



Ref: 22.7/8/1

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Dear Sir, *Stig,*

RE: PAAINE DP 2 : THE PERFORMANCE REPORTING DEBATE

BUSINESSEUROPE welcomes the opportunity to comment on the discussion paper issued by PAAinE on Performance Reporting.

The importance of the issues addressed in the Discussion Paper is to be linked to the objective of financial reporting. We believe that performance reporting shall distinguish clearly the entity's own performance, i.e. provide a basis for estimating future cash flows expected to derive from the entity's operations and strategy and to distinguish them from other changes in assets and liabilities which are very unlikely to feature future cash flows. Indeed certain changes in assets and liabilities feature scenarios which cannot materialise because they are contrary to the entity's strategy, some others feature changes which might eventually materialise but in the very long term, some others reflect hedging strategies and are therefore expected to be offset.

IS THERE A NEED TO HAVE A KEY LINE IN THE STATEMENT(S) OF INCOME AND EXPENSE THAT SUCCINCTLY SUMMARISES ENTITY PERFORMANCE, ACTS AS A HEADLINE NUMBER IN CORPORATE COMMUNICATION AND CAN BE USED AS A STARTING POINT FOR FURTHER ANALYSIS? IF SO, WHAT SHOULD THIS (OR THESE) KEY LINE(S) REPRESENT?

A.1- Coherence with IAS 1 Presentation of Financial statements

Under IAS 1 [par 83] and its proposed revised version [par 85], it is clearly disclosed that "*additional line items, headings and subtotals shall be presented on the face of the income statement when such a presentation is relevant to an understanding of the entity's financial performance*".



- Disaggregation of revenues and expenses in different levels of income is allowed as far as necessary to help users understand performance.
- Content of information provided in each category of the statement is explainable insofar as chosen by the entity to reflect its business model.

Theoretically, preparers ought to choose freely disaggregations and subtotals but it is advisable that a compromise is found in order to allow consistency and comparability from one period to the other and to a certain extent between entities, for the benefits of users.

A.2- Key lines

It seems that there are 2 Key lines which are of particular relevance to reflect most entities' performance: **Operating profit** and **Net Income**, on which entities communicate and which are basis for further analysis.

A.2.1 Operating profit

The operating profit represents the ability of the entity to create value from its continuing activities, measuring the entity's success in creating valuable output over and above the value of the matched input consumed in doing so (measured in terms of the cost of acquiring the input).

The operating profit shows the performance of the entity on the floor. It shows how much value has been created with the assets the entity can use and the workforce employed. This level of performance is part of the Key Performance Indicators usually used by the companies, internally and on a regular basis (on a monthly basis). Managers have to regularly explain its variation and thus it is a key variable which is reliably explained and that we cannot ignore.

This does not encompass the cost of financing and the tax cost because these are not directly linked to the performance of the basic business activities but are influenced by other factors (management decisions, other economic parameters, etc...).

The operating profit is for instance often the starting point for further analysis such as EVA types of measurements and a key performance indicator monitored closely inside the entity because it is a powerful indicator of the successfulness of operations.

A.2.2 Net Income

Net Income represents the ability of the entity to generate a surplus in running the company, a surplus which is secured for the shareholders and will be a basis for distribution of dividends.

Net Income reflects the outcome of management decisions: the performance of the operations shown in the operating profit, the cost of financing the activities, the profit or loss arising from discontinued operations and the tax effect of these all, excluding the effects of hypothetical transactions, the results of which have not yet been secured for shareholders and which are of low predictive value.

Both the Operating Profit and the Net Income are solid bases (reflecting how business works, audited and well known) on which the entity communicates to explain the period performance on a standalone basis or combined with other indicators.

WHAT ARE THE ATTRIBUTES OF 'PERFORMANCE' IN THE CONTEXT OF FINANCIAL REPORTING OF AN ENTITY? ARE THERE DIFFERENT TYPES OF PERFORMANCE (FOR EXAMPLE, MANAGEMENT PERFORMANCE, ENTITY PERFORMANCE) AND IF SO, WHAT ARE THE TYPES? WHAT DO THEY ENCAPSULATE AND HOW CAN/SHOULD THEY BE DIFFERENTIATED?

B.1- Performance Reporting objectives and predictive value

Financial Statements constitute a basis from which future cash flows generated by the entity can be assessed, however do not aim to show the projection of a future situation.

