entity.

[4] In Foreword to the LTI Task Force report « Betting on the Long-Term », p.7

24. Is the current accounting treatment for equity instruments under IFRS 9 [1] a decisive factor in **discouraging** a company from undertaking new long-term investments in equities?
[1] Under IFRS 9 Financial Instruments equity instruments are accounted for at fair value with the possibility to exclude fair value changes from the statement of profit or loss
Yes
No
* Please explain your response, including whether you already apply IFRS 9, and provide evidence where available
1400 character(s) maximum

7 Two main accounting issues in IFRS 9 have been raised by our stakeholders:

- Applying FVOCI to equity investments with OCI not being recycled;
- Equity-type instruments (such as mutual funds or other puttable instruments) treated as "non-SPPI" debt instruments and therefore mandatorily measured at FVPL.

1.1 Equity: Addressing the non-recycling issue

8 ANC supported IASB's principles (Conceptual framework) and decisions (IFRS 9) to consider the business models in the measurement. Business models have been introduced into the measurement requirements for debt instruments under IFRS 9. Current IFRS 9 provisions on equity instruments rely on a default measurement method being FVPL and a FVOCI alternative option. Choosing either of both measurements does not depend on a conceptual approach or a business model. We see no conceptual reasons for not referring to business models when measuring equity instruments.

9 Moreover, since OCI cannot be recycled, FVOCI generally does not represent a realistic alternative to FVPL. ANC however strongly believes that "dual measurement" is a valuable alternative to FVPL when applied to business models other than trading.

<u>FVPL may not be appropriate to business models other than trading</u>

10 As stated in paragraph 2, for equity instruments other than trading, applying a FVPL measurement will generally not properly reflect the performance in the P&L. ANC considers that the ability to identify realised vs. unrealised gains or losses is fundamental and highly relevant to the users of financial statements since a gain, or a loss, is certain only upon the sale of the underlying instrument.

11 Moreover, reflecting in the P&L each change in the market value leads to over-represent into the entity's performance its ability to immediately dispose of an asset, compared with other features (risks and performance drivers). This focus is addressed by Jacques de Larosière[5] when he stresses the limits of relying on mere market mechanisms to raise money from the financial markets, since "Financial institutions' risks are not market risks, even when their assets are acquired or sold on organised markets. Prudential and accounting standards should rather acknowledge that the long term does not entail greater risk, but simply presents a different risk profile."

12 In that specific context, historical cost measurement in the P&L may also provide relevant information on non-trading transactions without adding a temporary immediate volatility.

<u>FVOCI without recycling is an incomplete solution.</u>

13 "Dual measurement" (as referred to in § 6.83-6.86 of the conceptual framework) means that measurements used in the balance sheet and in the P&L differ, the difference between both being put in OCI. The FVOCI option is supposed to address the dual measurement issue of financial instruments measured at fair value in the balance sheet and at historical cost in the P&L. This works well for SPPI debt instruments but not for equity instruments, since OCI is not

[5] In Foreword to the LTI Task Force report « Betting on the Long-Term », p.7

recycled. In line with the IASB conceptual framework, consistently applying a "dual measurement", ANC considers that recycling OCI (and its corollary, having an impairment mechanism) is fundamental and highly relevant to the users of financial statements.

14 Moreover, applying the FVOCI option to equity instruments, the actual performance is difficult to understand as there is no conceptual reason to present differently in the statement of comprehensive income (i) a gain of 15 realised upon a sale and (ii) a gain composed of a dividend of 5 followed by a sale gain of 10. Indeed in both cases the actual realised performance is 15.

1.2 Equity-type: Addressing the Mutual funds issue

15 LTI does not solely comprise Equity instruments as defined by IAS 32. Investment can be held either directly or indirectly, for example through UCITS, ETF (Exchange Traded Funds) or AIF. From an economic standpoint, the decision to hold equity instruments indirectly can be motivated by various objectives such as;

- risk spreading and diversification,
- accessing to a higher level of liquidity,
- relying on dedicated experts monitoring the positions,
- isolating the assets backing some specific underlying liabilities,
- simplifying the operational burden of accounting for each single asset.

