EFRAG

European Financial Reporting Advisory Group

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Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
Rue de Spa 2
1049 Brussels

Dear Mr Faull,

Reflecting long-term investment business models in financial reporting

In its Green Paper on Long Term Investment, the European Commission questioned whether current financial reporting requirements – including the use of fair value – were having a possible adverse effect on long term investment in Europe.

In the course of its consultations of European constituents, more particularly in the discussions of IFRS requirements for the classification and measurement of financial instruments and insurance contracts, EFRAG had received indications from long-term investors in Europe that their business model was not being appropriately addressed in IFRS proposals. This has been of great concern to us, as EFRAG, supported by many European stakeholders, affirms that accounting requirements should not impede proper reflection of an entity's business model.

In this context and as the European Commission's technical advisor on financial reporting matters, EFRAG has decided earlier this year to run a specific consultation on how to best depict a long term business model and whether it would have features that accounting requirements should help best reflect. The purpose of this letter is to explain our findings and the conclusions that we have reached to date. It also explains the recommendations that EFRAG has already made to the IASB, so that they can influence the finalisation of IFRS 9 classification and measurement requirements, and possibly other amendments to existing standards.

Below we explain the findings of our consultation, the role the business model should play, conditions for effective performance reporting and the use of fair values. Finally, we describe the recommendations that EFRAG has made to the IASB on these issues.

Findings from our consultation

We have learned from our consultation on accounting for long-term investment business models that 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) Long-term development banks, which happen to be public banks and entities with public-interest objectives and other long-term investors, which manage and invest in rather '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 – and further recommendations to the IASB - if necessary.

Liability-driven business model

Balance sheet perspective

Based on the above findings, EFRAG believes that an appropriate accounting regime should reflect the effects of asset/liability management in aligning the measurement of assets with the measurement of liabilities that they are intended to back. There is broad agreement that the long-term liabilities are best measured at current value (e.g. current fulfilment value for insurance liabilities) and consequently there is a need to account for assets at current value (or fair value) to avoid mismatches in the statement of financial position. Hence, accounting would help providing transparent information on potential economic mismatches in the balance sheet.

Performance reporting perspective

There is a broad agreement that 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 consultations that many in long-term investment liability-driven businesses consider that the net return on the asset/liability management that incorporates the (i) income received in the period from assets, (ii) gains on realisation, (iii) less impairment losses, provides a relevant primary measure of performance. As a result these constituents wish to see the impact of changes in interest rate on the liability, and the changes in outstanding gains on the asset, shown outside profit or loss (i.e. in what is called "other comprehensive income"), so that profit or loss reflects the primary measure of performance. Other constituents, however, have been used to report both assets and liabilities on the basis of current values and report profit or loss including all short-term changes, and are therefore opposed to any mandatory reporting of any of these short-term changes outside profit or loss.

Discussions in the Accounting Standards Advisory Forum (ASAF) have shown that there is support for both the majority and the minority views encountered in Europe. There may therefore be the 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.

Importance of the business model

Role of the business model in performance reporting

Measuring, but also presenting assets, liabilities, income and expenses in such a way that investors can understand how they contribute to the entity's cash flow generation can in itself be a way of representing the entity's business model. Segregating assets and liabilities which play a different economic role in the entity, for example helping provide optimum daily cash management versus creating liquidity for acquisitions and capital expenditures, would provide users with both a better basis for looking at financial results and forming expectations of future financial results.

EFRAG believes it is important that no standard ends up preventing entities from reflecting their business models. However, measurement cannot be considered in isolation. In order to achieve useful performance reporting, it is essential to consider how the effects of subsequent measurements are presented in the financial statements and how they impact profit or loss.

A more detailed analysis on the role of the business model is provided in the Bulletin *The Role of the Business Model in Financial Reporting,* which was issued in June 2013 by EFRAG, the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Italian Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC) This paper reflects and well articulates views that have been expressed by EFRAG in past IASB consultations on behalf of Europe. One of IASB's preliminary views in the revision of the IFRS conceptual framework is that indeed the business model has a role to play in financial reporting.

Insurance

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 other comprehensive income rather than in P/L, there might be certain portfolios of contracts for which reporting through P/L would provide better financial information nevertheless. EFRAG will consider whether such portfolios exist and how their characteristics can be best depicted.

Performance reporting

Importance of profit or loss as a main performance indicator

Users from almost all sectors incorporate profit or loss in their analyses, generally as a starting point for analysis. Profit or loss is also acknowledged generally as the main indicator of an entity's performance in financial communication. EFRAG believes therefore that profit or loss is an essential number that supports users' needs as it is the primary measure of an entity's performance. Given that the communication between preparers and users relies heavily on profit or loss, it is crucial that users have a good understanding of what this measure of performance depicts. Nevertheless, acknowledging that profit or loss plays a significant role in financial communication does not mean that it is the only information that should be used.

The IFRS conceptual framework defines income and expenses based on changes in assets and liabilities, and the IASB's Discussion Paper on the Conceptual Framework confirms this. EFRAG is aware that some believe that this results in the statement(s) of profit or loss and other comprehensive income being secondary to the statement of financial position. EFRAG and standard setters in Europe (for example the standard setters of the UK, Italy and Germany) do not share this view. Defining income and expenses based on changes in assets and liabilities does not conflict with the objective of producing useful performance figures, provided that measurement attributes are selected with the objectives of providing relevant information in both the balance sheet and the income statement, without giving any primacy to one or the other. This is consistent with the preliminary view expressed by the IASB in the revision of the IFRS conceptual framework.