- Cash flows generated by the entity are derived from operations and so shall be consistent with the business model of the entity
- Performance presented being consistent with the business model:
 - Communication and explanations on the different categories is facilitated for the entity and certainly more reliable;
 - Consistency with the explanations provided in Management Commentary is increased.

We believe that predictive value of performance reporting doesn't mean that it is possible to guess future cash flows generated by the entity, but that economical parameters existing for the entity at the reporting date are taken into account when reporting performance.

Though it can be theoretically derived from the existing IFRS framework that performance is defined as the difference between income and expenses (i.e.



variations of assets and liabilities), and subtotals may be defined, the outcome is not satisfactory.

It does not reflect the entity's own performance because current accounting conventions have introduced complexity:

- Current standards include measurements based on hypothetical transactions or on transactions which are not reasonably certain.
- These hypothetical transactions can diverge significantly from the business model of the entity.

As a consequence, the total income measured in conformity with current standards cannot meet the expectations of the users because it includes elements that do not come from the economic business model of the entity.

Economic performance is not reflected in accounting performance and preparers, analysts, users feel the need to isolate items which have no predictive value of future cash flows.

B.2 Attributes and types of Performance

We believe that attributes of performance are reliability, clarity, usefulness for predicting future performance or for showing underperformance.

- When figures shown are closely linked to the operations, are monitored inside the company as a key indicator as well as utilized for corporate communication, the reliability is increased.
- When effects of hypothetical transactions are excluded from the level of result presented, clarity is increased because it is then based on measurable identified transactions.

B.3 Types of Performance

For industrial / commercial companies there are basically three minimum levels on which performance needs to be looked at and which each require a distinct nomenclature:

- Performance A: the entity's performance in its continuing operating activities (see A. above);
- Performance B: the entity's performance in generating *and securing* a surplus for shareholders (see also A. above and C. below);

- Performance C: the overall increase / decrease in the entity's net assets during the period, excluding transactions with owners and deducting the value of equity-settled share-based payments.

It is important to bear in mind that no single performance measure serves unambiguously to explain the performance of an entity: the above levels are tools for digging into that analysis. "Key lines are important because of the questions they provoke, rather than their own information content.

IS 'NET INCOME' (IN ITS CURRENT FORM OR A VARIATION THEREOF) A MEANINGFUL AND NECESSARY NOTION? IF SO, WHAT SHOULD IT REPRESENT AND HOW ARE ITEMS INCLUDED IN NET INCOME TO BE DIFFERENTIATED FROM OTHER ITEMS OF INCOME AND EXPENSE?

C.1- Net Income

Net income should reflect the performance of the entity itself, the performance of its business model as long as some corrections to the current definition are done to ensure that items foreign to the entity's performance are clearly excluded from it. Net income currently includes exogenous items derived from disposal scenarios or market values unaligned to the entity's business model.

Net Income also allows to remain faithful to the "reasonable certainty" criterion set forth for income in the existing framework while allowing assets to be revalued before the change in value becomes reasonably certain.

A criterion to use for recognition of income is the reasonable likelihood of the revenue. This criterion is met in the context of the business model of the entity where it is going to be confirmed by confrontation to the market (or realisation).

If a similar attribute ("reasonably certain") was chosen to characterize an asset, the net income would not be of any interest. But as soon as hypothetical transactions are introduced in the balance sheet, this attribute can only be presented through the net income, which will reflect the performance of the entity, the potential secured cash flows for the shareholders.

The difference between a reasonably certain income and variation of assets is demonstrated by the existence of, and need for, "recycling".

C.2- Net Income is a meaningful notion

The net income is both meaningful and necessary, as *one* of the key measures for starting performance analysis.



