

# **UNLOCKING INVESTMENT IN INFRASTRUCTURE**

**Is current accounting and reporting a barrier?**

B20 Panel of six international accounting networks

June 2014

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# Narrowing the **gap**

Encouraging infrastructure investment poses many challenges for governments and developers – and none as urgent or as complex as how to finance it. Over the next 15 years, the gap between available funds and demand for infrastructure development around the world could be \$500 billion annually.

This report focuses on whether improvements in accounting and corporate reporting could help to attract increased private financing by offering a broader perspective on shareholder value creation.

The Panel acknowledges that other factors – such as the evaluation of regulatory requirements or the development of credit enhancement structures for project bonds – have a more significant role to play in increasing investment in infrastructure. However, we believe that greater transparency of project data and risks would help to capture potential capital, and therefore certain improvements could make corporate reporting more conducive to infrastructure and other long-term investment.

Read on for more detail on our proposals.

## **B20 Panel of six international accounting networks**

# Our recommendations

## Corporate reporting

### Longer-term focus

The Panel recommends that the 2014 B20 make the following actionable recommendations to the G20.

- Encourage corporate reporting initiatives that provide investors with a longer-term and broader perspective on shareholder value creation to complement the historical financial performance and current financial position perspective provided by financial statements. The B20 notes the particular relevance of integrated reporting as an example in this respect. Each G20 Finance Minister should assess and address any practical, legal or statutory barriers to improved corporate reporting and work towards removing such barriers in order to make corporate reporting more conducive to infrastructure and other long-term investment.

## Accounting standards

### Financial reporting initiatives

The Panel believes that, for the most part, changes to accounting principles would not increase the attractiveness of long-term infrastructure investments. However, the Panel supports the International Accounting Standards Board's (IASB) ongoing work to improve financial reporting.

- The IASB should continue working with priority on the issuance of a global standard on insurance contracts in the near future and to avoid accounting mismatches between insurance contract liabilities and related assets.
- The IASB should give further consideration to performance reporting as part of the Conceptual Framework and Disclosure Initiative projects.

## Prudential regulation

### Risk calculations

The Panel believes that regulatory requirements and regulatory change can play an important role in investing decisions.

- Regulators should evaluate whether risk charges or calculations are appropriately aligned with the risk patterns of investments in infrastructure projects.

# Why is this important?

Standard & Poor’s (S&P) and McKinsey estimate that \$57 trillion, or \$3.2 trillion a year, will be needed to finance infrastructure development around the world over the next 15 years<sup>1</sup>. Based on this demand, S&P estimates that the gap between investment needs and available funds could be \$500 billion annually. The global financial crisis and weak macroeconomic factors have played a role in the growth of this gap by negatively affecting the supply and accessibility of long-term financing. As demand for infrastructure continues to climb, constrained government budgets, volatility and risk aversion in the marketplace, and the need for banks to deleverage have put pressure on project financing.

The challenge of how to address growing infrastructure needs has drawn global attention and discussion. One area of focus is the role that increased private financing – in particular from institutional investors such as pension funds, sovereign wealth funds and insurance companies – may be able to play in filling the gap. The World Economic Forum and a number of analyst and consultancy organisations report that private investors are showing increased appetite for infrastructure investments<sup>2</sup>; however, the ability to capture this capital is affected by the availability of well-prepared projects and other factors that influence the attractiveness of opportunities and drive investing decisions.

“As it stands, the long-term global project finance market consists of a handful of banks and various capital markets players, including insurers, infrastructure fund managers, and investors in public bonds. Of these competing businesses, institutional investors have shown the biggest increase in appetite for such investments.”

S&P, 2014

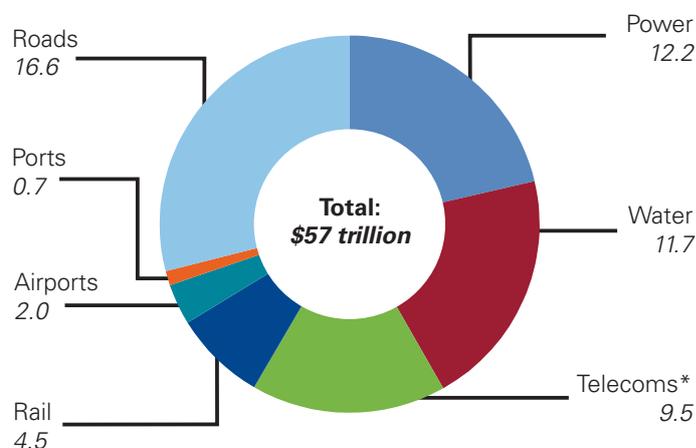
<sup>1</sup> *Global Infrastructure: How to Fill a \$500 Billion Hole*, Standard & Poor’s Rating Services, January 2014. *Infrastructure productivity: How to save \$1 trillion a year*, McKinsey Global Institute, January 2013.  
<sup>2</sup> *Bridging the Gap: Meeting the infrastructure challenge with public-private partnerships*, The Boston Consulting Group, February 2013. *Strategic Infrastructure: Steps to Prepare and Accelerate Public-Private Partnerships*, World Economic Forum, May 2013.

