

LONG-TERM INVESTING ACTIVITIES

BUSINESS MODELS

EFRAG ROUND TABLE

8 JULY 2013

FEEDBACK STATEMENT

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Round Table Panel

Chair

Françoise Flores EFRAG Chairman

Panellists

- **Mirzha de Manuel Aramendia** – *Research Fellow CEPS*
- **Herman Bots** – *Head of Fundamental Equities, APG Asset Management*
- **Karin Dohm** – *Chief Accounting Officer, Deutsche Bank AG*
- **Dennis Jullens** – *Lecturer Valuation & Accounting, RSM, Erasmus University and member of EFRAG User Panel*
- **Jean-Michel Pinton** – *Group Accounting Officer, CNP Assurances*
- **Fanny Pouget** – *Directeur Normes Groupe, Contrôles et Projets, AXA*
- **Frank Tassone** – *Head of Financial Control, European Investment Bank (EIB)*
- **Jens Houe Thomsen** – *Senior Corporate Bond Analyst, Corporate Bond Research, Jyske Bank*
- **Martin Zabel** – *Representative VMEBF (German Association of Family Business Engaging in Accounting Developments).*

Please refer to appendix 1 for the respective biographies.

Introduction

On 8 July EFRAG organised a round table with companies involved in long-term investing activities and users of financial statements of the companies involved in those activities to get input from and exchange views on the financial reporting aspects of long-term investing business models and financial reporting issues raised in the EC Green Paper on long-term financing.

The event was organised as part of EFRAG's public consultation on *Is there a need for specific financial reporting for long-term investing activities business models?* and in the context of the debate on the *Classification and Measurement: Limited Amendments to IFRS 9*.

The round table was chaired by Françoise Flores, EFRAG Chairman and included two panel discussions with nine panellists (please refer to the biographies in Appendix 1). The debate took place around the questions that are presented in Appendix 2.

This feedback statement summarises the key messages received from participants in the round table.

The input from participants in the round-table will be considered by EFRAG TEG in providing input to the European Commission on accounting issues addressed in the EC Green Paper on long-term financing, as well as contributing to accounting standard setting for companies involved in long-term investing activities.

Main messages from the EFRAG Chairman

In her introductory remarks, EFRAG Chairman Françoise Flores explained that EFRAG decided to launch a consultation in May – on the question *Is there a need for specific financial reporting for long-term investing activities business models?* – in order to contribute both to the European Commission discussions on the Green Paper and the IASB debate on the *Classification and Measurement: Limited Amendments to IFRS 9*. The round table was part of this consultation and was considering the issue even further taking into account all types of entities involved in long-term investing activities.

Françoise Flores highlighted the fact that EFRAG's due process on the *Classification and Measurement: Limited Amendments to IFRS 9* revealed that the IASB's proposals on the introduction of a third business model in IFRS 9 were rejected by many European constituents. While arguments for rejecting the proposals were diverse, the main argument was that they failed to characterise properly any business model and were therefore inconsistent with the original principles of IFRS 9. Some constituents, among which the insurance and the long-term investment industries, indicated that their business model would justify different financial reporting requirements from current IFRS 9. With its consultation and round table EFRAG hoped to contribute to accounting standard setting for such activities.

The context of the EC Green Paper on Long Term Financing of the European Economy

Dawn Robey from the European Commission, provided some introductory remarks in relation to the Green Paper *Long-Term Financing of the European Economy*.

She highlighted the fact that long-term investment was firmly on the agenda of the G20. In addition to the European Commission, also the OECD, the World Bank and the Financial Stability Board are actively engaged on different work-streams in this area. The Green Paper that was published on 25 March aimed to stimulate the broadest possible debate about how to foster the supply of long-term financing of the European economy and in particular, how to improve and diversify the system of financial intermediation for long-term investment in Europe.