16 Funds are integral to most LTI business models and excluding them from an accounting treatment designed to address LTI would clearly be a significant impediment to the overall approach.

17 We consider that the driving principle for accounting for equity type investment is both simple and straightforward: we see no conceptual reason to account differently for equity investment depending on whether they are held directly or indirectly.

25. Is the current accounting treatment for equity instruments under IFRS 9 [1] a decisive factor in **triggering divestment** by a company of existing equity holdings elected for the long-term?
[1] Under IFRS 9 Financial Instruments equity instruments are accounted for at fair value with the possibility to exclude fair value changes from the statement of profit or loss
Yes
No
* Please explain your response, including whether you already apply IFRS 9, and provide evidence where available
1400 character(s) maximum

18 See Q24

26. In your view, what are the factors that may impact the relevance to users of financial statements of fair value measurements for long-term investments?
You may choose more than one factor
X Volatility in reported earnings
Measurement errors (in Level 2 or 3 Fair Value)
X Complexity of calculations (in Level 2 or 3 Fair Value)
X Management's opportunistic behaviour (in Level 2 or 3 Fair Value)
Insufficient involvement of independent third-party assessment (in Level 2 or 3 Fair Value)
X Limited relationship with the expected developments of fair value in the long-term
X Other
* Please explain your response and provide evidence, where available
1400 character(s) maximum

19 The first factors to mention are the ones similar to those already raised by the implementation of IFRS 13 "Fair value"[6] and which can be categorised under the captions "Complexity of calculations and Management's opportunistic behaviour" as the frontier between level 2 and level 3 inputs is not clear and is in some instances highly judgmental. Related extracts from ANC's comment letter are as follows:

Applying judgment

Two main areas of judgment have been identified by ANC's stakeholders. Those areas are (i) assessing whether a market is active, (ii) categorising unobservable and significant inputs used in the fair value measurement.

 Active markets – Although entities in the financial sectors appear, 4 years after the first implementation of IFRS 13, not to find challenging the performance of this assessment, preparers agree on the fact that the definition of an active market is theoretical and that application difficulties arise in certain specific market conditions, in emerging countries or during systemic crisis.

 Unobservable and significant inputs to the entire measurement – Entities from the non-financial sectors have experienced difficulties to distinguish level 2 and level 3 inputs as the classification is in some instance highly judgmental. It has also been noted that some level 2 approach (such as market approach) provide sometimes less relevant information than present value techniques considered as level 3.

Regarding the limitations related to fair value measurement, be aware also of the listed below academic papers (financed by ANC):

- Fair value disclosures and fair value hierarchy by Ghio and al (http://www.anc.gouv.fr/files/live/sites/anc/files/contributed/ANC/3.%20Recherche/Travaux-Publications/ANC_2018-implementation-of-IFRS-13-and-SFAS-157_Filip-Ghio-Jeny%20.pdf)
- Marking to market versus taking to market by Plantin and Tirole : http://www.anc.gouv.fr/files/live/sites/anc/files/contributed/ANC/3.%20Recherche/B_Appels%20%c3%a0%20projets/2016/Travaux_finances/Rapport_final_IDEI_CDC_ANC_mai2015.pdf
- Is fair value a reliable and relevant measurement basis? by D. Marteau http://www.anc.gouv.fr/files/live/sites/anc/files/contributed/ANC/3.%20Recherche/D_Etats%20generaux/2015/PP_Fair%20Value_D%20Marteau%20VE.pdf

20 ANC notes that the EU High-Level Expert Group (HLEG) advised the EU in its last year report[7] on sustainable finance "*to confront short-termism in financial markets so as to reduce its negative impact on long-term corporate investment and development.*" ANC acknowledges that

[6] Post implementation review – IFRS 13 ANC's letter dated 22 September 2017
[7] High Level Expert Group Report on sustainable finance, 31/01/2018 : https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

there is a need to reconsider accounting principles or a need for more information on sustainability in the field of long-term investment.