Mind the gap: Global infrastructure investment needs vs public sector funding sources to 2030			
	Base case	Downside	Upside
Total need through to 2030	\$57 trillion	\$57 trillion	\$57 trillion
Government spending	3% of GDP	2% of GDP	3.5% of GDP
Total gap	\$8.4 trillion	\$24.6 trillion	Zero
Annual gap	\$500 billion	\$1.5 trillion	Zero

Source: Standard & Poor’s, 2014 (Based on: OECD; McKinsey & Co; Global Insight)

## Global infrastructure investment required

2013–30, \$ trillion, 2010 prices

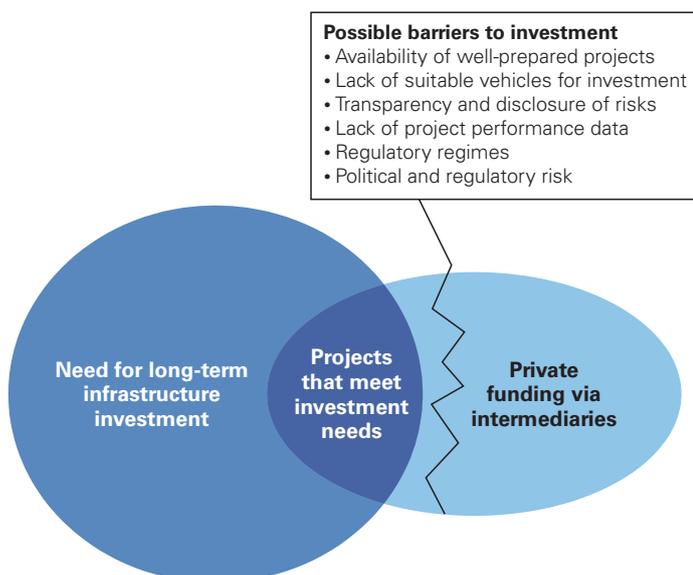


\*Brazil, China, India and OECD countries only

Source: McKinsey Global Institute

The World Economic Forum noted that a contributing factor to this gap is a lack of infrastructure projects with sufficiently reassuring commercial and technical feasibility, risk allocation, public sector contractual commitment and capacity, and institutional and legal frameworks<sup>3</sup>. Governments may need to revisit how they select, design, deliver and manage infrastructure projects – including frameworks or standard procedures for project procurement and approval. For example, they may want to increase visibility through the regular publication of a pipeline of project opportunities<sup>4</sup>. In addition, the creation of a transparent, harmonised and accessible infrastructure asset class on a global level to attract long-term investors would benefit from standardisation and the establishment of common governing laws and aligned contract terms<sup>5</sup>.

This report does not discuss enhancements that could be made in these areas; however, it does consider how the transparency of project data and risks could be increased, and evaluates the impact that reporting practices may have on investor decisions relating to long-term infrastructure projects.



“... Several impediments are holding back infrastructure spending: Ongoing banking sector deleveraging restricts lending and uncertainty regarding regulatory and political developments further reduces market participants’ appetite to commit long-term capital.”

Swiss Re, 2014

## Infrastructure financing

Infrastructure may be owned and managed by either governments or private companies and, in the case of government ownership, may be developed and operated in the private sector or through public-private partnerships. Infrastructure financing can take many forms, including direct lending, commercial bank loans, project bonds issued via public capital markets or private placements, direct equity investment and funds raised from managed infrastructure funds.

New financing structures have also been emerging that provide credit enhancement of senior debt through subordinated or shorter-term debt from commercial lenders, or that include some form of guarantee or support from government or a multilateral organisation.

## Shifting focus from the short-term

An area of concern is how short-term performance affects the ability to raise capital from savers, shareholders or policyholders. For example, fair value-related fluctuations in equity or financial results may trigger market responses such as changes in share price. Institutional investors may also face public scrutiny of results, and therefore fair value fluctuations may lead to questions about their investment decisions and asset management. Internally, compensation structures – including management incentive plans or board compensation – are often linked to financial results. All of these factors give rise to pressure to generate strong financial performance in the short-term, even if investments are intended to be held for a long time horizon.

<sup>3</sup> *Steps to Prepare and Accelerate Public-Private Partnerships*, World Economic Forum, May 2013.

<sup>4</sup> *How to Unlock Long-term Investment in EMEA Infrastructure*, Standard & Poor’s Rating Services, October 2013.

<sup>5</sup> *Infrastructure Investing. It Matters*, Swiss Re, February 2014.

“Money managers have huge incentives for making momentum-driven investment decisions. In the short run, going with the flow is often the safest bet, no matter how irrational this flow may be.”

Hans Hoogervorst<sup>6</sup>, IASB

One element to consider is the role that accounting principles play in encouraging short-term behaviour. However, identifying an alternative model to fair value accounting that would provide users of financial statements with useful information and enhance the transparency and consistency of information poses a significant challenge. Nonetheless, there may be other viable ways to discourage short-termism.

One approach recently recommended<sup>7</sup> includes encouraging companies to focus communication on metrics that are truly material to long-term value creation and most useful for investors, and insisting that their own analysts get a better grasp on long-term metrics and their asset managers integrate them into their investment philosophy and valuation models. This in turn would enable institutional investors to focus more capital on the longer term.

“Eliminating information asymmetry is the key to minimising moral hazard.”

Hans Hoogervorst<sup>6</sup>, IASB

In the context of infrastructure investments, a lack of information to assess long-term prospects tends to place the focus on short-term earnings. To shift the focus, corporate reporting needs to extend beyond merely a discussion of past financial performance and provide a more complete picture of value, including more emphasis on explaining the factors driving future performance and greater focus on explaining

how an entity uses and develops its key resources. As these matters are not highlighted in financial reports, consideration should be given to corporate reporting reform through initiatives such as integrated reporting.

