EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

31 May 2014

Subject: Research Paper – *The role of the business model in financial statements*

Dear Sirs,

We thank you for providing us the opportunity to comment on the preliminary views raised in the Research Paper published in December 2013.

The European Long-Term Investors association ('the association' or 'ELTI') was created in 2013 to promote and attract long-term financing of sustainable investment in the real economy. Its Members are long-term investors (or LTIs) sharing a public or promotional development mission in providing long-term funding to sustainable investment projects supporting EU policy.

We believe that the current international accounting framework leads to pro-cyclical behaviours of investors who have the capacity and mission to focus on long-term rather than short-term results. A review of the impact of accounting standards on Long Term Investment is therefore required to encourage investments supporting the sustainable growth of real economy rather than short-term profitability.

In this context, we welcome your initiative to launch the debate about the role of the 'business model' notion in financial reporting and the need to give more prominence to this notion.

We have considered the various questions raised in the Research Paper and focus our answers on the questions where we consider that our feedback as long-term investors could benefit the debate. In particular, we want to stress that it is key to give more prominence to the business model criterion in order to provide relevant and useful information to the users of the entity's financial statements.

You will find our detailed answers in the annex to this letter.

We remain of course available, should you wish further clarification on our opinion.

Best regards,

Dominique de Crayencour
Secretary General

Question 1 - Implicit use of the business model

Chapter 2 discusses the explicit use of the term 'business model' in IFRS. The chapter also includes implicit examples of earlier use of the business model.

(a) Do you support the analysis of the implicit examples in IFRS? Please explain.
(b) Are you aware of additional implicit examples in IFRS?

No specific comment.

Question 2 - Cash conversion cycle

Chapter 3 discusses the assumed meaning of the business model, including an analysis of the cash conversion cycle.

(a) Do you agree with the analysis of the cash conversion cycle? Please explain.
(b) Are there any other attributes to add?

In order to fulfil its primary mission/objective, an entity may undertake various activities that are different in nature (e.g. 'selling assets' versus 'holding assets' activity type) however this does not necessary imply that such entity has two business models. The business model is best seen as derived from the primary mission/objective, while ancillary activities (e.g. treasury activities) support the realisation of the primary mission.

For those activities where the cash conversion cycle is over the long term, whatever the financial instrument characteristics, appropriate measurement should be applied. See also our comments to question 6.

When it comes to a Group and consolidated financial statements, our view is that a Group would be a combination of different, sometimes identical, business models reflecting the strategy of the parent company and therefore during the preparation of the consolidated financial statements the parent company's accounting policies should be applied. In itself a Group would not necessarily have a single business model but it would then consist in the aggregation of the respective business models of the entities forming the Group.

Key characteristics of the business model

Although we agree with the list of characteristics described in paragraph 3.11 of the Research Paper, we think that it would also be relevant to consider the nature of the value created by the business activities and who benefits from the value created.

Paragraph 3.19 argues that the reason a business exists is to create or add value for its owners. We believe that this approach is too narrow as the value created by an entity is not appropriated to the exclusive benefit of its shareholders. There are many other stakeholders to benefit from the businesses of companies.

This characteristic is at the heart of LTIs business model whereby the financial value created by the entity's activities serves a specific fundamental objective that is to invest and provide funding to long term projects supporting public policies. In this context, the financial value generated by LTIs activities is used to make the model self-sustainable over the long term for the benefit of the real economy and not only for the benefit of the entity's shareholders. See also our comment to question 3.

The cash flow conversion cycle

Paragraph 3.42 of the Research Paper identifies the attributes of the cash flow conversion cycle to be considered when identifying specific business models justifying different accounting treatment, namely:

- Length of the activity cycle
- How inputs are used
- How outputs are used to generate cash
- The type of risks related to the activity
- The degree of certainty in the generation of cash flows
- The degree of capital intensity.

We agree with the attributes described above in particular the need to consider the length of the activity cycle which is a key differentiating factor for LTIs. However, we consider that the length of the activity cycle should be analysed in the context of the value creation process of the entity. Indeed, LTIs may fulfil their objective of financing the long-term needs of the economy through different activities with different length of time without actually jeopardising their business model. See also our comment to question 3.1.

Question 3.1 - Banking example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If the different activities of Entity A and Entity B were both conducted in the same entity, would your answer to the above question be different? If so, why?

The example described in the Research Paper reflects two strategies:

- *Originate-and-Hold-Strategy*: Bank A has originated long-term assets and uses short-term deposits as a primary source of funding. As a consequence of the different duration between assets and liabilities, Bank A may have to hedge the resulting interest rate risk.

- *Originate-and-Sell-Strategy*: Bank B, which also uses short term deposits as a source of funding, subsequently sells the originated loans to other banks.

If entity A and B are traditional commercial banks, we consider that the above examples describe different business models because the value created for the benefit of the entity's stakeholders is achieved differently. Therefore the recognition and measurement of the loans should differ because the expected future cash flows of both entities are different (view A).

If those two activities were conducted in a single entity (commercial bank), a different approach to measurement for each portfolio of loans would still be required as the expected future cash flows for each activity is different.

The business model of entity A is close to a LTI business model that is to supply long-term financing to the real economy with loans but also with other instruments, such as equities. LTIs have the capacity to hold their assets over very long periods of time. However, although they have that capacity, this does not preclude them from selling those assets at a later stage and re-investing the proceeds for the benefit of the real economy (similar to activity of entity B). In that case, the recognition and measurement of assets should not differ because the value created by the entity is the provision of long term finance to the real economy and not a profit resulting from the sale for the benefit of the entity's owners.

