



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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EFFAS Financial Accounting Commission (FAC). Comments on the IASB Discussion Paper on Preliminary Views on Financial Statement Presentation

Dear Sirs:

The Financial Accounting Commission ("the Commission") of the European Federation of Financial Analysts' Societies (EFFAS) would like to take this opportunity to comment on IASB Discussion Paper Preliminary Views on Financial Statement Presentation (FSP).

The Commission welcomes the publication of the DP as it represents a major step towards improving the financial reporting of an entity. This undertaking reaffirms IASB leadership and commitment to present a solid foundation to predicate the accounting debate for financial reporting.

In Annex A, the Commission presents its views regarding what it considers are the key points of significant concern for financial analysts. The Commission acknowledges the Board addressing additional issues although it is deemed those issues to be less compelling for financial analysts.

Best regards,

Javier de Frutos
Chairman

On behalf of the
Financial Accounting Commission

Annex A

Comments to the Discussion Paper on Preliminary Views on Financial Statement Presentation

The European Federation of Financial Analysts' Societies (EFFAS) through its Financial Accounting Commission (FAC) has reviewed the Discussion Paper, Preliminary Views on Financial Statement Presentation. The Commission would like to express its appreciation and recognition to the Board for this undertaking to improve financial reporting particularly financial information that is the "bread and butter" for financial analysts. The Commission thus hopes the Board will consider its views with the utmost attention, as users are at the center of the accounting standard setting process.

The Commission has reviewed the DP and its comments are as follows:

1- Presentation Objectives

The Commission would like to acknowledge that by and large it supports the proposed financial statement presentation with the objective of providing a (1) cohesive financial presentation, (2) disaggregate information in a consistent and comparable manner and (3) financial flexibility.

2. - The Management Approach

We believe that this approach has merits to reflect the particularities of a company or a business and to understand how management operates the business. Nevertheless, we believe that these advantages do not compensate for potential drawbacks. The lack of clear guidance for accounts classification is a rather unsatisfactory approach for analysts. Moreover, the overall cohesiveness objective that the new standard embeds might not be achieved.

Specific guidance on financial presentation is strongly suggested to be incorporated to avoid potential misrepresentation by management.

a).- Comparability between companies and for a company over time

Comparability between companies was one of the fundamental reasons for the European Union to choose IFRS as the reporting framework in 2000. However, the Commission believes that the management approach lessens significantly the

possibility of comparability of financial statements (1) between companies and (2) within the same company over the years.

Based on the current proposal, we think that as management changes and a new organizational structure is implemented financial statement presentation can change. Experience dictates that management, new and old, tends to change the business structure of company's when a new approach to the business activity is defined implying largely a new classification.

Although financial accounts for the previous year would be restated we consider that a two-year tracking period does not provide adequate information to analyze the trends of a business. Preferably information for the previous three years should be presented for comparative purposes and to analyze an ongoing activity in the long run. Therefore, we strongly believe that the Board has to provide significantly more guidance to companies in order to offer an acceptable level of comparability.

b). - Optimization of performance reporting in the interest of management

Leaving aside valuation and recognition, the classification of operating and financing information can largely impact analysts' perception of a company's performance. We think that the proposed guidance on classification of the categories is not specific and permits management to classify items based on its own criteria. Companies' accountants and auditors also might find difficult not to have a proper framework to refer to in discussions with the management. Moreover, there is a risk that undesired results in a year are classified outside the operating category similar to the experience ten to fifteen years ago when companies classified items as extraordinary in the income statement.

c). - Additional disclosure cannot compensate for potential misleading in the primary financial statements

We believe that arguments stating that additional disclosure in the notes provides users with information to understand the classification methodology and the reasons for changes from year to year is not convincing. It is time consuming to review notes in detail and analysts will anticipate disclosure of the most relevant information to be directly in the primary financial statement. Primary financial statements should include adequate information to prevent analysts from reading the entire set of notes every time that an entity financials are reviewed.

To conclude, we believe, the Board absolutely needs to provide significantly more guidance on the management approach to facilitate comparability to users while preventing a potential "flexible" use of information.

3. – Cash-flow: Direct and Indirect Method

As a starting point, we would like to underline how analysts utilize cash flow information and why it is used in such a way. Analysts mainly use information to assess the non-cash items included in the income statement either fair value

changes through the income statement or other non-cash revenues and expenses, particularly depreciation. This is a key step of the quality assessment of the performance for the period. The widely utilization of a pro-forma measurement such as EBITDA is a clear expression of the importance of this role. Also it should be noted that the wide use of this pro-forma measurement is an evidence of the strong preference for disaggregation by nature rather than by function.

a).- Indirect Method

The Discussion Paper proposes the direct method while we believe that by and large analysts favour the indirect method. The indirect method along with proper disaggregation in the income statement, we think, provides a more adequate set of information needed from a user's perspective.

The Commission would also like to point out that the direct method presents profit and loss information on a cash basis rather than on an accrual basis. This may wrongly suggest that the net cash flow from operation is as good as or even better than the income statement information. Moreover, the use of the direct method as presented implies a reconciliation table that could be avoided.

The key reason for preferring the indirect method is that most analysts, if not all, are calculating cash flow estimates starting from the income statement and then introducing adjustments being the main difference between expenses and revenues and cash flows. Usually analysts do not start working directly with cash flows as these are inherently volatile and make an accurate forecast rather difficult.