One of the thirty questions raised in the Green Paper addressed the role of accounting and corporate governance and the role of information and reporting. The Green Paper posed specifically the question whether stakeholders believed that the use of fair values contributed to short-termism in investor behaviour. The European Commission welcomed EFRAG's initiative to discuss and analyse the question of the business model thoroughly since mixed views were held in reaction to the IFRS 9 recent exposure draft.

The European Commission had received some 300 answers to the EC Green paper which are being analysed. The European Commission intends to provide an overall assessment of the Green Paper consultation in a Communication in autumn 2013.

Summary of Key Messages

Summary of the key messages session 1 – Characteristics of a Long-Term Investing Business Model and observable evidence of a Long-Term Investing Business Model for financial reporting purposes

The first session focused on discussing the characteristics of a long-term investing business model from a financial reporting perspective and whether a long-term investing business model can be supported by appropriate objective and observable evidence.

Long-term investing business model from insurers' perspective

The panellists from the insurance industry highlighted the following key characteristics of a long-term investing business model:

- (a) Stability of the insurance liabilities cash flows – the insurance liabilities profile was described as statistically stable with duration between 7 to 20 years, and illiquid. Results from stress tests performed on the insurance liabilities cash flows showed that there would be almost no risk of forced sales which is considered as a strong proof of the stability of insurers' cash flows.

The stability of the cash flows has been noted as a more important characteristic than the duration. Property and casualty insurers have shorter durations than life insurers, but the characteristic of having stable and predictable cash flows is what really matters. One observation was that insurers hold stable portfolios except (1) when their business is suffering from large redemption trends or (2) in the case of unanticipated events.

- (b) Asset-Liability Management (ALM) – the 'consistency' of asset-liability management has been highlighted as a core aspect of the life-insurance business model. This consistency refers to an investment policy on the asset side to match the cash flow characteristics of the liabilities with the aim to fulfil the obligations towards policyholders, bondholders and shareholders in different market conditions.

The panellists from the insurance industry observed that for long-term investing activities the nature of the assets should not be taken into account to qualify them as institutional long-term investors.

A panellist explained that a long-term business model for insurers might be different depending on whether or not the contract includes options and guarantees. Usually options and guarantees lead to more variable cash flows, and when the latter are combined with more stable long-term cash flows, the combination results in hybrid business models. Such hybrid business models are more difficult to define a long-term strategy. A question that arises is whether policyholders will rely in the future on sustainability of returns on guarantees.

A user noted he was surprised to hear that insurers describe themselves as long-term investors when they need to change their portfolios due to Solvency II regulation. He wondered whether a

long-term investor should not be someone who sticks to an investment even in stressed conditions, both for equities and bonds. A panellist from the insurance industry responded that long-term investing from the insurers' perspective was not about holding on to assets, but about matching durations on a portfolio basis, in order to fulfil the obligations of the liabilities.

Long-term investing business model from banking perspective

Panellists from the banking industry explained the ALM commonalities with the insurance industry, but indicated that the driver for public banks was the lending activities and the public mission of the bank as opposed to the insurance liabilities. The governance structure of this type of institution drives the limited risk appetite and the dividend distribution was not considered a short-term objective.

A user panellist noted that the definition of long-term assets and long-term investors should be stricter as many corporate groups could claim to be long-term investors based on the nature of the assets in which they invest.

Information currently provided by companies involved in a long-term investing business model and what information in a long-term investing business model is considered relevant

The panellists from the insurance industry highlighted the numerous disclosures that insurance companies produce today, including disclosures on duration mismatches, yield curves, European Embedded Values as well as 'value in force' or 'value of new business' to inform users about latest developments, and assist them in their sensitivity analyses. The insurers' risk management framework was providing sufficient diversification of the risks, which helped insurers to be better protected against financial crises and thus limiting the need for insurers to report on excessive short-term volatility to shareholders and policyholders. This was evidenced by regulatory liabilities adequacy tests.

The panellists from the insurance industry noted the importance of more business model information as all information should be considered as relevant, including voluntary non-GAAP measures and segment reporting. A panellist from the banking industry observed that information on the business model was considered relevant. However, cash flow and risk profile disclosures were needed to ensure comparability and transparency.