- Its importance lies primarily in the **exclusion of various hypothetical transactions** which standards require to be recorded as income / expense but **whose ultimate occurrence as real transactions is so distant or uncertain** – or is based on assumptions which differ significantly from the way the business works - that their inclusion in the performance measure would give a misleading impression of the surplus actually generated and *secured* for shareholders in the period. Such items therefore have a low predictive value.
 - For instance, on a going-concern basis, cumulative translations differences are not going to flow to or from shareholders in the foreseeable future, unless the business to which they relate is divested – in which case they should be considered in analyzing performance.
 - Also on a going-concern basis fluctuations in the market value of an industrial entity's production plants which are going to be used for the operations for the next 20 years are not particularly helpful information when confirming or predicting the operation's cash flows: the transaction hypothesized will not take place.
 - Similarly with defined benefit plan assets and liabilities the length of time over which substantial fluctuations in value can take place makes the recording of short-term fluctuations in the performance of the period an unhelpful basis for predicting long-term cash flows or for measuring the underlying personnel costs of the period.
- The term "*secured*" above is also meant to emphasise the desirability of separating out those elements of performance which, in an economic sense, are not sufficiently certain as to be "bankable" or distributable. It is appreciated that profit distribution and other funds available to shareholders are subject to local laws and regulations for the parent, but it is important to have an indication of the achieved surplus which in economic terms could be more freely available.
- It is a critical measurement supported by various users stating that, if it were to be eliminated from the required format, they would have to derive it themselves.
- It is useful to note at this stage that all elements which are today excluded from net income may however usefully measure variations in the entity's exposure to risks and opportunities, and as such, include valuable content for a second step in the analysis of an entity's financial position.

C.3- Content of Net Income

It has been suggested that net income might be generically defined as:



- the overall increase in net economic benefits generated by the entity's activity during the accounting period which have generated, or will generate, cash inflows and outflows most of them within the entity's operating cycle,
- less any consumption of, or loss on, capital engaged (employed) recorded during the period (e.g. depreciation and impairment losses.)

This would reflect the return on capital derived from the business cycle of the company during the period and, with its components, would form the basic element for predicting future cash flows. It would exclude value variations on long-term assets and liabilities not traded on liquid markets which will not result in cash flows in the short term. This approach is a useful starting-point, though a little trimming might be necessary in some respects (e.g. Are we excluding both gains and losses on such assets and liabilities, or just gains? Are we excluding both gains and losses from currency translation? Does the net income definition adequately cover long-term provisions, as it logically should?). The exclusions would be something like those items of income / expense which derive from hypothetical transactions from revaluations of assets and liabilities where

(1) no active market with observable prices exists or

(2) valuations are based on disposal or settlement scenarios which are unlikely to occur (in the next business cycle?) because they would be contradictory to the entity's strategy and course of operations or would suggest immediate replacement scenarios the financial consequences of which are not considered in the valuation.

DOES THE BOTTOM LINE OF A STATEMENT OF INCOME AND EXPENSE BEAR MORE WEIGHT AND SIGNIFICANCE THAN OTHER LINES OF THE STATEMENT SIMPLY BY VIRTUE OF BEING AT THE BOTTOM? CONSEQUENTLY, HOW MANY STATEMENTS OF INCOME AND EXPENSE SHOULD THERE BE AND WHY?

D1. Virtue of being at the bottom

As seems to be corroborated by academic research, there is apparently some marginal tendency for users to pay more attention to a "bottom line". It is, however, disputable whether the focus is simply by virtue of it being at the bottom. While many users are under time pressure when using financial statements and may therefore take a "bottom line" as an easy starting-point, most intelligent users – especially those with competent technical support – would be highly unlikely to have such a focus if it wasn't giving them what they needed. Current investors can more easily assess from "the bottom line" (net income) what the entity has actually achieved and secured for them with the funds which they have invested, without the effects of hypothetical surpluses and deficits which might have been achieved if somebody had picked up the phone on December 31. And since many (most?) other users wouldn't attribute much predictive value to items currently reported below "the bottom line" (OCI items) it presumably

helps them to have a distinct line where such items are excluded. Furthermore, since preparers generally exclude OCI items for their internal analysis of business performance and focus on “the bottom line” of the current income statement, preparers and users are able to enjoy a common basis for communication.

In other words, the bottom line is a means to share among employees, customers, suppliers, financial analysts, shareholders and preparers a performance indicator of high quality.

The other elements (which would not satisfy the criterion of being “reasonably certain”) are of interest too if they can help to understand risks and opportunities that the entity faces because of its strategy and business model.

D2. How many statements?

2 statements seem to be meaningful linked to the elements described above and the different levels of performance measures (see B. above)

- Performance A and B address the same issue of giving a measurement of the company’s ability to create value (derived from operations, and secured for the shareholders) which is of clear predictive value and explainable by the choices of the Management. Thus Perf A and B can presented in a single statement.
- Performance C includes items of very different nature and purpose and should therefore be presented separately.

