EFRAG consultation

Is there a need for specific financial reporting for long-term investing activities business models?

The MEDEF position

MEDEF thanks EFRAG for publishing this invitation to comment on a subject it deems important for the European economy. As part of the consultation on the European Commission's Green Paper on long-term financing, it is necessary to make a thorough diagnosis of the impact of accounting standards on increasingly scarce long-term financing, which is a fundamental aspect of the question, in the same way as prudential regulation, financial regulation and taxation. EFRAG, as an expert to the Commission on matters relating to financial reporting in Europe, has the authority and legitimacy to provide its detailed analysis of the subject. It would be useful that it takes into account in its analysis the link between accounting standards and prudential measures as there is a close relationship.

MEDEF calls for a more in-depth examination of the question, which should constitute more than just a mere study of the improvements to make to any particular IFRS. The analysis should have regard to the overall question of the impacts of IFRS on long-term financing and the development of recommendations to address them.

Long-term financing is a major challenge for Europe

Europe is facing a pressing need for long-term financing, as much for the development of its businesses as for increasing investment in infrastructure, stimulating the economy and supporting employment. At a microeconomic level, companies are struggling to meet their long-term financing requirements.

Through its Green Paper, the European Commission has put forward its willingness to explore all aspects of the regulations that impede long-term financing in order to define the measures that need to be taken. MEDEF supports this initiative and took part in the consultation (see MEDEF reply).

Diagnosis: international accounting standards discourage long-term financing

Among the issues raised in the Commission's Green Paper, the role of accounting standards is raised. Note that the question is worded from a precise angle: has fair value favoured short-termism? From MEDEF's point of view, the answer is yes.

The European Union has decided to adopt IFRS for all listed companies - a choice that has demonstrated a real interest and which is not questioned here - adopting thereby a philosophy that places considerable emphasis on market value. Today, many stakeholders highlight the effects of this set of standards on the behaviour of investors, pointing to the short-termist pressure it generates. Indeed, the market value promotes a snapshot of the value of the company at the expense of long-term analysis of its ability to generate performance. MEDEF considers it appropriate to ask a broader question, which includes that of fair value: why is long-term vision undermined by the use of the IFRS? In its opinion this is the result of an overly broad use of market values or current values that is supported by the entire construction of the standard.

At the broadest level, the general philosophy of the standard is **insufficiently critical of the theory of efficient markets**; the widespread use of market value by the IFRS reflects the excessive reliance upon this theory, whose limits have been highlighted by successive crises.

In addition, analysis of the requirements to which accounting standards must respond **is too focused on the needs of the short-term investor**, justifying the preference given to instantaneous values, clearly much less relevant for a long-term investor.

In the specific principles adopted, the accounting standards **pay insufficient attention to the business model - both in relation to the investor and the company that has financing needs** - not allowing therefore an analysis of performance over the long term, both for the investment choice as for the analysis of its profitability;

In addition, the IASB has abandoned the principle of prudence, allowing too extensive use of short-term valuations (market value or current value) in all financial statements, which **results in volatility and procyclicality and consequently promotes short-term arbitration**. Although the wide use of such valuations in accounts certainly responds to some of the needs of short-term investors, this is not the case for long-term investors, where the artificial volatility resulting from this choice creates a blurring effect in the financial information by introducing a parameter not relevant for assessing performance and its robustness. This promotes the development of "management accounts" on which the dialogue between analysts and financial managers is based in order to correct the accounting results of the effects of instantaneous volatility that affects both the readability and usability of accounts.

The situation is even more detrimental to financial institutions (insurance, banking and other long-term investors) for which it is **inappropriate to determine a method of accounting for assets without taking into account liabilities,** as a key point for the long-term investment business model is to match the joint management of assets and liabilities as closely as possible.

<u>The recommendations: A specific approach to long-term financing is necessary</u>

To address the multiple aspects existing in accounting standards that inhibit this activity and to be able to create some of the conditions necessary to meet the economic and social needs of Europe's long-term financing, MEDEF believes that it is necessary to develop a specific approach on an accounting level. Indeed, the business model of long term financing/investment is radically different from the business model that serves as an implicit reference to the IFRS, very focused on the needs of the short-term investor. At the centre of the definition of long-term investment should be the criteria of a link with a long term liability, since long-term investment is the acquisition of an asset, whatever its nature, which is part of an investment policy and responds to a portfolio allocation backing a long-term liability.

Thus, among the assets of the companies, some business segments are part of a long-term approach. In this regard, EFRAG rightly emphasises in its analysis that the long-term investments do not only concern certain categories of actors or instruments. They relate to strategies implemented by many categories of involved parties, not exclusive of other business models within the same entity; they concern different types of investments, like properties for example.

MEDEF has consistently made the case for accounting standards to better reflect the business model of companies in order to provide an accurate representation of performance. It considers that the business model of the long-term investor is unique and requires ad hoc accounting treatment. The difficulty that the standard setter may encounter when defining the scope and criteria that set it apart from existing models cannot, in any case, justify the eviction of the issue. A new model must be developed.

The issue of the long-term financing business model requires a cross-cutting approach. In debates relating to the conceptual framework, MEDEF calls for expanding the notion of users of financial statements so that accounting, in its principles and rules, is not governed primarily by a strategy dictated by the expectations of short-term investors. Long-term investors must be subject to closer attention, in accordance with the objectives set by the European Commission, to promote long-term financing. This complementary angle of analysis would justify reviewing the valuations to be used in the accounts as appropriate. Indeed, the short-term investor may be interested in a presentation focused on instant balance sheet valuations, market values and current values, but the long-term investor needs, for its part, to have information that enables it to project the operating performance of the company to consolidate its investment decision. It is therefore necessary to reconcile these two objectives.

<u>Accurately reflecting the business model of long-term investment in accounting standards</u>

It is necessary to better reflect the time horizon in financial statements, in order to translate the different investment strategies resulting from that into the accounts, and this, beyond the characteristic of the assets involved. In particular, the reference to the business model is of vital interest for financial institutions to the extent that the investment policy should be modelled on the structure of liabilities. For the manager of a balance sheet with long-term liabilities, long-term investment is not only a power but a genuine fiduciary duty and the accounting of its operations should reflect the orientation of its investment policy, regardless of whether the assets to which the investments relate can be negotiated or not.

Portfolio management should therefore be given its rightful place in, by the adoption of accounting rules that reflect its stability. Relevant information relies on valuations which ensure the consistency between assets and liabilities, the time horizon and performance of the portfolio.

MEDEF, recognising the important work of questioning IFRS dogmas that this requires, encourages EFRAG to develop recommendations on the subject without accepting to be confined to existing strategies. It is possible to develop the characteristics of the long-term investment business model by complementing the accounting standards, both on the conceptual framework and in the standards where this is applicable. Such work is essential to meet the needs of the European economy and promote, in the discussion with the IASB, a broader vision of economic strategies, firmly structured around three activities: producing, trading and long-term investment.

***