Association pour la participation des entreprises françaises à l'harmonisation comptable internationale

Mouvement des Entreprises de France
MEDEF

A F E P

Association Française des Entreprises Privées

EFRAG
35 Square de Meeûs
B-1000 Brussels

Paris, December 17, 2009

Re: *Performance Reporting – A European Discussion Paper*

We welcome the opportunity to comment on the PAAinE discussion paper related to Performance Reporting. We believe that crucial debates are yet to be taken by the IASB and regret that none is at present part of an active project on the Board's agenda.

However we believe that the PAAinE paper fails to address the conceptual debate that needs to be undertaken. We have therefore serious doubts about the efficiency of the PAAinE effort. Indeed the paper addresses primarily disaggregation issues, the area in which the IASB and FASB have already made substantial progress and introduced quite innovative and interesting ideas.

We understand that at the outset the timing was appropriately right. PAAinE has undertaken this project quite early with an advisory group set up in 2005 and the issuance of a first paper by the end of 2006. At the time, the debate looked very promising. The publication of the second paper three years later makes the efforts lose most of its interest for the following reasons:

- the paper reflects more a compilation of already old academic contributions than a basis for innovative ideas, although the PAAinE acknowledges in its introduction that new ways of reporting performance are necessary in the light of financial markets becoming increasingly complex and sophisticated;

- the paper does not meet its first objective, i.e. to stimulate debate at an early stage in the standard-setting process. The debate about disaggregation of gains and losses in the income statement has already taken place, triggered by the IASB-FASB joint consultation process. PAAinE efforts are efficient when they come first, as it has been the case with Revenue Recognition and the Reporting of Pensions.

We also disagree with the direction taken in the paper. Instead of stimulating debate on how to best report performance, the paper induces the view that the controversy about net income being a key performance indicator is useless and void of content. In the same manner, the whole issue of recycling is dealt with in quite a biased fashion.

No paper or modern thinking about performance reporting can ignore that primary financial statements are already at the heart of financial communication and will soon be left with no other role, in a context where XBRL technologies are increasingly used. Analysts and investors require performance indicators from which they can derive sustainable flows of performance. From that perspective, net income may need to be further disaggregated, and should not be lost in the analysis of a change in net assets. Use of fair value measurements or other revaluations have increased over the years in the IFRS literature without performance reporting being adjusted on any robust basis. We would have hoped that the PAAinE effort would drive progress in this area.

In addition to the main comments above, answers to the detailed questions of the invitation for comment are provided in the appendix.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

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Patrice MARTEAU	**Alexandre TESSIER**	**Agnès LEPINAY**
Chairman	Director General	Director of economic and financial affairs

Appendix to our letter on PAAinE Discussion paper on Performance Reporting

***Question 1**: Do you think there is anything else in the development of existing standards (apart from that discussed in chapter 2) that should be taken into account when considering the way forward for performance reporting?*

Chapter 2 is in our view a relevant description of present IFRS requirements for disaggregation of gains and losses in the income statement. However further references to the conceptual framework, more particularly to the objectives of financial statements, would have been welcomed. Moreover we would have expected to find in Chapter 2 an analysis of the existing presentation requirements (components of net income, OCI components, use of recycling) showing whether those requirements provide consistent and meaningful information content.

We are also surprised that no reference to Earnings Per Share is made. EPS is viewed by many as an important performance indicator and a standard is devoted to its calculation. We observe that while the IASB was switching focus from net income to comprehensive income, EPS has remained based on net income. We believe the paper should have highlighted that fact.

***Question 2**: Do you agree with the observation in this chapter that, at the level at which standards are written, there is no generally agreed notion of what represents 'performance' and that in fact performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers? If you do not, please explain your reasoning.*

We agree that "performance" is a wide and complex notion, encompassing a lot of financial and non financial information, if and when taken away from the purpose of the discussion paper, i.e. how to best present performance in the income statement. We therefore believe that the observations in chapter 3 are out of purpose in the debate that the PAAinE team is supposed to stimulate. Market shares or social behaviour indicators are long known as not having any role to play in financial statements. Introducing preliminary conclusions on such bases is therefore, at best useless, at worse biased.

Brought back to the financial statement issue, referring to the conceptual framework helps narrow down the relevant analysis. As mentioned in the proposed chapter 1 of the new framework, financial reporting should provide information useful in assessing cash-flow prospects and in assessing stewardship.