Question 3.2 - Mobile network operator example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If the different sales channels of Entity A and Entity B were both conducted in the same entity, would your answer to the above question be different? If so, why?

No specific comment.

Question 3.3 - Insurance example

(a) Do you think the example describes different business models? Please explain.
(b) Do you support View A or View B? Please explain.
(c) If both insurance products of Entity A and Entity B were provided by the same entity, would your answer to the above question be different? If so, why?

No specific comment.

Question 4 - Playing a role in financial reporting

Chapter 4 discusses the conceptual debate as to whether the business model should play a role in financial statements. The Bulletin includes a tentative view that the business model should play a role in financial reporting, including financial statements, and asked whether constituents support that view.

Do you have any additional comments?

Does financial reporting based on the business model notion provide relevant information?

We agree that providing information reflecting events that are not likely to occur, or using valuations that do not reflect the most likely way an entity will realise its cash flows does not help users in assessing future cash flows. This is typically the issue faced by LTIs whereby assets held for the long term still need in some instances to be recognised and measured at fair value on the basis of the instruments characteristics.

For long-term oriented entities, short-term valuation effects do not provide relevant information when the risk management strategy of the entity is to hedge for potential losses. This is crucial in *Hedge Accounting* where, for instance, changes in the tenor basis spread are temporary and therefore should not result in any volatility in earnings.

The same holds true for *Impairment* where a 'through the cycle' approach should be adopted for those entities with a long-term oriented business model.

The purpose of financial statements is not to capture the cash flow potential that has been created or destroyed by the entity but to capture the performance of the entity in the context of its business model. Investors assess the performance of the entity in a given context i.e. the entity's business model and therefore there is a need to make the link between reported performance and business model.

As LTIs, recognition of transitory unrealised results that will never materialise into cash flows does not provide relevant information to the users of financial statements. In our view, too much emphasis is put on the characteristics of the instrument resulting most of the time in the same accounting treatment applied to different transactions but involving the same instrument type (e.g. equity, derivatives). Most of the time, users of the financial statements would exclude unrealised results from their analysis based on the description of the business model provided by the entity's management in supplementary information.

However, we recognise that fair value can be informative even in the context of a LTIs business model. Therefore, we would support an approach whereby assets and liabilities are presented in the primary financial statements at amortised cost and fair value provided as additional information in the notes to the financial statements.

Does financial reporting based on the business model notion provide faithful representation of economic phenomena?

We support the argumentation of paragraph 4.34 that reflecting the business model of an entity is enhancing faithful representation of economic phenomena.

Does financial reporting based on the business model notion provide information that is comparable?

We support the view that comparability is also about accounting differently for dissimilar activities and events. The 'business model' notion contributes to increase the comparability of financial statements of entities with similar business models.

Does financial reporting based on the business model notion provide information that is understandable?

We also observe that when net income reflects gains and losses that will not materialise in an entity's cash flow generation in the ordinary course business, management needs to devise its own performance indicator to eliminate those gains and losses in its communication to investors in order to provide understandable information.

Introducing the notion of 'business model' in financial reporting could increase the comprehensiveness of the information communicated however, it would need to be combined with a review of disclosures which usually tend to be more extensive that what is actually required by the standards.

Question 5 - Criteria for use of the business model

Chapter 5 discusses the implications of the business model in IFRS and proposes criteria to be used in the *Conceptual Framework* to identify when the business model might be used in accounting standards. The chapter also proposes principles for identifying business models in those accounting standards.

> (a) Do you agree that criteria should be included in the Framework to provide a more systematic approach for accounting standard setters to consider the business model?
> (b) If so, do you agree with the suggested criteria?
> (c) Are there additional criteria that should be included? Please explain.

The 'business model' concept should be a key element of the Conceptual Framework and should be the basis of the development or revision of accounting standards.

As long term investors with a specific business model, we consider that to adequately portray the economic reality of our activities, more prominence should be given to the business model concept from which the accounting treatment of transactions should then be derived. This implies that the Conceptual framework should make explicit reference to the business model when setting or revising accounting standards.

We agree with the criteria proposed in paragraph 5.7 of the Research Paper. We also support the view that standards should include criteria to ensure verifiability of the business model application.

Question 6 - Implications of the business model

The Bulletin proposes some implications to IFRS and asks whether constituents support the implications to the IFRS literature.

> Do you have any additional comments?

The need to consider the specificities of long-term investing business models, notably in the context of IFRS 9 and fair value accounting, was recently highlighted in a Communication from the European Commission on the long-term financing of the European economy. In that context, EFRAG conducted a public consultation on characterising long-term investment business models from financial reporting perspective and recommended, on the basis of the input received, 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*'.

The business model concept would therefore be the most helpful criterion in defining **measurement**. For example, in the context of a "long term investment activities" business model, we consider that fair value is not always the appropriate measure; it creates artificial volatility in that transitory unrealised results will not normally materialise given the purpose and intention of holding certain instruments.

Given that the current Conceptual Framework does not consider the role of the business model in financial reporting and in the context of the forthcoming endorsement of IFRS 9 by the European Commission, we propose to have an alternative and pragmatic approach whereby the business model of holding financial assets over a long term perspective would be given primacy over the mere characteristics of such instruments. Such approach should be the basis to determine the appropriate measurement of these instruments.

The business model concept would also be useful in defining **disclosures**. Again in the example of long term investment activities, we believe that a more comprehensive analytical presentation could be put in place to help the readers better understand and identify such investments. Disclosure of transitory unrealised results could be done in the notes and would therefore avoid artificial volatility impacting the entity's results. Such approach would also be more transparent.