## Our discussion

The central question that the Panel was asked to address was “Can improvements in accounting and corporate reporting be made to support investment in infrastructure?”

To frame this discussion, the Panel considered the perspectives of both target entities for investment (investees) and those whose role it is to channel funds from savers and policyholders to investees (intermediaries). This report focuses first on investigating challenges faced in raising funds for long-term investment and improvements that the Panel believes can be made to the broader corporate reporting model to increase the transparency of project data and risks. Subsequently, it focuses on exploring whether accounting standards, such as International Financial Reporting Standards (IFRS), generate obstacles to investment and, if so, where changes could be made by standard setters to reduce any such impediments.

<sup>6</sup> *Building Trust in Financial Markets: Accounting and Moral Hazard*, Hans Hoogervorst (Chairman of the IASB), Ken Spencer Memorial Lecture, Sydney, April 2014.

<sup>7</sup> ‘Focusing Capital on the Long Term’, *Harvard Business Review*, D Barton and M Wiseman, January 2014.

# Why is **corporate reporting** important to investment in infrastructure?<sup>8</sup>

## Key issues & findings

- Information about key inputs for investment decisions is not captured in a cohesive, balanced and structured way by the existing corporate reporting model.
- Lack of information on operational factors and lack of transparency of infrastructure project performance hinders long-term investing decisions.
- The balance of objective information available to investors tends to be weighted towards short-term performance, and information gaps result in heightened investor uncertainty.
- Corporate reporting needs to provide information that supports investor assessments of potential project outcomes – historical earnings information is an essential part of this, but it cannot provide the complete picture on its own.
- Improved corporate reporting should be more focused on key drivers for investment, such as the earnings and cash flow potential, risk profile or regulatory capital impacts of long-term infrastructure projects, providing a more holistic view of how value is created over time.
- Integrated reporting principles are one possible way of achieving improved corporate reporting that provides investors with a longer-term perspective on shareholder value creation to complement the historical earnings perspective provided by financial statements.
- Companies should be allowed flexibility to experiment with the implementation of such principles. Accordingly, countries should focus on removing barriers to innovation in corporate reporting rather than trying to prescribe new forms at this stage.

In making investment decisions with respect to infrastructure projects, financial targets and risk assessments play an important role. The latter includes consideration of the commercial and technical feasibility of a project, construction risks, political risks, the regulatory and legal framework within which the project is conducted, and potential tax implications, as well as the financing vehicle for investment. Information about such key inputs for investment decisions may be available to potential investors on a proprietary basis or, alternatively, they look to investor briefing packs and other voluntary disclosures<sup>9</sup>. It is not, however, widely available, nor is it captured in a cohesive, balanced and structured way by the existing corporate reporting model.

The lack of information on these operational factors means that the balance of objective information available to investors is weighted towards short-term performance, with the result that investors may be driven towards investments that generate short-term returns over those that may have better, but less visible, long-term prospects.

In a report that discusses key factors that could unlock investment in infrastructure projects, S&P expresses the view that sharing infrastructure project performance data is vital to improving transparency in the market<sup>10</sup>.

<sup>8</sup> There is no universally agreed nomenclature for corporate reporting. For the purposes of this report, corporate reporting includes all the information produced by an entity for users, including the entire collection of statements that comprise the financial report, which typically includes a front-end narrative (e.g. 'management discussion and analysis' or 'strategic report') as well as the financial statements comprising a detailed summary of the financial picture for a given period of time. It also includes other forms of corporate information for users, such as press releases and analysts' presentations.

<sup>9</sup> Primary investors in infrastructure projects typically have access to information that is not available in the investee's corporate report, such as the project finance model, demand forecasts and discussions with project advisors, as well as ongoing monitoring and updates to this information.

<sup>10</sup> *How to Unlock Long-term Investment in EMEA Infrastructure*, Standard & Poor's Rating Services, October 2013.

The report indicates that:

