



COMMENT LETTER

To
European Financial Reporting Advisory Group
13 -14 Avenue des Arts,
1210 Brussels
Belgium

Date
31 March 2007

12 APR. 2007

By email - CommentLetter@efrag.org

Dear Sirs,

Discussion Paper 2: The Performance Reporting Debate
What [if anything] is wrong with the good old income statement?

We are pleased to have the opportunity to comment on the above discussion paper issued by the European Financial Reporting Advisory Group ("EFRAG"), on behalf of BDO International¹. We believe that radical changes should not be made to the current performance reporting model without a thorough debate of the issues and extensive consultation with users and preparers of financial statements. On that basis, we welcome the discussion paper as an appropriate contribution to the start of that debate.

In regard to the question 'what is wrong with the good old income statement?', we would argue, conceptually not a great deal. Where the problems lie are firstly, with International Accounting Standard ("IAS") 1 and secondly, with the issue of what to do with performance related accounting entries that do not readily fit within the currently accepted understanding of what constitutes an income statement.

We recognise that the requirements and guidance on performance reporting contained in IAS 1 are well overdue for revision. The existing version of IAS 1 did not envisage the widespread adoption of International Financial Reporting Standards ("IFRS") in key capital markets and contains insufficient guidance to ensure consistency and comparability of reporting in an increasingly complex reporting environment.

There is, of course, a strong argument that a significant amount of the increased complexity is a result of developments in accounting standards themselves, rather than in the underlying commercial environment. We believe there should always be robust challenge to the necessity for new or fundamental changes in accounting standards. We have noticed in recent years, particularly since the widespread adoption of IFRS, a significant increase in the use of non GAAP measures (or additional analysis of GAAP numbers) in financial statements that appear to add back more items each year to arrive at the result that the entity (and by inference the analyst community) believes is most important to assessing its financial performance. Of course, entities might seek to dismiss 'unpopular debits', but if the elimination of share-based payment charges, amortisation of intangibles and even the effects of IAS 39 are seen to have widespread relevance to understanding financial performance, then one

¹ BDO International is a world wide network of public accounting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country.

might begin to question whether the standards themselves are giving the information that users of accounts need. Is it right that there must be an accounting solution for every ‘problem’ or would effective and robustly prescribed disclosures be more helpful to the users of accounts?

We also caution heavily against an incremental approach to ‘fixing’ IAS 1. We note that this paper does not take into account the Exposure Draft issued by the International Accounting Standards Board (“IASB”) in March 2006, proposing ‘limited’ revisions to IAS 1. We would agree with this stance and note that, in our response to that Exposure Draft, we were highly critical of its limited approach and the introduction of non mandatory alternatives and recommended its withdrawal. It is disappointing to note that, despite “substantial disagreements” from respondents to the amendments in the Exposure Draft (as noted in their own “Comment Letter Analysis”), the IASB decided at their December meeting to press ahead with the amendments.

We believe that some of the issues raised in this paper are affected by recognition and measurement issues, e.g. anomalies between the recognition of assets and liabilities and treatment of items in performance statements (recycling). It is difficult to see how the appropriate presentation can be fully determined unless or until all such recognition and measurement issues are resolved.

Furthermore, whilst we understand this paper’s scope limitations, the other primary statements, i.e. the cash flow statement, balance sheet and statement of changes in equity, are intrinsically linked with the assessment of performance of an entity and the wider debate must therefore encompass these statements.

We set out below our views on the specific questions raised in the discussion paper.

A 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?

IAS 1 currently prescribes the use of only one key line, being ‘profit or loss’. In our experience, this is rarely used as a headline number for entity performance. Instead, operating profit or profit before taxation are the most common key lines. Companies commonly use non GAAP measures derived from the above two key lines by eliminating unusual, ‘exceptional’, or non-recurring items and a whole host of other items.