A panellist from the banking industry observed that the current liquidity disclosures should be improved because the current time buckets were assessed as too broad, and were not reflective of the various liquidity risk sensitivities.

A user panellist suggested that disclosure of the breakdown of the asset portfolio and the turnover of the portfolio might be helpful, also in cases where the risk of forced sales would be assessed as low.

Summary of key messages session 2 - Long-Term Investing business model from a financial reporting perspective

The second session focused on the consequences that the business models and business strategies, described by the panellists in the first session, may have on financial reporting requirements. Panellists also provided views on whether fair value leads to short-termism as an answer to the question raised in the European Commission Green Paper on long-term financing, and the relevance of fair value for long-term investing business models.

The panellists, in particular the user panellists, discussed what information and which components of performance they found relevant in the assessment of companies with long-term investing business models, and provided their views about the relevance of fair value and cost measurement for long-term investing activities.

The panellists highlighted the following key aspects of the performance reporting of companies with long-term investing business models:

(a) Deficit/surplus between assets and liabilities

A user panellist noted that an equity analyst for defined benefit schemes is usually looking for information on how assets and liabilities move due to financial market developments and if there is a link between assets and liabilities, an analyst would look at deficits and surpluses taking into account the relevance of that deficit/surplus for the organisation's cash flows.

(b) Long-term rate of return

The importance of the long-term rate of return has been noted by the panellists from the banking and the insurance industry. They observed that fair value was a good measure at a specific date, but what was important was the return the investor wants to get and, in the case of long-term investment, it was the long-term return. In their view expected losses also needed to be reflected in the long-term return.

(c) Business model information

The panellists from the insurance industry noted they wished to see more emphasis on the business model in the standards, and on how value is derived from the business model for the shareholders.

However, user panellists expressed different views on the business model. A user panellist expressed concern about the business model role in measurement or presentation, and pointed to the need for it to be ring-fenced. He suggested that other criteria could be considered including the type of evidence of asset stewardship that can be demonstrated, and the extent to which the management incentive structure supports the business model.

Another user panellist noted he would like to understand the business model, but also how a company executes the business model, and which part of the results is a return from operations and which part is caused by pure market developments.

Does the nature of the assets matter in a long-term investing business model?

The user panellists discussed whether or not the nature of the assets matters in the analysis, i.e. whether, in companies with long-term investing business model, similar assets contribute in a similar way to how an entity generates cash flows and mitigates risks.

The user panellists noted the importance of the characteristics of the assets, and of the kind of risks the company is exposed to in order to reach a certain level of return.

Does too much information in the financial statements makes it difficult to understand the long-term nature of the company's activities?

A panellist from the insurance industry noted that too much information did not help users in analysing the relevant information in a long-term perspective. Analysts want to understand the capacity of an entity to generate earnings and its capacity to pay dividends. A user panellist responded that sophisticated users are usually not getting confused by more rather than less information.

Relevance of fair value in long-term investing activities business models and use of other comprehensive income (OCI)

The panellists discussed whether fair value provides relevant information for companies involved in long-term investing activities and whether fair value brings to short-termism. They also discussed the roles of other comprehensive income in the performance reporting of companies in long-term investing activities business models.

The user panellists noted that fair value information was important to understand a company's exposure to financial market risks; and was a good indication about the liquidity in the market. To some of the users, it would not matter whether the investments are valued at fair value on the face of the balance sheet, profit and loss account, other comprehensive income, or in the notes; whereas others would find it essential that information be included on the face of either balance sheet, profit or loss or other comprehensive income and not in the notes.

A user panellist pointed out that there was no academic evidence that fair value was leading to short-termism. He noted that he was comfortable with the idea of pension funds relying on fair value for both pension assets and liabilities. He agreed that not all changes in fair value should be reported in the profit or loss account. However, if changes are part of the operations of a business – and he would argue that they are indeed part of the business for insurance companies – most changes in fair value should go through profit or loss.