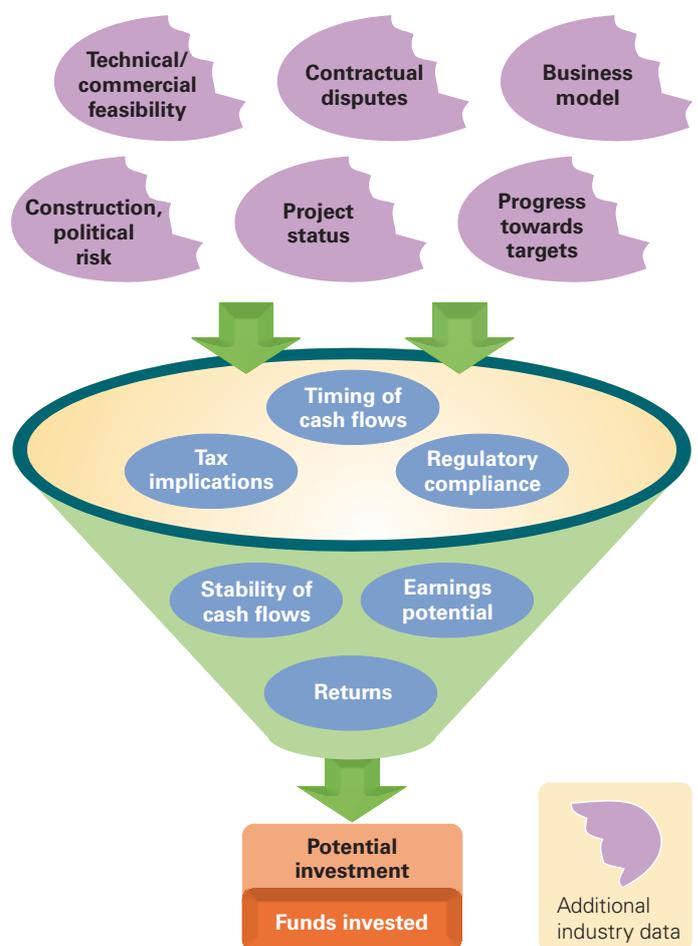
“... Lack of industry data is often cited by potential investors as a deterrent to funding infrastructure projects... Lack of transparency and disclosure of risk heightens investor uncertainty and creates market unease. Of particular concern is the general lack of information regarding operations, financial statement line items, and the nature and effect of other events and conditions such as the consequences of adverse weather on a project’s operations or disputes over the terms of the contract that are relevant to the analysis of project finance transactions.”

S&P, 2013

The Panel believes that improvements to corporate reporting in a broader sense could address these concerns and thereby potentially attract additional funds to investment in infrastructure.

If corporate reporting is to be more conducive to investment, it will need to provide information that supports investor assessments of potential project outcomes. Historical earnings information is an essential part of this, but it cannot provide the complete picture on its own. This is particularly true as new and innovative financial instruments are being developed for infrastructure investments, with the aim of attracting pooled investment from wider circles of investors, who individually may not have direct access to all the information needed to make their capital allocation decisions<sup>11</sup>. Investors may also initially receive more information when evaluating whether to invest, but once the investment has been made, they and potential future investors may not receive the information necessary to evaluate or monitor the performance of the project(s), resulting in reduced liquidity and therefore attractiveness of the investment.

<sup>11</sup> Pension fund trustees have been reluctant to invest in long-term projects, partly because current corporate reporting has not fully explained project risks and their mitigation. Local currency corporate bonds for infrastructure projects, supported by an integrated report in fundraising documentation, may be an effective mechanism in mobilising pension monies for infrastructure and other long-term investment.



## The need for increased transparency and better corporate reporting

Providing a more holistic view of how value is created over time and increased transparency into key value drivers and risks would enable informed long-term investment decisions and could unlock financial capital.

Broadening the audience this information is available to, by refining corporate reporting, would provide alternate investors with decision-useful information that may increase their level of comfort with an investment opportunity.

“Strengthening transparency and accountability in public construction yields benefits both domestic and international. It curbs mismanagement, waste, and corruption and reduces risks to public safety from poor building practices. It improves fairness in competition for contracts and can also increase the flow of foreign direct investment and development finance into a country’s construction sector.”

CoST<sup>12</sup>, 2013

However, the specific information relevant to each entity will be different. Reporting should therefore be more focused on the key drivers of value for each entity and on providing relevant and reliable information that investors can use in their own assessments of business cash flow prospects, in a more integrated and timely way than is the case under today’s corporate reporting model. Such information might include, for example, disclosure of metrics that relate to key drivers, information relating to underlying operational risks and their mitigation, and the earnings potential or the stability of cash flows generated by infrastructure projects.

A recent report<sup>13</sup> recommends that entities begin their efforts to communicate business value with simple metrics that reflect how a sustainable business strategy bears directly on three key concerns of investors: current and future revenue growth, the organisation’s overall productivity and operating margin and its exposure to risk. It proposes the following model as a tool that can assist entities in constructing their own metrics to describe the connection between their business strategy and overall performance.

### Value driver model



Source: UN Global Compact, 2013

### Integrated reporting as a means to improve corporate reporting

The Integrated Reporting Framework – issued by the International Integrated Reporting Council (the IIRC) – has been designed to achieve a more holistic view of how value is created over time by providing more insight in business strategies, performance and prospects in corporate reports. This broader perspective has the potential to support better investment evaluation models even for the most complex projects, and hence better investment decisions with a more forward-looking time horizon.

The Panel recognises integrated reporting principles as a means by which improved corporate reporting could be achieved. Businesses worldwide can consider using its principles for the better articulation of their investment value proposition, by explaining strategy, performance and prospects, to engage investors on a more long-term journey to attract investment<sup>14</sup>. Integrated reporting builds on current financial reporting by expanding the content of communication from historical financial results and current financial position to the much broader concept of how the organisation has created value in the past and how it intends

<sup>12</sup> CoST Factsheet, Construction Sector Transparency Initiative (CoST), December 2013.

<sup>13</sup> *The Value Driver Model: A Tool for Communicating the Business Value of Sustainability*, UN Global Compact and the Principles for Responsible Investment (PRI), December 2013.

<sup>14</sup> 'The International <IR> Framework Released with Business and Investor Support', Paul Druckman (IIRC Chief Executive Officer), December 2013.

to continue to create value in the future. Financial reporting continues to play an important role in integrated reporting, by providing financial information to monitor the entity's progress and act as confirming evidence, alongside operational performance information.