We believe that IAS 1 should be more prescriptive in the definition of, and requirement for, other key lines. In particular, we believe that IAS 1 would be significantly enhanced by defining both ‘operations’ and ‘operating profit’. Paragraph BC12 in IAS 1 explains that reporting ‘results of operating activities’ is not required as a line item, as there is no definition in the standard. We note that IAS 1 gives the option for entities to report such a line but cautions that it should truly reflect what is ‘operating’. In the absence of a definition, the usefulness of such a cautionary statement is reduced. However, it must be recognised that, as evidenced by the widespread use of non GAAP measures, defined key lines are unlikely to meet the requirements of all companies. Future versions of IAS 1 ought, therefore, to embrace, and provide clear guidance on, the use of additional line items and the analysis and use of non GAAP measures, in order to avoid a drift to ill-defined, ‘exceptional’ items, debates as to whether items are ‘above or below the line’ and arguments surrounding whether a particular non GAAP measure simply represents earnings before unpopular debits and/or unwanted volatility.

B 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?

At a high level, it could be said that the objectives of a set of financial statements are to explain the (historic) performance of an entity and to allow judgment to be passed on the performance of management in terms of directing the entity's operations and stewardship of its assets. We believe that an analysis of performance in the context of financial reporting should focus on performance of the entity – this in itself is an indicator of the performance of management. We do not see the need to debate different types of performance and do not believe the overall model for financial reporting requires reassessment in this area.

We consider that the three key aspects of assessing entity performance are the cash flows of the entity in the period, the financial position at the end of the period and the components underlying the change in financial position from one year to another. We believe this structure has served its purpose well and it is the last aspect that the debate now needs to focus on. In particular, the debate should focus on:

- i. whether current recognition and measurement principles contributing to the change in financial position produce measures of performance that are important or relevant to users of the financial information; and
- ii. whether there is sufficient guidance to streamline practices and reduce areas of uncertainty and inconsistency in presentation.

C 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?

We do not believe the notion of 'net income', as encapsulated by current income statements, is a concept that needs fundamental revision. We believe that increased focus is needed on the items of income and expenses (and gains and losses) outside net income and on an analysis as to whether they:

- i. are conceptually and consistently sound treatments, in terms of measurement and recognition;
- ii. are of importance to user groups in assessing financial performance; and
- iii. should form part of net income in its current form.

D 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?

We do not believe this is the case. As noted above, entities and users often place greater emphasis on other subtotals within the income statement and we believe that more key line items should be defined. We believe that there remains a strong argument for two 'performance' statements in line with the current model. The key question is whether all the items are in the right performance statement.

E Is recycling needed? If so, what should it be used for and on what criteria should it be based?

The concept of recycling does need further consideration and we do not believe it has been addressed on a full and consistent basis. A comprehensive analysis of the circumstances in which recycling arises should be carried out. We believe that the treatment of items in the statement of recognised income and expense, and the consequent recycling in the income statement, is currently a poorly understood concept and therefore is potentially (and wrongly) ignored by users of financial statements. Conceptually, there is often an underlying logic linking recycling with realisation of assets or liabilities or with profits. However, recycling can often appear to be simply a way of dealing with recognition and measurement anomalies between the financial position and the income statement, or merely as a compromise for items where no definitive treatment can be determined.

F 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? (NB. Please specify your own criteria if the criteria you believe to be necessary are not listed below.)

In considering the need for further disaggregation, it is important that comparability is not impaired. In judgemental areas, we believe there should still be scope for additional, relevant information to be given by entities, albeit in a tighter overriding framework than currently provided by IAS 1. Our views on the acceptability or otherwise of each of the criteria are noted below:

- **Disaggregation by nature;**

Yes. This is potentially the least judgmental approach and works reasonably well already, as does disaggregation by function (which is not mentioned here).

- **Fixed vs. variable;**

Unlikely. For many companies, this is done to a large extent in determining ‘cost of sales’, although a high degree of judgement would be involved in grey areas and comparability year-on-year may be difficult, as costs could switch between categories.

- **Recurring vs. non-recurring;**

No. This is too judgmental and would be open to widespread abuse. It would run counter to the move away from items badged simply as exceptional or extraordinary.

- **Certain vs. uncertain;**

No. Again, this is judgmental and, in any event, key uncertainties impacting on the results, e.g. provisions, will be transparent in the presentation of the financial position and in the disclosures already required by IAS 1 paragraphs 116.

- **Realised vs. unrealised;**

Possibly. To an extent, disaggregation of this nature is already achieved in the ‘two performance statement approach’ of the income statement and the statement of recognised income and expense. However, there are instances where this is not the case, e.g. revaluation gains on investment properties which are taken to the income statement. This is an important conceptual area, in our view, and does require greater clarity (as noted above in our comments on recycling). However, legal positions on realisation differ among the jurisdictions applying IFRS, which makes deriving a consistent approach difficult. A better solution might be to differentiate between holding and non-holding gains and losses (see our comments below).