The panellists from the insurance and banking industry noted they would prefer that fair value does not impact the profit and loss account when their business model is long-term investing. They highlighted the fact that volatility due to short-term variations does not provide information on the real performance as it is expected to reverse over time. Fair value was considered appropriate measure in the balance sheet, but changes in fair value could be provided through appropriate disclosures. In their view IFRS 7 and IFRS 13 provided sufficient disclosures for sensitivities to market values.

The panellists from the insurance industry stressed the importance of consistent measurement between assets and liabilities for insurers, and of the avoidance of accounting mismatches; in their view, other comprehensive income was a solution for both the asset and the liability side. In relation to the role of recycling, a panellist from the insurance industry noted that recycling needed to be allowed for favourable changes as well as for unfavourable changes.

In the context of the avoidance of accounting mismatches for insurers, a panellist from the insurance industry also stressed the need for IFRS 9 to be endorsed in the EU, including the macro hedging proposals.

Does ‘value in use’ as defined in IAS 36 provide relevant information in a long-term investing business model?

The panellists from the banking and the insurance industry were advocating ‘value in use’ as a measure, which provides relevant information about future cash flows and expected losses. However, user panellists did not support ‘value in use’ as being subjective and allowing management to provide their desired measurement results.

Use of non-GAAP measures to present long-term investing business model

The panellists from the banking and the insurance industry expressed their concern about the use of non-GAAP measures to present a long-term investing business models in a way that was understandable to users. They believed this should alert standard setters to the need to take a more holistic view towards standard setting.

A user panellist did not agree that standard setters could provide comprehensive definitions of non-GAAP measures as accounting standards are necessarily incomplete. Having non-GAAP measures is inevitable and companies give their best measure of performance. It is informative to see what non-GAAP measures companies select to present their performance, and to see how these non-GAAP measures are prioritised.

Investments in non-traded debt securities and Level 3 fair value measurement

A user panellist highlighted the rising trend of investments in non-traded debt securities because the listed ones do not provide the required rate of return, and more particularly the interest of insurance companies to invest in such instruments. More transparent audit and control and fair value level disclosures are needed if insurance companies want to increase their investments in those assets.

BIOGRAPHIES



Françoise FLORES

Françoise Flores has been Chairman of EFRAG since 1 April 2010.

Prior to joining EFRAG as Chairman, she was a partner of Mazars in France and one of the IFRS experts of the firm. In that capacity, she has been acting for several years as IFRS Technical Advisor to large European businesses (through Acteo, ERT and BUSINESSSEUROPE). She has been a member of EFRAG TEG since April 2004. Her IFRS expertise is backed up by over 20 years in controlling and financial reporting, of which 10 years as CFO, in the context of large and medium-sized international listed corporations.



Herman BOTS

In 2008 Herman Bots joined APG as Senior Portfolio Manager as PM for the Energy sector. Since 2011, he has been head of the team responsible for managing the European Fundamental Equities team, which manages the internal European Fundamental portfolio.

Prior to joining APG, Herman Bots held positions as Managing Director Research at Theodoor Gilissen Bankiers, a Dutch private bank; Senior Analyst/Portfolio Manager at FDA, a Dutch independent investment research provider and Business analyst at the European headquarters of a US corporation specialized in water treatment. Herman holds a Master's degree in Economic History from Leiden University. He is Chartered Financial Analyst from the CFA Institute and holds CMA/CFM Certificate from the Institute of Management Accountants (IMA).



Mirzha DE MANUEL ARAMENDIA

Mirzha de Manuel has been a Research Fellow at the European Capital Markets Institute (ECMI) and the Centre for European Policy Studies (CEPS) in Brussels since September 2010. In this capacity, he set up a Task Force on "Long-term Investing and Retirement Savings" in December 2012, which Final Report will be released in the Fall of 2013.

At CEPS, his research focuses on public policy and market aspects in relation to investment management, retirement savings, broader asset management - including life insurance - and investor protection. It extends to connected aspects in the fields of financial stability, institutional settings and supervisory practices, economic growth and competitiveness, corporate governance, social inclusiveness, competition policy, market structure and industrial organisation.