Infrastructure and long-term investing energy businesses such as Sasol, Eskom, Transnet, AES Brasil and National Grid have already started developing integrated reports and are leading the way in evolving corporate reporting. The IIRC also now has formal arrangements with the IASB (global), Financial Accounting Standards Board (USA) and other key standard setters.

To support long-term investment, improved corporate reporting content should be driven by the needs of investors in relation to the specific circumstances of the business. It should therefore allow companies to determine how best to tell their own value creation story rather than being restricted by formal requirements. Accordingly, the Panel does not recommend that integrated reporting be mandated or regulated at this stage, but rather believes that businesses should be encouraged to explore reporting changes and continue to drive innovation in this area.

**“It is the right time to participate in the journey towards a better, more cohesive reporting landscape that makes sense both to businesses and to the decisions of providers of financial capital, in this interconnected, complex and resource-constrained world.”**

Paul Druckman<sup>15</sup>, 2013

The IIRC's pilot programme is one of those initiatives that has helped drive innovation in this area, and the South African 'apply or explain' approach through Johannesburg Stock Exchange corporate governance principles, although not requiring full compliance with the Integrated Reporting Framework, is an example of an effective model for national, non-mandatory and widespread adoption.

The Panel encourages G20 nations to consider the implementation of reporting initiatives that provide investors with a longer-term perspective on shareholder value creation to complement the historical earnings and current financial position perspective provided by financial statements. The Panel notes the particular relevance of the principles that form the basis for integrated reporting in this respect. Many countries' narrative reporting requirements already contain aspects that are consistent with these principles, but these national requirements are typically applied in the context of the financial performance of the business, rather than its broader operating performance.

Each country will need to examine any practical, legal or statutory barriers, such as safe harbour provisions, to improve corporate reporting and work towards removing such barriers. It will also need to consider whether to emphasise a particular report to which reforms could be applied<sup>16</sup> and how to ensure that reforms are applied to corporate reporting in its broadest sense, rather than purely the reporting of financial information.

<sup>15</sup> 'The International <IR> Framework released with business and investor support', Paul Druckman (IIRC Chief Executive Officer), December 2013.

<sup>16</sup> For instance, in the UK, this could be the strategic report; in the USA, it could be the management discussion and analysis; in Australia, it could be the operating and financial review.

# Are **accounting standards** the obstacle?

## Key issues & findings

- It has been suggested that the use of fair value accounting principles has led to short-termism in investor behaviour.
- Differing investor business models and regulatory environments may drive different strategies or objectives when evaluating investment opportunities. Therefore, accounting principles may give rise to different concerns depending on the investor's business model.
- When making investing decisions, investors tend to place the emphasis on the underlying features and risks of infrastructure investment opportunities. As a result, for the most part, changes to accounting principles would not increase the attractiveness of the long-term infrastructure investments.
- Accounting information provides important input and confirming evidence to financial markets; therefore, ongoing financial reporting initiatives, such as the IASB's Conceptual Framework and Disclosure Initiative projects, have a role to play in the continued improvement of corporate reporting. The IASB should also continue working with priority on the issuance of a global standard on insurance contracts in the near future and to avoid accounting mismatches between insurance contract liabilities and related assets.
- Prudential regulations may influence investing decisions – consequently, regulatory risk charges or calculations should be appropriately aligned with the risk patterns of investments in infrastructure projects.

Financial reporting is an essential element of corporate reporting and is the only element that has detailed standards. Accounting is the means by which companies communicate to their investors and the financial markets, and therefore is part of the information set that supports long-term investment. The Panel therefore explored whether, from the perspective of investors and intermediaries, existing accounting standards form an impediment to infrastructure and other long-term investment.

## Is fair value accounting a problem?

When evaluating challenges and opportunities relating to long-term financing, questions have been raised about fair value accounting. Some long-term investors argue that short-term volatility resulting from fluctuations in the market values of their investments does not provide information on real performance as the fluctuations are not indicative of the prospects for future net cash inflows. Suggestions have therefore been made for the use of accounting principles with the objective of eliminating transitory short-term volatility from the statement of profit or loss.

In a recent public consultation, the European Commission asked stakeholders to what extent they considered the use of fair value accounting principles has led to short-termism in investor behaviour. The summary of responses indicates that many respondents thought the use of fair value had led to short-termism to some degree, but acknowledged the issue is complex and that there is no perfect alternative<sup>17</sup>.

Fair value information can be important to investors and intermediaries because the decision to buy, continue to hold or sell an investment in an entity is influenced by the expected future cash flows to be generated by its assets (individually and in combination), the timing and the riskiness of those future cash flows.

<sup>17</sup> Responses to Commission Green Paper on Long-term Financing of the European Economy, European Commission, January 2014.

Arguments have been presented that during the financial crisis the requirement to account for and disclose certain financial instruments at fair value helped to identify issues on a timely basis and highlighted issues that would have remained hidden under cost-based models. Reporting fair values therefore provided market participants with an early warning of potential losses on certain types of instruments. There are also views that investors cannot afford to ignore short-term fluctuations as they need to assess to what extent they believe those short-term changes are indicative of longer-term changes in value, and act accordingly.

Currently, accounting principles try to report economic performance as it happens, which includes the short-term. Frameworks that attempt to reduce volatility to show a long-term trend, such as a buy and hold approach that uses a forecast return as a basis for valuation or a target-date accounting approach, involve some form of hidden reserve or excess provision, which translates into reduced transparency and therefore potentially creates a new barrier to long-term investment.