The main purpose of requiring cash information is to assess the quality and timing differences of earnings that contribute to forecasting cash inflows and outflows. In fact, the Board quotes in the DP that some users prefer the indirect method as it offers links with the income statement and balance sheet as important information -like depreciation is reported. We believe that the indirect method represents the views of a vast majority of financial analysts while responding to the cohesiveness objective of the financial statement presentation.

A mechanic and systematic application of the cohesiveness principle with its associated disaggregation can provide limited information. As presented in the Discussion Paper (page 110) *capex* is split between the different functions of the income statement such as cost of goods sold, selling costs, general and administrative expenses. However, there is only a single amount in the general and administrative expenses category. Analysts need to find easily and readily a single total amount of *capex* in a cash flow statement. This amount is key to compare with the cash flow from operating activities after interest and taxes or cash flow from operating activities before interest and taxes.

Moreover an additional element from a European perspective needs to be considered. Cash received from customers would include VAT whereas the amount of corresponding revenues is VAT-free. If there is a big change in the composition of revenues, i.e. revenues from Europe which include VAT and non-European revenues which exclude taxes, the amount of cash received would change significantly with no change in

revenues. The difference between the cash amount and the revenue figure could be very misleading.

Initiating the cash-flow reconciliation on the indirect method should be based on net profit and not comprehensive income, as all other comprehensive income items are non-cash items. We also support including sub-totals such as *Cash flow from operating activities, before interest and taxes*. This sub-total would reach the goal of cohesiveness between financial statements.

b). - Information Required in a Cash Flow Statement

As noted, analysts largely favour the indirect method although we believe that this method needs to display a minimum set of information on cash flow from operations far more detailed than under the current practice. We attempt, as shown below, to present a list of what we believe is the least information that should be provided. This is not a comprehensive list but it is merely the main items currently used by analysts.

The starting point of the indirect method should be net profit and not comprehensive income as all other comprehensive income items are non-cash items. It avoids repeating them every time.

Starting with *net income (profit and loss)*

Adding:

Depreciation and amortization
Impairments (long terms assets)
Provisions (of which impairments and provisions recycled)
Non-cash part of the pension costs
Share-based personnel costs
Share of profit from associates
Dividends received from associates
Gains and losses on consolidated subsidiaries (and associates) disposals
Gains and losses on other assets disposals
Change in working capital (change in inventories, receivable and payable should be at least available in the Notes, or in the Financial Statement if important or relevant).
Interest expenses
Interest income
Fair value changes through the P/L of financial items
Tax expense

At this point, we suggest including a subtotal: *Cash-flow from operating activities before interest and taxes*. This subtotal we believe contributes to reach the objective of cohesiveness between financial statements.

Then, we should add:

Interest paid
Interest received
Tax paid

Another subtotal should be included at this point: *Cash Flow from operating activities after interest and taxes.*

Moreover, in the investment section of the cash-flow statement at least the following items should be included:

Total Capital Investment
Gross amount of cash received from disposal of consolidated subsidiaries
Gross amount of cash paid for newly consolidated subsidiaries
Cash paid for new subsidiaries but not consolidated
Cash received from subsidiaries but not consolidated
Cash received from the disposal of individual assets.

In the financing section of the cash-flow statement dividends paid should be included although the amount of dividends paid to minority interests should be disclosed separately, if significant.

The bottom of the cash flow statement should end with the cash section including the follow details:

Cash at the beginning of the period
Cash received from newly consolidated subsidiaries
Cash received from consolidation of subsidiaries acquired in previous periods
Cash lost from disposal of consolidated companies
Cash lost from deconsolidation of subsidiaries but not disposed of
Total foreign exchange changes on cash
Cash at the end of the period

Assuming that an adequate level of disaggregation is provided, analysts believe that the indirect method of presenting cash-flows should prevail.

4. - Presentation by Nature or by Function

Analysts prefer financial reporting presented by nature rather than by function. This preference particularly reflects the fact that a presentation by nature regularly provides a more disaggregated level of information than by function, as in many occasions cost of sales would include a large majority of total operating costs. In most cases, the by function presentation provides a very limited disaggregation level. The extended use of the pro-forma EBITDA measurement as reflects the strong preference of analysts for reporting by nature.

We also believe that presentation by nature permits a better predictability than by function. This is due to the fact that some Items displayed in a by nature income statement can be reconciled with available indicators such as costs of personnel, plan property and equipment, etc.. Also we believe that the by function presentation introduces a greater level of subjectivity when entities classify their components i.e. marketing cost.

Moreover, presentation by nature provides useful information that can be compared to other items of the balance sheet and the cash flow statement. This permits a very useful way to assess the drivers and the quality of the performance.

Presentation by nature would also permit a better comparability, a key feature of financial information from a user perspective

5. - Discontinued Operations

We believe that there is a need to display the cash flow from discontinued activities in a separate section. We support therefore a separate section.

EFFAS Financial Accounting Commission (FAC)

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. EFFAS headquartered in Frankfurt am Main, comprises 25 member organisations representing more than 14,000 investment professionals. The Commission on Financial Accounting (FAC) is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint.

FAC is composed of experts from several constituencies participating regularly on international consultations and financial accounting gatherings across Europe. Recently, among others, the Commission has participated on consultations undertaken by the European Commission in connection with the European Parliament.

FAC members are Javier de Frutos (Chairman, Spain), Friedrich Spandl (Vice-Chairman, Austria), Jacques de Greling (SFAF, France), Hugo Haarbosch (VBA, The Netherlands), Henning Strom (NFF, Norway), Ivano Mattei (AIAF, Italy), Taras Koval (USFA, Ukraine), Jérôme Vial (SFAA, Switzerland) and Rolf Rundfelt (SFF, Sweden).