Mirzha is MA in European Economic and Legal Analysis from the College of Europe in Belgium (2010) and a qualified lawyer from the Bar of Madrid. He holds both a master in Business Economics and a master in Spanish and Common Law (2009) from the University of Valladolid (Spain).



Karin DOHM

Karin Dohm is Managing Director at Deutsche Bank and as Head of Group External Reporting and Chief Accounting Officer responsible for the Financial and Regulatory Reporting of the Group. This comprises the quarterly and year-end reporting (IFRS/20F and HGB) as well as regulatory reporting to various external stakeholders. Karin is also the Global Head of the Accounting Policy and Advisory Group of Deutsche Bank and a member of the Supervisory Board and Head of the Audit Committee of Deutsche Euroshop AG, a MDAX company that invests in commercial real estate. Before joining Deutsche Bank she was a Partner in the Financial Service Industry of Deloitte & Touche focussing on audit and advisory projects for Financial Service Institutions, Equity Investors, Hotel Business and Real Estate Funds. Karin represents Deutsche Bank in various industry bodies (e.g. BDB, EBF) and is also a member of the Financial Instruments Advisory Group of EFRAG. Karin Dohm holds a Master in Economics having studied in Germany and Spain and has qualified as Chartered Accountant and Tax Advisor.



Dennis JULLENS

Dennis Jullens is lecturer and researcher in Valuation & Accounting in the Accounting & Control Group of the Rotterdam School of Management. Before joining RSM, Dennis spent 20 years in banking of which the last 12 years at UBS where he was European Head, UBS Valuation & Accounting Research. In this role, he published applied research and advised institutional clients on a range of accounting topics, finance issues and valuation methodologies. He was also responsible for training graduates in UBS Equity Research in both London and Hong-Kong.

Dennis is a Visiting Professor at the University of Edinburgh - Business School and has taught extensively at IE Business School Madrid, WHU Vallendar, University of Amsterdam and Nijenrode Business University. In addition to his academic responsibilities, he is a member of the Capital Markets Advisory Committee (CMAC) advising the International Accounting Standards Board on the implications of IFRS for users of financial statements. Dennis is also a member of the Analyst User Panel at EFRAG; the advisory body to the European Commission on IFRS.



Jean-Michel PINTON

Since 2007, Jean-Michel Pinton has been group accounting officer of CNP Assurances, which he joined after a six-year assignment as deputy director in charge of economic & financial affairs of the French insurance trade association (FFSA). Graduate of the Master degree of financial techniques of ESSEC business school and member of the French institute of actuaries, Jean-Michel began his career at the broker Oddo & Cie as an equity financial analyst. In 1993, he joined the rating agency IBCA (now FitchRatings) to create and develop the insurance sector in Paris until 1995 and from 1999 to 2000. From 1995 to 1998 he was “fondé de pouvoir” in the Corporate financial department of the AGF Group (now Allianz’s French subsidiary). He is also a member of the Insurance Working Group of EFRAG (European Financial Reporting Advisory Group).



Fanny POUGET

Since the beginning of 2012, Fanny Pouget has been head of Group standards and transversal projects for the AXA group. She covers standards related to IFRS and Solvency 2. She is also extensively involved in the CFO Forum activities (Accounting topics, Solvency 2). Prior to joining AXA, Fanny started her career in insurance in 1998 as head of ALM and of the Actuarial department. In particular, she was involved in the quantitative aspect of the Solvency 2 project. Fanny Pouget is an engineering school graduate and Master in Statistics from Cambridge University and the French Institute of Actuaries.