IFRS<sup>18</sup> does not currently prescribe a full fair value model of accounting. Rather, the measurement basis of assets and liabilities depends on their characteristics, the intent with which they are held and, in some cases, the business model of the entity. Very few non-financial assets and liabilities are measured at fair value under IFRS and, when they are, changes in fair value are usually not recognised in profit or loss. However, financial assets are different because they generate cash flows in their own right.

The IASB takes the view that there are some financial assets, such as investments in equities, whose cash flows are uncertain and variable such that fair value is the only appropriate basis for measuring them in financial statements. On the other hand, some financial assets such as loans and investments in bonds, and most financial liabilities such as borrowings and issued bonds, have cash flows that are consistent with a basic lending arrangement and are measured at amortised cost if held for the long-term.

Reporting of gains in income when a borrower's credit position deteriorates has been a source of concern for a number of years. When financial liabilities are measured at fair

value, recent changes to IFRS mean that fair value changes resulting from changes in the borrower's own credit standing are excluded from reported profits and reported, instead, in other comprehensive income (OCI).

For equities (e.g. when held as long-term strategic investments), an entity would usually recognise gains and losses outside reported profits, in OCI. This mitigates the impact of short-term changes in value on the reported performance.

It should be noted, however, that the value of strategic investments is not fully captured by measuring the underlying shares at their market values. Benefits such as market access and those generated by strategic alliances, enhanced reputation, shared branding, etc. are not reflected in the market value of traded shares because they arise only when the relationship between investor and investee goes beyond providing capital funding in return for dividends. The Panel has yet to find a measurement approach that is reliable *and* that properly captures the value in a strategic equity stake in another business; however, market value is certainly more relevant than the alternative of historical cost.

As discussed in more detail below:

**“The Panel believes that for the most part, changes to accounting principles would not increase the attractiveness of the long-term infrastructure investments, as in the experience of the Panel investors place more emphasis on the underlying features and risks of these instruments.”**

While reform to accounting principles may not be able to resolve the infrastructure financing gap, accounting information continues to provide important input and confirming evidence to financial markets. Performance reporting is one area, already being evaluated by the IASB as part of its Conceptual Framework project, that the Panel believes would benefit from further consideration. In particular, the evaluation of the use of OCI for reporting fair value gains or losses and the ability to reclassify (recycle)

<sup>18</sup> Or other financial reporting frameworks or national regimes, including US GAAP and/or regulatory or supervisory valuations.

changes in value reported through OCI to profit or loss in subsequent periods. Many long-term investors are in favour of an approach that uses OCI to reduce potential accounting mismatches that arise if changes in economic conditions affect both assets and liabilities, but their carrying amounts do not respond equally to those changes.

## Different categories of investor

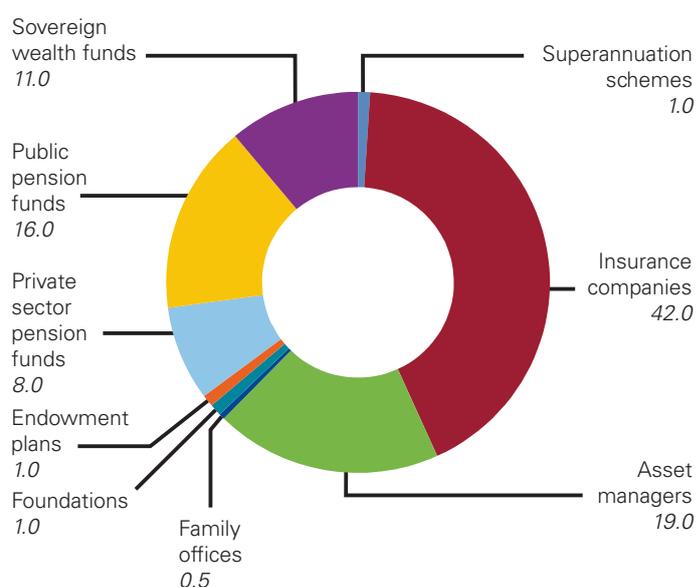
Various forms of investment opportunities and financing models are available for infrastructure projects that would result in either debt or equity instruments being held by intermediaries. The question then arises whether these instruments should be accounted for at fair value or amortised cost, as well as where or how any changes in fair value should be reported.

Recently, there has been increasing attention and discussion about the role business models should play in accounting standards development and the selection of accounting policies adopted by entities<sup>19</sup>. As part of this debate, concerns have been raised as to whether accounting requirements appropriately reflect long-term investing business models<sup>20</sup>.

Differing investor business models may drive different strategies or objectives when evaluating investment opportunities. For example, there may be variation in the target stage of project completion among investors, certain forms of investment may be more attractive than others for particular investors (e.g. bonds vs equity) or the availability of alternative investment opportunities may differ. Different categories of investors are also subject to varying degrees of regulation, which may play an important role in investing decisions.

Given that accounting principles may give rise to different concerns depending on the investor's business model, the Panel evaluated whether changes are needed to current practices based on the information needs of different categories of potential investors in infrastructure projects.

## Breakdown of institutional investors active in infrastructure by type and aggregate AUM



AUM – Assets under management  
Source: Preqin Infrastructure Online. © Standard & Poor's 2014

## Insurers

“The longer term investment of senior debt in infrastructure projects seems perfectly suited to the institutional investors' fundamental requirement: long term assets to match their long term liabilities.”

