

25 October 2013

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH  
United Kingdom

Dear Sir / Madam

**Feedback from EFRAG's work on the specific financial reporting need for long-term investing activities business models**

In April 2013 EFRAG provided the IASB with its comment letter on the IASB's ED *Classification and Measurement: Limited Amendments to IFRS 9*. EFRAG expressed the view that the ED failed to clearly identify the business model underlying the introduction of an additional measurement category at FV-OCI. EFRAG still supported that measurement at FV-OCI is necessary to address insurers' concerns about accounting mismatches versus economic mismatches and performance reporting.

In the context of the European Commission long-term investment green paper consultation EFRAG conducted public consultation on characterising long-term investment business models from financial reporting perspective.

This letter provides an analysis of the input received from constituents during the EFRAG public consultation and some recommendations. This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

**Characteristics of long-term investment business model**

In its public consultation on long-term investing activities business models, EFRAG identified the following main types of long-term investors:

- (a) insurance companies, primarily life insurers and pension funds
- (b) development banks and entities with public-interest objectives,
- (c) long-term investors, which manage and own sufficiently 'stable assets' to be able to build an investment strategy based on a long-term horizon, and
- (d) others with long-term commitments, such as nuclear facilities operators, which must acquire financial assets to meet future decommissioning costs.

Those investors identified several key characteristics of their business models:

- (a) their long-term investment strategy is financed by 'stable liabilities'; 'stable liabilities' are described as liabilities with a predictable profile and characteristics of the cash flows (tested by actuaries and risk management stress tests). This stability is considered to be the primary characteristic of a long-term business model;
- (b) where their investments are subject to market price risk, this risk is secondary in the evaluation of their financial position, because the stability of their liabilities provides great flexibility in recovering the value of their assets; and
- (c) the primary indicator of their performance is their long-term investment return.

A common characteristic of a long-term investment business model is the relationship of the investing activities with long-term liabilities, and the objective is to achieve a long-term return. 'Asset-Liability consistency' is the foundation of any long-term investment business model. While sharing the common characteristics above, the long-term investors who participated in our consultation can be divided into two broad groups:

- (a) Insurers, pension funds and others with long-term commitments, such as nuclear facilities operators facing future decommissioning costs; their long-term business model is 'liability-driven' as their investment strategy is driven by the economic objective of matching their long-term liabilities and generating returns, so as to cover interest cost and generate profit. The asset-liability management that supports the business model is quite dynamic so as to deliver optimised matching and highest yields, however, does not exclude assets held to maturity;
- (b) Development banks, which happen to be public banks and entities with public-interest objectives and other long-term investors, which manage and own sufficiently 'stable assets'; their business model is 'asset-driven' with the investment strategy serving public policy objectives. They are granted easy and cheap access to stable financing sources to meet those public policy objectives.

EFRAG has not yet debated and has not formed any preliminary view on whether the asset-driven long-term business model should have effects on the accounting requirements for financial and other assets and financing liabilities. EFRAG will consider this in future meetings and will provide a supplement to this letter if necessary.

### **How accounting should better reflect a long-term investment business model**

#### *'Liability-driven' business model*

Based on the above findings, EFRAG believes that an appropriate accounting regime should reflect the effects of the asset/liability management in aligning the measurement of assets with the measurement of liabilities that they are intended to back. Hence, accounting would help providing transparent information on potential economic mismatches in the balance sheet. Moreover, changes in assets and liabilities should be presented in the statement of comprehensive income with the objective of best portraying the long-term return that is generated from the asset in accordance with the entity's business model.

We have learned from our consultation on long-term investing activities business models that many in this long-term investment liability-driven businesses wish to see the impact of both, the changes in interest rate on the liability, and the changes in outstanding gains on the asset, shown in OCI, so that profit or loss reflects the primary measure of performance, i.e. is not impacted by short-term changes, except when impairment losses are incurred. However, those constituents who already report both assets and liabilities on the basis of current values and report profit or loss including all short-term changes are firmly opposed to showing those short-

term changes in OCI. Their experience brings evidence that the use of current values is not impeding the assessment of their financial position by investors, even though short-term changes are not isolated outside of profit or loss.

