



## EFrag's Consultation

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

### **CONTRIBUTION OF Mr GERARD DE LA MARTINIÈRE**

Mr Gérard de La Martinière<sup>1</sup> would like to thank EFRAG for having launched a consultation on the "long-term investing activities business models".

Indeed, this is **a major issue for the financing of the European economy**, at a time when the European Commission consults the stakeholders on the various aspects of long-term financing of the economy in the framework of its Green Paper launched on March 25<sup>th</sup>.

Undoubtedly, Europe is facing a pressing need of long investment, to expand its business and also to finance its infrastructure, stimulate the economy and support employment: the long-term funding is a major challenge for the economies of the European Union.

In these conditions, **the strategic priority is to restore the conditions of long term investment.**

#### **A finding: a positive stock tarnished by the financial crisis**

It can be reasonably argued that **the introduction of IFRS has brought real progress** in improving financial reporting and integration of the European financial system.

This has been made possible by both the unconditional support of companies (notably the multinational ones) and the "wait-and-see" attitude of the EU.

**But the crisis raises strong questions about the suitability of a repository too focused on the short term** and amplifying market volatility.

By adopting IFRS for all of its listed companies, **the European Union has made an important place for the "market value". However, this standard reinforces the short-**

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<sup>1</sup> *Honorary Inspector General of Finance, former member of the EFRAG's Supervisory Board. This individual contribution is largely based on the work that Mr de La Martinière conducted with the Task Force on "Long Term Investment" set up in 2011 with the economic and financial actors of the French market to study the barriers to the development of long-term investment.*

**term approach and the herd behavior of investors** as the market value promotes an instant view of the company's value to the detriment of its performance over the long term.

### **An illustration of IFRS's weaknesses through the case of Long Term Investment**

The members of the Task Force have organized in Paris in November 2011 the "**National Conference on Long Term Investment**", the result of an analysis work realised in France in with the support of the French economic and financial actors.

The goals of this reflection were to:

- Assess the extent of long-term investment needs of the European economy (infrastructure - industrial equipment - research and innovation - Sustainable Development),
- Questioning the origin of funding that will meet these needs:
  - Inability of public budgets
  - Diversion of international capital
  - Forced withdrawal of financial institutions constrained by crippling regulations

At the end of this analytical work, the members of the Task Force concluded to the need to channel the household savings toward Long Term Investments.

Indeed, long-term savings are potentially huge (at least in continental Europe) and it will continue to increase with the need to cover the longevity risk. But household savings is typically affected by a strong preference for liquidity and the illegibility of the modern financial markets discourages its direct investment.

**It is therefore necessary to restore the channeling circuits of these savings toward LTI through a « balance sheet intermediation » of the financial institutions, including by cautiously fostering the « short term resources transformation » in long uses.**

**The new prudential regulations are likely to seriously undermine this capacity particularly Solvency II. Until now, the accounting standardization represented by IFRS completely ignored the point.**

**It can be denied that the business model that serves as implicit reference to IFRS is too focused on the needs of the short-term investor. Therefore, the needs for long-term financing of the European economy require that an *ad hoc* accounting approach is applied to the "Long Term Investment" (LTI).**

### **The "LTI" regime is to invent**

Clearly, it is inappropriate to determine a method of accounting for assets while ignoring liabilities: **the investment activity of any economic actor can not be validly analyzed independently of the structure of its liabilities ("Asset & Liability Management")**.

**The duration of liabilities**, whether statistical, contractual, or legal (in terms of taxation), **determines the investment horizon**: this horizon of investment determines the optimal assets allocation that must combine safety and performance according to the fiduciary obligation incurred with respect to the principal.

The performance evaluation of asset management can only be conceived through the portfolio management (the “line by line process” is meaningless) and the fact that investments tools are negotiable or not is secondary compared to the « Asset & Liability Management discipline »

**It is urgent today to promote a specific regime for long-term investment**, not only to create favorable conditions and restore its development, **but also to protect the various stakeholders affected by the regulations** related to bank or insurance by giving them the opportunity to place under the new regime a part of their business.

### **Further thought on the “fair value” concept**

**Accounting standards gave insufficient attention to the economic model** - both on the investor and on the company side - **and does not allow an analysis of the performance over the long term**, both for the choice of investment and for the analysis of profitability.

In addition, **the IASB has abandoned the principle of prudence**, enabling a wide extensive use of short-term valuations (“market value” or “current value”) in all financial statements, **resulting in volatility and pro-cyclical behavior**.

**The « mark to market » approach is perfectly adapted** to the description of trading activities, to the mutual funds activities (with daily valuation) and, more generally, it is adapted **to the balance sheets exposed to liquidity risks**.

**But this approach is nonsense for the evaluation of financial statements that have the capacity and the fiduciary duty to invest for the long term.**

**It is imperative to further the thinking on accounting in order to develop a new approach on “fair value” projected at maturity of liabilities**, which may neither be the “book value” nor the “market value”.

**IFRS standards admit the notion of long-term investment for industrial equipment and goodwill: in these circumstances there is no objective reason that IFRS do ignore this reality when investment is made in tradable securities.**

### **Business model et auditability**

A long-term investment policy is based on a streamlined expectancy of global cumulative performance forward: the fair value of the assets bought today to meet a commitment to be settled in X years is the probabilistic value withdrew from this asset when it will be the time to sell it in order to resolve this commitment.

**The accounts must strive to track this using value and its possible variations to measure the performance of management; in parallel, risk measurement can pass through the detection of temporary spreads with instant market values.**

The auditor in charge of the accounts certification will have to decide on the robustness of the evaluation of the projected values, as he already does in other cases (e.g. goodwill impairment) and then will justify its added value, which is nonexistent when simply applying the « market value ».

## Next steps

EU must open the path to the economic recovery that can only come from investment.

EU is the first customer of the IFRS and is now released from American control because of the recent decision taken by the SEC. In this context, **Europe must require the international accounting setter to accelerate the adoption of a standard appropriate to the reality of the “Long Term Investment business model”**.

It is necessary to set aside the dogmatic debates that have prevented the setter until now to deal seriously with the subject (e.g. the endless discussion on insurance regulation): in this context, **a detailed analysis of the impact of prudential and accounting regulations on long-term funding is needed** (on the overall impact of IFRS on the long-term financing and not on an IFRS standard in particular) and EFRAG is undoubtedly the relevant advisory group to provide the appropriate diagnostic given its expertise in this regard.

Mr de La Martinière relies on EFRAG to lead the way on this crucial topic and help to defend the long term investment in the talks with the IASB.

## Key Messages

- **The long-term investment is first defined on the liability side** because “long liabilities” allow implementing a long investment policy and can even turn this opportunity into an obligation, under the terms of the “fiduciary mandate” it implies. As a corollary, an investor who does not have a stable liability could not rely on the rules applicable to long-term investors.

The “Asset-Liability consistency” built upon the notion of long term constitutes the foundation of long-term investment, which itself can be made by a large variety of actors.

- **Institutional investors with a long-term horizon should be regulated and supervised appropriately.** In this case, the appropriate approach is to evaluate assets and liabilities in an integrated manner. This basic principle can be applied to the accounting field.
- Next to the “fair value” and “amortized cost” portfolios, **it could be relevant to create a third category of accounting portfolio dedicated to financial investments held for the long term**, benefiting of a specific accounting treatment adapted in the prudential matter.

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