25 June 2013

Our ref: ICAEW Rep 93/13

Ms Françoise Flores
Chairman
EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

By email to commentletters@efrag.org

Dear Françoise

Is there a Need for Specific Financial Reporting for Long-Term Investing Activities Business Models?

ICAEW is pleased to respond to your request for comments on the discussion paper *Is there a Need for Specific Financial Reporting for Long-Term Investing Activities Business Models?*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REP 93/13

ICAEW REPRESENTATION

IS THERE A NEED FOR SPECIFIC FINANCIAL REPORTING FOR LONG-TERM INVESTING ACTIVITIES BUSINESS MODELS?

Memorandum of comment submitted in June 2013 by ICAEW, in response to the European Financial Reporting Advisory Group discussion paper: *Is there a Need for Specific Financial Reporting for Long-Term Investing Activities Business Models* published in May 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Is there a Need for Specific Financial Reporting for Long-Term Investing Activities Business Models?* published by the European Financial Reporting Advisory Group (EFRAG) in May 2013, copies of which are available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The Faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

COMMENTS

5. The questions in the discussion paper (DP) are addressed to firms that have long-term investing activities and to investors in such firms. While, as a body of accountancy and finance professionals, we have members engaged in investment activities, it would not be appropriate for us to respond specifically from their point of view, and so we are not answering the questions posed in the consultation. Instead, we respond to the substance of the issues raised.

6. Although this may not always be recognised, business models already play a significant role in financial reporting. We support this role and we believe that a firm's reporting should reflect its business model so that the model's success or failure can be properly assessed. We discuss the role of the business model in financial reporting in our 2010 report *Business Models in Accounting: The Theory of the Firm and Financial Reporting* and more recently in our response (ICAEW REP 52/13) to the IASB exposure draft *Classification and Measurement: Limited Amendments to IFRS 9*.

7. This does not of course mean that every business model requires its own distinctive approach to financial reporting. There are advantages in applying accounting principles across different business models, both to keep requirements simple and to improve comparability across different types of enterprise. The question that arises in some cases is whether using a common accounting approach across different activities results in less useful information because it obscures the differences between business models and potentially gives a misleading impression.

8. Differentiated approaches are typically applicable where identical assets (or liabilities) play different roles in different firms' business models and therefore need to be accounted for differently to provide the most useful information. So identical physical assets – property, for example – may be trading inventory for one firm, a fixed asset for another, and an investment for a third. And identical financial instruments may be held for trading by one firm and held to

maturity by another. In cases such as these, where differences in business models mean that identical assets have different functions, it is accepted that accounting methods sometimes need to differ in order to reflect this.

9. The questions in relation to a long-term investing business model are therefore whether such a model exists and whether, if it does exist, it requires to be accounted for in a distinct manner.

10. As an initial point, it would have been helpful for the DP to have explained what 'long-term' means in the context of this consultation. We suggest that it would normally mean holding investments for at least 10 years, and some might see the long term as meaning 20 or 30 years.

11. We are doubtful how far there is such a thing as a long-term investing business model. Paragraph 12 of the DP identifies four characteristics of the purported long-term investing business model:

    - 'Investing activities are primarily aimed at earning a return on assets' – presumably as opposed to selling them for a profit. This sounds like a feature of a held-to-maturity model rather than a specifically long-term investing model. Many investments that are not long-term may also be held to maturity and also therefore be invested primarily to earn a return; money invested overnight may be invested primarily to earn a return.

    - **Either:** 'sales when they occur are aimed at optimising the level of return'. It is not clear what is distinctive about this feature. Is it being suggested that, under other investing business models, investors do not wish to optimise returns when they sell investments?

    - **Or:** 'sales when they occur are aimed … eventually, at achieving a better matching of long-term liabilities.' This may well be a distinctive feature of some business models, but it is the relationship with long-term liabilities that is distinctive.

    - Long-term investments may be made 'to maintain a long-term relationship with the issuer'. This sounds like yet another type of business model, as such investments are typically made by firms that are not investment businesses.

12. The first two features listed do not seem to help identify a distinctive long-term investing business model. The third feature is distinctive because of the relationship of the investing activities with long-term liabilities; we discuss this point further below in the context of insurance companies. And the fourth feature does not seem to apply primarily to investing activities, but to building relationships with suppliers and customers, and the investment supports this.

13. What is conspicuously absent from the DP is any identified business model that involves long-term investing for its own sake, rather being driven by the nature of the firm's liabilities or its desired relationship with a particular customer or supplier. Indeed, with the possible exception of Berkshire Hathaway, we are not aware of investment funds that are known for holding investments for the long term and not selling them. (And even Berkshire Hathaway is increasingly a conglomerate rather than an investment fund.) Most investment funds, even if their stated aim is to maximise long-term returns, indicate that they will do so by actively managing their portfolio. Passively managed funds, of course, have to buy and sell regularly to mirror changes in the index.

14. Paragraph 14 of the DP seems to brush aside the question of whether long-term investing activity actually involves holding on to investments for a long time once they have been acquired. But holding investments for the long term, and not selling them when a better opportunity turns up, must surely be the essence of long-term investing if such an approach is distinctive from other approaches to investing.

15. Responses to the DP from investment firms should help to clarify whether a long-term investing model does indeed exist and, if so, what its characteristics are.

16. The consultation suggests that insurance companies might come within the scope of any financial reporting approach developed for long-term investing activities. The most distinctive features of an insurer's business model are the nature, uncertainty and duration of its liabilities. Its assets as such are not usually distinctive, but to the extent that the unusual characteristics of its liabilities shape its investment activities, there is a case – though not necessarily a conclusive one – for thinking about how it accounts for its assets as part of the larger question of how best to reflect an insurer's business model. We have indicated in our responses to the IASB that, because of its special characteristics, it may be that the insurance industry would be best served by an industry-specific standard. But we do not think that a convincing case has yet been made to include the investing activities of insurers within a larger category of long-term investing activities, which requires its own distinctive accounting model.

17. We do not wish to comment in detail at this stage on the possible accounting treatments for the supposed long-term investing business model, as we do not believe that this model, if it exists at all, has yet been satisfactorily described. In general we take the view that assets held as investments are most usefully reported at their fair value. How gains and losses on the fair value of investments are best reported is a question that it is difficult to answer in the absence of a clear underlying rationale for what should be recognised through profit or loss and what should be recognised through other comprehensive income. However, we would not wish to rule out the possibility that such an underlying rationale could be related to firms' business models.

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