Use of Other Comprehensive Income and recycling

EFRAG has discussed the use of Other Comprehensive Income (OCI) extensively in its deliberations on the projects mentioned above. We do not agree with the arguments by some that splitting items between profit or loss and OCI will prevent users from seeing and evaluating all items of income and expense. Indeed, EFRAG notes that other comprehensive income items bring meaningful information also, however, at a secondary level in the analysis of an entity's financial position. In many jurisdictions in Europe revaluations on the basis of current values have been introduced in accounting by IFRSs. EFRAG has observed that for most European stakeholders distinguishing between profit or loss and other comprehensive income is necessary for a proper understanding of an entity's performance and prospects for future net cash inflows.

EFRAG has therefore come to the conclusion that the distinction between profit or loss and other comprehensive income is quite helpful in providing more relevant information in both the balance sheet and the income statement. Indeed, in certain circumstances showing separately changes arising from the re-measurement of assets and liabilities at current value helps ensure that profit or loss has more predictive value and therefore better qualifies as starting point in the analysis of an entity.

It is well known that currently there is no clear conceptual rationale that explains why some items of income (and expense) are excluded from profit and loss, and reported in other comprehensive income instead, but some take the view that prudence may play a part. Others -more particularly in the international debate (e.g. Canada and Australia)[1]- tend to say that other comprehensive income is a compromise for those who resisted to the use of current values. In Europe, we have learned that there is very broad support for a distinction between profit or loss and other comprehensive income, provided that it is properly defined in the conceptual framework. Once the distinction is made, there remains broad support for 'recycling', i.e. reporting in profit or loss changes that are first recorded as other comprehensive income items, upon a pre-defined triggering event (e.g. sale of an asset, derecognition of a liability or unwinding of discounting). Developing principles for sound and understandable performance reporting is one of the priorities of the revision of the Conceptual Framework that is now underway. Also, we note that most consider that faithful representation, supported by the application of the prudence concept (which is discussed below), may command the recognition of gains under certain conditions of uncertainty be subject to a high probability realisation threshold, whilst losses should be recognised immediately.

[1] This appeared clearly from the discussions held at the first ASAF meeting in April 2013

EFRAG considers profit or loss as a useful primary performance indicator and believes that the components of this primary performance indicator may vary from one business model to the other.

Use of fair value

EFRAG supports the view that when selecting the measurement basis for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and other comprehensive income. In addition, EFRAG believes that the business model should also play an important role in selecting the appropriate measurement basis.

Whether or not current market prices should be used needs to be determined. Current market values will always be relevant for assets that are ultimately realised through sale. Depending on the circumstances – for example, whether the assets are quoted, whether the sale is to be realised in the short term, or whether assets are backing liabilities that are measured at current value – the standard setter needs to determine whether the information should be provided in the notes or drive the measurement basis.

Observable markets

EFRAG believes that circumstances in which current market prices are difficult to determine call into question whether the measurement objective should be to represent current market prices. Indeed, the absence of observable market prices calls into question whether a market exists and, therefore, whether a transfer scenario is probable. If, after further analysis, a current market price measurement objective is confirmed as a fair representation of an entity's business model and/or of the underlying economics of a specific transaction, cash flow based estimates should be used.

Prudence

In April 2013, EFRAG published the Bulletin *Prudence* together with the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Italian Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC).

The Bulletin observes that prudence does not necessarily mean that the income reported in financial statements is sustainable. Prudence may require the recognition of non-recurring losses, for example, when assets are impaired. However, prudence should not come at the expense of a transparent and faithful representation of an entity's financial position and performance. Beyond a certain level of 'prudence', financial reporting would no longer meet its objectives, as it would introduce bias in financial reporting and hence hinder reliability. Indeed, prudence if not defined and applied appropriately can also have the effect of distorting reported performance, as prudent accounting applied in an earlier accounting period reverses later and at that point provides a much too optimistic view of the entity's profitability.

Exercising prudence does not, in itself, rule out measurement at fair value (or any other form of current value). If estimates provided have the appropriate level of reliability, and the use of current values provides the best representation of how assets and liabilities contribute to the entity's financial position and performance, then the use of fair value should be required. Risk margins need to be factored in the estimate and encompass in the circumstances how prudence is addressed appropriately.

EFRAG notes that accounting requirements (such as the use of fair value) have been claimed by some as inappropriate and a driver of sub-optimal short-term behaviour. As explained above, the use of fair value may be necessary to achieve transparent and relevant financial reporting. It therefore does not make any sense to ban fair value as such. Europe's influence in the development of IFRSs must ensure that fair value measurements are mandated only when they support high quality financial reporting, including relevant performance reporting, as discussed above. This is on this basis that EFRAG has expressed its recommendations to the IASB in the past and continues to do so currently.

EFRAG's recommendations to the IASB

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, we have recommended to the IASB that:

(a) 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. Accounting should help provide 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 expected from the assets and the cost of bearing liabilities;

(b) symmetrical treatment of the changes in assets and liabilities is critical to faithfully represent the asset-liability management. Profit or loss should reflect the primary measure of performance that is not impacted by short-term fair value changes that are secondary in the analysis of the financial position of the entity, except when impairment losses are incurred; and

(c) the long-term investment business model(s) should be considered in the classification and measurement requirements for financial instruments under IFRS, and specific accounting requirements should be available to best depict them. Some consequential amendments to other standards dealing with assets should also be considered, so that the results of an asset and liability management can be reflected in the statement of comprehensive income on a consistent manner, whether certain short-term changes are reflected outside of profit or loss or not. In this context, it is important that the accounting requirements do not incentivise investments in certain types of assets (e.g. fixed income securities) over other (e.g. equity securities).

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

Yours sincerely,

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EFRAG, Chairman