In a way the current practice review presented in the second part of chapter 3 is consistent with the PAAinE paper purpose.

Nevertheless it seems rather odd to us that the diversity observed in current practice is taken as a signal that there are as many different ways to apprehend financial performance as they are different industries or different analysts. Is such an observation the sign that financial performance is a "multi-faceted" notion or the sign that the current IFRS compliant practice is not adequate?

As a result of the above, we believe that chapter 3 fails to demonstrate its preliminary conclusions.

***Question 3*: Do you agree that key lines are still useful, though only because of their value as a basis for communication to the market and as a starting point for analysis and comparison? If you do not, please explain your reasoning.**

Key lines are undoubtedly useful. There is hardly any debate about that. The mere fact that there is strong interest in indicators such as revenue or gross margin does not negate the need for **one** more comprehensive indicator of financial performance that users find useful as a starting point in their analysis of the operations of the period and on the basis of which management is expected to communicate. Earnings per share, for example, are a widely used indicator (we would have expected the PAAinE team to highlight such a fact). As it is of the utmost importance that EPS remain as meaningful as possible, it is of the utmost importance that **one** indicator of performance is defined to serve as numerator. Having one indicator play a *key role in communicating performance* does not make the other key lines less useful in the *analysis of performance*.

Here again, we believe that the PAAinE team is dumping the debate on erroneous bases.

***Question 4*: Do you agree that, in order to fulfil this function, it is important that there are clear principles that underpin what is included and excluded from the key line(s) (in order to make their content understandable) and those principles need to be such that the content of a key line is standardised to a fair degree (in order to ensure the necessary comparability).**

We agree that the necessary indicator of overall performance and the other key lines need to be appropriately defined. Users need indeed to rely on a widely shared knowledge and understanding of the key indicators presented in the financial statements, and more particularly in the income statement. This calls for a minimum level of standardisation.

Nonetheless an appropriate balance must be struck between comparability and relevance, in order to ensure that reporting financial performance appropriately reflects the huge diversity in industries and sectors.

Such a balance can be struck, we believe, if clear principles underpin performance reporting requirements. In our comment letter to the IASB, we have approved of the balance reached in the joint boards' discussion paper between definitions applying to all in a model calling for a management approach.

Relevance may further be increased if entities have the ability to add subtotals (for example, gross margin for an industrial company or net interest margin for a bank). We are therefore in favour of an approach that would combine approach B and approach C as described in the PAAinE paper.

Question 5*: This chapter discusses the need for standard setters to balance the competing demands of comparability and flexibility, in order to give users fairly consistent starting points for analysis, while allowing management to present income and expenses in a manner that reflects the particular circumstances of the entity. Has the range of approaches to flexibility and comparability given in the chapter been appropriately described? What do you believe would offer the best approach in practice?

Please refer to answer to question 4. As indicated we believe the balance to strike is between relevance and comparability. Flexibility is in our view an unnecessary notion. The reporting model must be such that businesses that are comparable can be compared while substantial differences between industries and sectors are not ignored.

Question 6:* This chapter finds no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Do you agree that it is not important for the "bottom line" of statement(s) of income and expense to be a key line? If you do not, please explain your reasoning.

We completely disagree with this conclusion. In an ideal world, there wouldn't be any limitation to the relevance of measurement of assets and liabilities and all changes in assets and liabilities would therefore be relevant to the understanding of performance. In such an ideal world, there wouldn't be any difference between "net income" and "comprehensive income".

However we are not living in an ideal world. Existing standards have shortcomings, there are tensions between the needs for relevance and comparability, and measurement at the reporting date may fail to reflect the impact of management horizon or of the long-term nature of some assets and liabilities.

We agree with all those who claim that a full and in-depth understanding of the entity's financial position requires that all changes in assets and liabilities need to be analysed and understood. As indicated in the PAAinE paper and dealt with in question 3 above, there is however the need for a relevant starting point in the analysis and a basis for quick and easy financial communication. A bottom line in a statement is the appropriate fashion, we believe, to indicate what the starting point in the analysis should be.

Such a highlight may not be necessary for quite sophisticated users. However we strongly believe that financial presentation should be used in order to assist less sophisticated users.