Norton Rose Fulbright<sup>21</sup>, 2014

From the perspective of insurers, the attractiveness of investments in infrastructure is increasing due to the ability to match these assets to the long-term and illiquid nature of their portfolio of liabilities and the potential higher returns they offer. Insurers have a liability-driven business model with an economic objective of investing funds in financial assets

<sup>19</sup> *The role of the business model in financial statement: research paper*, European Financial Reporting Advisory Group (EFRAG), December 2013.

<sup>20</sup> *Reflecting long-term investment business models in financial reporting* [Letter to the European Commission], EFRAG, October 2013.

<sup>21</sup> *Infrastructure development: Attracting institutional investors to close the funding gap*, Norton Rose Fulbright, February 2014.

that generate stable returns and repayments at maturity and/or that can be sold in order to pay claims, to fund customer withdrawals as needed and to generate profit. Their investing strategies are driven by the profile (duration and predictability) of liabilities, the risk profile of available assets and other conditions such as prudential regulation.

### **The role of prudential regulation**

In comparison with accounting, investing decisions by insurers are likely to be more heavily influenced by the expected stability of cash flows, prudential regulation and tax implications associated with the investment. For example, the regulatory capital treatment proposed under Solvency II may discourage European insurers from investing in unrated or below investment grade project debt<sup>22, 23</sup>.

The Solvency II regulation is based on a corporate loan matrix and does not take into account the specific default and recovery characteristics of the project finance sector, or other characteristics such as a strong security package and transaction structure. As a result, strong credit characteristics of project finance may not be reflected from a regulatory perspective, which, depending on the particular situation of the insurer, may have a significant impact on their investing decision.

According to the European Commission, Solvency II will repeal certain investment obstacles, particularly for less liquid asset classes, that currently exist in European member states. Insurers will be free to invest in any type of asset subject to the prudent person principle, whereby they should be able to “properly identify, measure, monitor, manage, control and report” the risks associated with such assets<sup>24</sup>. However, the removal of regulatory obstacles may not yet apply to infrastructure investments. In a report to the European Commission, the European Insurance and Occupational Pensions Authority (EIOPA) noted that despite the importance of infrastructure investment, there is very little consistent pan-European data available on the performance of infrastructure loans. The lack of data was highlighted by EIOPA in its December 2013 report to the European Commission as a hurdle that did not allow it to carry out the necessary analysis to recommend a lower calibration of capital requirements for infrastructure assets.

**“Overall, the default pattern of infrastructure debt differs significantly from that of corporate bonds – a fact that should also be reflected in the regulatory treatment of these investments.”**

Swiss Re, 2014

Given the role prudential regulations such as Solvency II play in insurers’ investment decisions, the Panel encourages prudential regulators to further align risk charges or calculations with the default and recovery rates of infrastructure investments.

### **The role of accounting**

Current accounting guidance<sup>25</sup> permits a wide variety of accounting practices for the liabilities that relate to insurance contracts, resulting in diversity in practice. The financial assets acquired by insurance companies are currently accounted for in accordance with financial instruments guidance, which may not fully take into consideration the management of these assets or the treatment of the associated liabilities.

For example, if an asset and a liability respond the same way to changes in interest rates (i.e. have the same cash flow profile) but the measurement basis differs, an accounting mismatch arises if the asset is required to be measured at fair value through profit or loss and the liability is measured at amortised cost or at a current value with changes presented in OCI / equity. As a result, parties structuring infrastructure investment vehicles intended to attract insurers should take into consideration the form of investment or features in an arrangement that affect the accounting for the financial asset.

The areas of concern and challenges relating to accounting for insurance contracts are not specific to infrastructure investments, but rather arise in general from the interaction of current accounting principles with the business model of insurers. The IASB is undertaking a fundamental review of the accounting for insurance contracts and working towards the issuance of a new standard that better meets the needs of users. To achieve consistency, sections of the insurance industry will have to fundamentally change their accounting

<sup>22</sup> *Infrastructure Investing. It Matters*, Swiss Re, February 2014.

<sup>23</sup> *How to Unlock Long-term Investment in EMEA Infrastructure*, Standard & Poor’s Rating Services, October 2013.

<sup>24</sup> *Communication from the Commission to the European Parliament and the Council on Long-Term Financing of the European Economy*, European Commission, March 2014.

<sup>25</sup> IFRS 4 *Insurance Contracts*.

practices. While this has generated some resistance to new guidance, the Panel encourages the IASB to continue working with priority on the issuance of a global standard on insurance contracts in the near future and to avoid accounting mismatches between insurance contract liabilities and related assets.

### Pension funds/sovereign wealth funds/endowments/foundations

Similar to insurers, the potential for higher returns, an opportunity for diversification and the long-term nature of investments in infrastructure make them attractive to pension funds and sovereign wealth funds. These funds are not typically subject to short-term pressure from capital markets and therefore have more flexibility to take a long-term perspective and employ an investment strategy intended to grow capital over a long time period in order to fulfil future obligations.

This long-term view means that accounting implications are generally not a key factor driving investment decisions – rather, areas of focus include the risks and returns associated with an investment and the stability of future cash flows. Pension funds and sovereign wealth funds are also not subject to same level of regulatory pressure as insurers. Given the nature of their stakeholders and the long-term view of these funds, the Panel does not believe that changes to accounting principles would significantly increase the attractiveness or frequency of investment in infrastructure projects.