Discussions in the Accounting Standards Advisory Forum have shown that there is support for both views in Europe as noted above. There may therefore be a need, from the IASB perspective, to grant an option for all changes to be shown through profit or loss, whilst providing a basis for profit or loss to reflect the primary measure of performance as depicted above. In this event, disaggregation requirements should be such that the same information is provided on the face of the statement of comprehensive income to the extent possible and in the notes for the remaining information.

This difference in views illustrates that past financial reporting practice has quite a significant influence on the assessment different constituencies may make of the relevance and reliability of accounting requirements – and ultimately of how they contribute to meeting the true and fair view principle. Where profit or loss is affected – i.e. what is considered as the primary measure of performance – changes in financial reporting have to be evolutionary to ensure that they do not run the risk of disrupting financial communication between entities and investors. However, those evolutions should not be detrimental to improvements in transparency and comparability.

In its continued due process on the IASB's Insurance Contracts project, EFRAG aims to obtain a better understanding of existing asset-liability management strategies of long-term investors, and how they can serve as objective evidence of the long-term liability-driven business model. Where an entity would rather select the option of reporting all short-term current value changes in OCI rather than in profit or loss, there might be certain portfolios of contracts for which reporting through profit or loss would provide better financial information nevertheless. EFRAG will consider whether such portfolios exist and how their characteristics can be best depicted.

### **What model for impairment?**

EFRAG acknowledges that a decision to extend the use of OCI (with recycling) to a broader set of asset classes – in particular, debt instruments that do not meet the contractual cash flow characteristics assessment, and investments in equities – would require the development an appropriate impairment model.

Some respondents suggested an impairment model based on the lower of 'acquisition cost' and 'value in use'. They believed that the definition of 'value in use' as per IAS 36 could be extended to financial assets when the business model applied is to hold these assets for a long period. However, users expressed resistance on the 'value in use' considering that this leads to subjective measurement.

EFRAG had previously recommended an impairment model based on the lower of cost or market, because of its simplicity and its link to how the asset may be realised (i.e. through a market transaction). Allowing reversals keeps the performance reflected in profit or loss based on cost.

EFRAG aims to discuss the impairment model in the coming month and has at this stage not formalised a recommendation as to what this model should be.

### **Summary and recommendations**

Subject to the general limitations and constraints inherent in such type of consultations and subject to further work to be performed by EFRAG in its due process, EFRAG recommends:

- (a) that any accounting requirements applicable to long-term investment entities should not ignore the interaction between the liabilities and the related assets when selecting measurement bases and defining performance reporting requirements.

- (b) considering symmetrical treatment of the changes in assets and liabilities, as this is critical to faithfully represent the asset-liability management.
- (c) including the long-term liability driven<sup>1</sup> investment business model in IFRS 9 and considering what specific accounting requirements should be available to best depict it as well as whether some consequential amendments to other standards dealing with assets should be made (e.g. investment properties), so that asset and liability management can be best reflected, either in a fair value through OCI or a fair value through profit or loss option.

EFRAG believes that the above preliminary findings and recommendations would be useful in the IASB's redeliberations on the business model assessment in the *Classification and Measurement: Limited Amendments to IFRS 9* project, particularly as regards:

- (a) the articulation of the business model assessment and the information that should be used to make the assessment;
- (b) the objectives for the different business models, including the need to consider three measurement categories; and
- (c) the application guidance relevant to each business model within which the financial assets are managed;

If you would like to discuss our comments further, please do not hesitate to contact Ralitza Ilieva or me.

Yours sincerely,

Françoise Flores  
**EFRAG, Chairman**

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<sup>1</sup> As indicated EFRAG has not yet considered the accounting requirements that would best fit an asset driven business model.