- **Core vs. non-core;**

No. This is highly judgmental and again open to widespread abuse.

- **Operating vs. non-operating;**

Yes - assuming an appropriate definition of what is operating profit (see our comments above).

- **Sustainable vs. non-sustainable;**

No. This is highly judgmental and again open to widespread abuse.

- **Operating vs. financing vs. other;**

Yes - assuming appropriate definitions (see our earlier comments regarding operating profit).

- **Controllable vs. uncontrollable;**

No. This is highly judgmental and again open to widespread abuse.

- **Based on actual transactions vs. other;**

No. We cannot conceive what 'other' transactions (as opposed to actual) would be appropriate in this context.

- **Cash flow vs. accruals;**

No. The cash flow statement is already a primary statement. We question what benefit there would be to further disaggregation on this basis in the performance statement.

- **Re-measurement vs. before re-measurement;**

No. We do not understand the rationale, and therefore the usefulness, of this type of disaggregation.

- **Holding gains and losses vs. non-holding gains and losses.**

Yes. To some extent, this links in with the rationale for disaggregating realised and unrealised items, since holding gains (as conventionally understood) are more likely to be unrealised. Issues that would need to be considered include the potential volatility of holding gains and losses and the corresponding usefulness; the judgment involved in determining the holding gains and losses; and the requirements of other standards that allow valuation models (e.g. IAS 16) or that adopt fair value accounting (IAS 39).

G 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?

We believe that the netting of items in any statement of performance should be allowed only in strictly limited circumstances, which is largely where the current requirements stand. We believe that the circumstances where netting provides more useful information are inherently limited.

H 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?

The use of the word 'underlying' is appropriate as, in our experience, many companies are seeking, in their use of non-GAAP measures, to identify the underlying performance of the entity. There can

clearly be many interpretations of what ‘underlying’ means in this context and our view is that it should not, and cannot, be the task of GAAP financial reporting to address this. It would be impossible to mandate measures that could be applied consistently by all entities, while meeting their individual requirements.

Items that may be adjusted are unusual items, which can be called a number of things, e.g. exceptional items, abnormal items and non recurring costs (sometimes with further description of precisely what the items are). The identification of such items is often judgemental. It is also fairly commonplace for amortisation of intangibles to be separately identified, as are share-based payment expenses under IFRS2, even if the amounts are not material. It is questionable whether it is appropriate for such items always to be regarded as needing to be eliminated when arriving at underlying earnings.

We believe that financial reporting standards should be drafted to ensure sufficient detail in the financial statements on the performance of entities, to enable the preparer or user to derive non GAAP measures appropriate to their circumstances. Financial reporting standards should address the use of non GAAP measures in the context of the explanation of their derivation and a requirement to reconcile such measures with GAAP equivalents. Any potential use of non-GAAP measures should be restricted to those that are *required* in order that financial statements show a true and fair view of an entity’s operating performance, with a clear prohibition on any presentation that could be regarded as placing undue emphasis on a particular result and, in particular, on any presentation that could be regarded as being misleading.

I 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?

We believe that the level of standardisation currently demanded by IAS 1 needs enhancement. The requirements of that standard are too simplistic to deal with the current complexities of financial reporting and many have viewed it as permitting flexibility of presentation that, in our view, is excessive. We believe that enhancement can be achieved without compromising the need for some degree of flexibility. In doing so, the apparent need (as opposed to desire by some) for flexibility should not be overestimated, i.e. it must not undermine comparability. Flexibility is most likely to be necessary only to cover the case of different industry types and these are limited in number. Within an industry group there should be a significantly reduced scope for flexibility, i.e. businesses in the same sector should report the same things in the same way.

We have noted above the need for greater definition of key lines, e.g. operating profit, as being a key area of increased standardisation. We have also noted the need for any non GAAP measures to be clear, unbiased and incapable of being regarded or viewed as being misleading. An appropriate combination of these factors is needed to ensure that financial reporting is of an appropriately high quality.

We would be happy to discuss our views with you. If you would like to discuss these comments, please contact Helen Thomson of BDO Global Coordination B.V. on +32 2 778 01 30.

Yours faithfully,



BDO Global Coordination B.V.