With regard to the number of statements, some IASB members stress that it is “just a matter of a page-break” – without explaining why, if it really is such a trivial matter, they are so insistent on not having a page-break. While theoretically OCI meet without any ambiguity the definition of income and expenses, there is no concept whatsoever that calls for all items of the same nature to be displayed on a single sheet of paper. The issue is whether there is some useful difference to make between two distinct categories of elements and users tell us that they make such a difference, referring to the second set of information in a second step of their analysis.

Moreover many preparers are reluctant to accept such a move as it would facilitate dropping net income at a later date – now the declared objective of the Boards. Such elimination, sooner or later, is plainly unacceptable to them. Indeed managers carry out their responsibilities internally measuring performance to be delivered to shareholders. Net income is the basic measurement of such performance, with eventually minor amendments. If net income were to be eliminated and comprehensive income be analysed in a very different manner from today’s practice, preparers and users would have no other choice than rely on non GAAP measures. This would clearly reflect the standard setter’s failure to fulfil users’ needs.

IS RECYCLING NEEDED? IF SO, WHAT SHOULD IT BE USED FOR AND ON WHAT CRITERIA SHOULD IT BE BASED?

So long as key lines or subtotals are reported and hypothetical transactions included, recycling is absolutely indispensable to maintaining their integrity and meaningfulness. With regard to the two principal items where recycling is at present not permitted:

- It is not clear why actuarial gains and losses taken direct to equity are not recycled (as required by the latest FASB rules) as legitimate pension costs – positive or negative – thus by-pass operating expenses.
- Revaluations of PP&E and intangible assets were foreseen as allowed alternatives to historical costs for entities favouring a current-cost regime. However, these are practically irrelevant as the number of entities taking this route is minimal.

As defined under C. above, certain items of income and expense meet criteria for recognition as such but may not (yet) meet all the tighter criteria for recognition in net income. Recycling needs to take place once those tighter criteria are met, e.g. through realization or confrontation to the market.

WHICH OF THE FOLLOWING DISAGGREGATION CRITERIA BOTH HAVE MERIT AND ARE CAPABLE OF BEING IMPLEMENTED? HOW WOULD YOU DEFINE THE TERMS USED IN THOSE CRITERIA AND WHAT ARE THE PROS AND CONS OF USING THE CRITERIA FOR DISAGGREGATION PURPOSES? DISAGGREGATION BY FUNCTION; DISAGGREGATION BY NATURE; FIXED VS. VARIABLE; RECURRING VS. NON-RECURRING; CERTAIN VS. UNCERTAIN; REALISED VS. UNREALISED; CORE VS. NON-CORE; OPERATING VS. NON-OPERATING; SUSTAINABLE VS. NON-SUSTAINABLE; OPERATING VS. FINANCING VS. OTHER; CONTROLLABLE VS. UNCONTROLLABLE; BASED ON ACTUAL TRANSACTIONS VS. OTHER; CASH FLOW VS. ACCRUALS; RE-MEASUREMENT VS. BEFORE RE-MEASUREMENT; HOLDING GAINS AND LOSSES VS. NON-HOLDING GAINS AND LOSSES.

Function vs. nature	Present flexibility is needed (corporate presentation should derive from internal presentation at least for Perf A level). Pharma companies will probably stay with function plus statistical by-nature information, while banks (e.g.) will go by nature. This reflects the way the businesses work and has higher predictive value.
Fixed vs. variable	Nice ideas but not very realistic or practical to

<p>Recurring vs. non-recurring Sustainable vs. non-sustainable Controllable vs. non-controllable</p>	<p>build into the fixed structure. The present pragmatic approach of indicating what the preparer believes are “unusual” or “non-recurring” items is better to work on in a relatively free form, based on his judgment of what is necessary for understanding the performance of the period, leaving the user to make his own judgment <u>on the usefulness / reliability of that information for his own purposes</u> and for assessing what are future sustainable earnings.</p>
<p>Core vs. non-core</p>	<p>As for the 4 categories above. However, the similar “continuing vs. discontinued” dichotomy – as embodied in IFRS 5 – is useful and workable, as an additional element to consider in forecasting.</p>
<p>Cash flow vs. accrual</p>	<p>Cash flows are displayed in the cash flow statement, no need in the income statement. This would maybe be useful for users, but it would be very cumbersome to include in the main financial statements (yet another dimension) and very difficult for preparers to actually segregate (you don’t run the accounts separately, and the cash trail rapidly vanishes through payables, inventories, PP&E, etc.). If the information is felt to be crucial, we need to look – perhaps using the example of how cash paid for a machine flows through eventually into cost of sales – what precisely we are trying to separate: here too a more pragmatic approach with statistical information on critical positions might be more practical (see also I below), and perhaps disclosed in the notes to the financial statements only.</p>
<p>Certain vs. uncertain Realised vs. unrealised Hypothetical transaction vs. other* Re-measurement vs. before re-measurement</p>	<p>All of these are closely related and connect with the idea of a net income as opposed to a comprehensive income – please see C. above.</p>