### Banks

The banking sector has historically played an important role in financing infrastructure projects. While they continue to be significant players, particularly in developing countries, regulatory pressure following the financial crisis has required banks to deleverage and reduce exposures. In light of continued regulatory change, such as the implementation of Basel III, banks are more likely to be involved in arranging or facilitating financing (e.g. local currency corporate bonds to be issued by infrastructure entities<sup>26</sup>) or providing bridge financing for infrastructure projects, rather than being a major source of long-term investment – particularly equity financing.

“European lenders, which used to dominate infrastructure lending, are now busy repairing their dented balance-sheets. Meanwhile the new ‘Basel III’ rules are steering banks away from the long-term loans (often stretching beyond 20 years) required by backers of infrastructure projects.”

The Economist<sup>27</sup>, 2014

To meet its business objective of generating returns through the provision of long-term loans, a bank funds loans through shorter-term deposits from customers and from other banks and by issuing bonds. Typically, a bank can identify which assets are held with the objective of holding them for the long-term, to collect interest and principal, and which assets are held for liquidity or for trading purposes, and therefore can appropriately measure each asset category in accordance with current accounting standards.

In terms of infrastructure financing, financial assets relating to standard long-term loans are typically measured at amortised cost and therefore changes in fair value are not reflected in profit or loss of the bank. However, structured loans with more complex features may not qualify for amortised cost classification so that the accounting treatment takes into consideration the uncertainty or volatility of the cash flows. For long-term equity instruments, a bank is permitted to recognise gains and losses in OCI, rather than through profit or loss.

The Panel believes that recent developments on accounting for financial instruments have gone a long way towards ensuring that accounting principles are aligned with a bank’s asset-driven business model and, for the most part, are unlikely to create tension or discourage investment in long-term opportunities such as infrastructure projects.

While there are other relevant factors that will affect a bank’s long-term investing decisions, including regulatory requirements and liquidity needs, the Panel does not believe that further changes to accounting principles would significantly increase the attractiveness or frequency of bank investment in infrastructure projects.

<sup>26</sup> The 2013 B20 recommended that steps be taken to develop local currency corporate bond markets as a vehicle for investors (e.g. insurers, pension funds, sovereign wealth funds) to invest in infrastructure and other long-term projects.

<sup>27</sup> ‘A long and winding road: The world needs more infrastructure. How will it pay for it?’, *The Economist*, March 2014.

### Private equity and other investment funds

Depending on the investment strategy employed and the nature of their investors' desired risk profile, the investment objectives of private equity and other investment funds can be similar to those of other institutional investment types – e.g. pension funds and sovereign wealth funds – but managed towards a different purpose.

Typically, these types of vehicles are managed primarily based on the desired risk profile of the collective fund investors, by trying to maximise return on investment through capital appreciation, current income or both. While cash received from investors may be locked in for a fixed duration, private equity vehicles may face pressure to report strong returns in the short-term in order to attract additional funds for investment. Accordingly, some would prefer the use of a framework that reduces volatility, such as historical cost accounting.

The Panel believes that such changes would lead to reduced transparency and therefore potentially create a barrier to long-term investment, rather than encouraging additional investment. Rather, the Panel is supportive of ongoing projects by the IASB to improve financial reporting, including the introduction of a new financial instruments standard, the Conceptual Framework project and the Disclosure Initiative.

### Service concession arrangements

The Panel also considered potential implications of accounting guidance applicable at the level of infrastructure projects themselves<sup>28</sup>. The development, financing, operation and maintenance of some infrastructure projects are undertaken in the form of a service arrangement with the government.

Under existing accounting guidance<sup>29</sup>, when a private sector entity incurs expenditure in the early years of an arrangement, the consideration receivable is recognised by the entity as a financial asset when it will be collected from the grantor and/or as an intangible asset when the entity has the right to charge users of the public service. While this accounting does not necessarily provide a complete picture of arrangements, in the Panel's view it does not currently discourage parties from investing or being involved in these contracts.

### Role of financial statements

In making these recommendations, the Panel also stresses its belief that the financial statements are and will continue to be an essential part of the overall corporate reporting model. Financial statements that are prepared in accordance with high-quality and widely accepted accounting standards, and are subject to external audit, play an essential role in facilitating investment and capital allocation. Financial statements prepared in accordance with IFRS also offer the significant advantage of being comparable for investors and potential investors across the globe and are therefore especially relevant in the context of cross-border capital flows. While financial statements do not (and should not) aim to provide all of the information required for decision-making by investors and potential investors, their reliability and standardisation represent key comparative advantages. Audited financial statements also thereby add discipline to the broader communication process.

<sup>28</sup> The application of public sector accounting standards was not addressed by the Panel.

<sup>29</sup> IFRIC 12 *Service Concession Arrangements*.

# About this report

In light of the importance of infrastructure and other long-term investment for the global economy, the B20 created an infrastructure and investment taskforce, which developed actionable recommendations for the G20. As a result of one of these recommendations, the large accounting networks formed a panel to analyse existing accounting and corporate reporting practices and suggest improvements that would help the corporate reporting model provide a broader perspective of business performance that is more conducive to long-term investment.

This paper has been prepared by the following members of the six largest global accounting networks (the Panel) to present a summary of the Panel's key observations and its resulting recommendations.

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