Frank TASSONE

Frank Tassone is currently head of Financial Control at the European Investment Bank and as such he oversees the preparation of the financial statements and the financial reporting of the EIB and EIB Group with a balance sheet total of currently some EUR 520 bn. At the same time, and separate from his responsibilities at the EIB, he is also responsible for the preparation of the financial statements and the financial reporting of both the EFSF and the ESM. Frank started his career at what is now PricewaterhouseCoopers and where he was auditing large international banks as manager. He then moved to the European Court of Auditors as audit manager, where he was in charge of the audit of various financial instruments and entities of the EC. Subsequently he joined the European Investment Fund where he was during 8 years Financial Controller and Head of Administration with responsibility also for Finance and Risk Management. Since 2003, Frank has been with the EIB. Apart from being audit board member for two financial entities of public interest since a number of years, he has been member of the Financial Instruments Working Group of EFRAG since 2012. As such Frank has over 25 years of vast experience in the financial reporting of financial institutions from the auditor, user and preparer perspectives. He holds a Master of Business Administration and Finance.



Jens Houe THOMSEN

Mr Thomsen has been holding positions in Credit and Equity Research as well as Portfolio Management and Financial Communication since 1987. He is currently working for Jyske Bank, previously Danske Bank, BankInvest and Bottomline Communications and is a Board member of CFA Denmark. He was awarded Portfolio Manager of the year 2004 in Denmark and Stockpicker of the year 2012, Nordic (Starmine).



Martin ZABEL

Martin is Managing Partner of AC CHRISTES & PARTNER and heads its Frankfurt office, specializing on international accounting/reporting and company / asset valuations. For 30 years he has accompanied the development of international accounting while serving German industrial groups of any size in converting to and applying international accounting standards (US GAAP, IAS, IFRS, UK GAAP, French GAAP). Martin worked 10 y. with KPMG, thereof from 1988-91 in the German Practice, NYC. In the early 1990s he worked 2 years with the French accounting firm MAZARS. He was a member of working groups for IFRS for SMEs at BDI (Federation of German Industry) and German Accounting Standards Committee (ASCG). He is a member and auditor of VMEBF, an association of mostly very large German family owned business groups to engage in the national and international development of accounting and reporting rules.

EFRAG would like to thank all panellists for their valuable contributions to the debate.

SET OF QUESTIONS

Session I Focusing on the Long-Term Business model

Question 1

How would you describe a long-term investing business model, what characteristics does it have, and how is it distinguished from other business models? What is the observable evidence of a long-term investing business model?

Question 2

What impact does the long-term investment horizon have on:

- how the entity is managed?
- the selection of the assets?
- the information that is relevant to the investor?
- the definition of long-term?

Is the long-term investment horizon the only feature, or are there other criteria such as governance structure (shareholder objective, public role) and regulation aspects to be considered in the long-term business model?

Are there types of assets that are not compatible with a long-term investment business model, and why? Are there types of assets that are characteristic of a long-term investing business model, and why?

Question 3

How should a long-term investing business model be analysed in terms of liquidity and solvency?

Question 4

Is there a need for any specific balance sheet structure? If so, please describe?

Question 5

What are your key performance indicators from a stewardship perspective?

Question 6

Do you think that the following types of investors have long-term investing activities with similar characteristics:

- institutional investors such as insurers, pension funds, institutions with long-term liability commitments;
- regulated institutional investors (nuclear facilities operators);
- investors playing public role like investment public banks.

Session 2 Focusing on the measurement of assets and liabilities, and performance reporting in long term investing activities

Question 7

Do you think the business model should take precedence over the characteristics of the assets in which an entity invests, in order to better reflect the purpose for which those assets are held?

Question 8

What are the benefits and advantages of the measurement of long-term assets based on fair value?

Question 9

What are the benefits and advantages of the measurement of long-term assets based on cost? What should be the basis for impairment?

Question 10

Under IFRS, are there inappropriate measurement requirements for assets invested with a long-term horizon? If so, what are they?

Question 11

Are there alternative measures to fair value (target date accounting, other current value)? If so, what are they, and how would they lead to better financial reporting?

Question 12

What should an investor understand of the long-term business entity's performance? Please, indicate the various components?

Question 13

Would you welcome guidance on non-financial key performance indicators relevant to the business in the disclosures to enhance comparability?