Holding gains and losses vs. non-holding G&L	
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* re-wording

ARE THE CURRENT IFRS PROVISIONS IN RELATION TO THE NETTING OF ITEMS OF INCOME AND EXPENSE APPROPRIATE? WHAT (IF ANY) ARE THE SPECIFIC AREAS WHERE THE CURRENT REQUIREMENTS ALLOW INFORMATION ESSENTIAL FOR ANALYSIS TO BE CONCEALED OR, ALTERNATIVELY, DO NOT PERMIT NETTING WHERE IT WOULD RESULT IN MORE USEFUL INFORMATION?

By and large, there is no need for change. The current principles work – which is the most important thing.

WHAT IS THE UNDERLYING NATURE OF THE ADJUSTMENTS MADE BY ENTITIES WHEN REPORTING NON-GAAP MEASURES IN THEIR COMMUNICATIONS WITH THE MARKETS? WHAT ARE THE ADJUSTMENTS SEEKING TO ACHIEVE? PLEASE PROVIDE SPECIFIC EXAMPLES ILLUSTRATING THIS. SHOULD ANY OF THESE NON-GAAP MEASURES BE INCORPORATED INTO THE IFRS FINANCIAL REPORTING MODEL? IF THAT WOULD BE DESIRABLE, IS IT FEASIBLE AND HOW SHOULD IT BE DONE?

From the information assembled by the PAAinE group it seems that, in Europe at any rate, the adjustments made by preparers when reporting non-GAAP measures are intended to identify

(1) special, infrequently occurring items – whether income or expense (e.g. gains and losses on disposal of assets) – and

(2) non-cash effective items (e.g. intangibles amortization and impairments) to help the users, especially analysts, to discern the underlying performance of the continuing business as a basis for forecasting the future earnings and cash flows of the entity. (It would be naïve to believe that there is never a “preparer’s agenda” behind the choice of items, but where year for year a consistent explicit approach is applied it is our experience that the additional information is appreciated by users, who can make their own interpretation of it).

We believe that the IFRS financial reporting model should consist of a minimum reporting format (see below) and freedom to the entity to represent within that format information which it believes is helpful to users to understand the entity’s performance in the period. In view of its widespread use, a standardized definition and disclosure of EBITDA might be worth considering (similar to – but hopefully much less complex than – EPS).



IN DETERMINING THE OPTIMUM DEGREE OF STANDARDISATION OF THE REPORTING FORMATS, WHAT IS THE RIGHT BALANCE BETWEEN COMPARABILITY AND FLEXIBILITY? IN OTHER WORDS, IS THE LEVEL OF STANDARDISATION IN THE CURRENT IAS 1 APPROPRIATE OR SHOULD MORE PRECISE FORMATS BE PRESCRIBED? IF THE LATTER, WHAT ARE THE SPECIFIC AREAS THAT SHOULD BE MORE STRINGENTLY PRESCRIBED?

A minimum format is necessary. IAS 1 seems to work reasonably well and can be taken as a practical basis, though the elimination of “operating profit” in the “improvements” project was a retrograde step. Further, IAS 1 should take more account of the accounting process when it requires by-nature information on operating expenses, since it is extremely difficult to determine (e.g.) personnel expenses reflected in P&L when their separate identity has been lost on the way through inventories and, with self-constructed assets, PP&E and intangible assets. Otherwise, preparers should retain the flexibility within the minimum format to structure the data in the most informative way to permit understanding of the entity’s performance in all its diversity. This would mean that the results of hypothetical transactions are not included in the net income.

Yours sincerely,

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