Question 7*: In chapter 4, the paper observes that there is no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Assuming that is correct, do you agree that it follows that the number of** **performance** ***statements provided is not particularly important either. And thus that the one or two performance statements debate is a non-issue; the real issues relate to the key lines. Do you agree with this analysis and conclusion? If you do not, please explain your reasoning.

We refuse to consider that the conclusion in chapter 4 is correct. In answer to question 6, we see value for users in the segregation of changes in assets and liabilities in two distinct statements.

We also see value in having the **one** performance indicator (ref to answer to question 3) being the bottom line of the income statement (or performance statement).

Our position on this issue suggests that we see a rationale for a relevant and useful segregation of all changes in assets and liabilities. This rationale is described in our response to question 12.

***Question 8*: Do you agree that recycling is mainly an issue if a realised/unrealised split is the main disaggregation criterion for the statement(s) of income and expense, that therefore recycling is really a secondary issue and that the main issue is which disaggregation model should be used? If you do not, please explain your reasoning.**

The main goal in this debate is to be able to define the one performance indicator that will be the relevant starting point for the analysis and a robust basis for quick and easy financial communication. We therefore would agree that the main issue is to identify how to make the relevant segregation between the changes in assets and liabilities that ought to be reflected in that one performance indicator and those that should be presented separately.

However this does not lead us to think that recycling is a secondary issue. Recycling may be absolutely necessary to make that one performance indicator fully relevant or to make the rationale on which it is based hold. A change in an asset or liability may not be relevant to the performance analysis in one period and be relevant to that analysis in a later period.

***Question 9*: Would the issue of recycling on its own affect your decision as to the best approach to disaggregation? Please explain your reasoning.**

No. As explained above in answer to question 8, we consider the definition of the one performance indicator as the first step of the reasoning; the recycling issue follows.

***Question 10*: Do you have any comments on the basic models of disaggregation presented in this chapter? Are there any other broad types of model that would have been worth exploring?**

We regret that the disaggregation by function or by nature is not further analysed in this chapter. It is today an important issue for preparers who often use a mix presentation in order to isolate some nature of expense / income with no predictive value or that is not specific to any function, while an overall disaggregation by function is assessed as more relevant to understand their Business.

***Question 11*: Is the discussion of the advantages and disadvantages of each disaggregation model fair and complete? If not, how could it be improved?**

We do not agree that the business model approach impairs comparability[1]. We do not expect a lot of divergence because in our view a business model is reflected in a set of broad facts, not a set of subjective detailed appraisals. As a result, we do not think that companies that are in a same position might categorise the same item differently.

[1] We are surprised by the PAAinE team presenting a lack of comparability as a consequence of applying a business model approach. Indeed EFRAG has advocated in favour of the management approach to the presentation of financial statements (as proposed in the joint IASB-FASB DP) in the same way as we do here.

Differences would reflect differences in business models, and would therefore bring information of value to users.

We are also opposed to see recycling as a disadvantage as it often mentioned in this discussion. Advantages / disadvantages should only focus on qualitative characteristics as comparability or reliability, not on practical difficulties. Moreover, recycling will cease to be a practical issue since it will be defined by a robust and consistent principle serving the relevance of the performance statement. The discussion paper should have scrutinized current policies on recycling and tried to identify a clear principle which would harmonize practices, rather than to reject it without further consideration. There again, we regret what we see as a biased approach in the DP.

Question 12: Which of the models of disaggregation—or combinations of models— do you favour and why do you believe it meets the needs of users better than the alternatives?

Given the shortcomings in measurement of assets and liabilities that we have highlighted earlier in this comment letter – some of which would remain even if all existing standards were brought to a high level of quality -, we believe that a segregation between changes in assets and liabilities that are to be reflected in the bottom line of the income statement and those that should be displayed apart is necessary.

A performance statement based on a Business model approach doesn't only reflect "things that management might have the power to change" (as you state in § 3.7). The distinction based on the business model is appropriately described in § 5.15 of the paper:

> disaggregation model that separates items of income and expense derived from assets or liabilities that are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured from other items of income and expense.

For example, banks most often run two different business models. The related portfolios of investments are usually reflected, in a trading book on one hand, in a banking book on the other. The two portfolios of investments are managed separately on the basis of different management objectives. For the trading Business model, we believe that fluctuations of the portfolio value should be part of the bank performance in the period in which the change arises. This is because fair value changes fairly depict the economic impact to the entity of the business strategy. On the opposite, market changes would not affect the value to the entity of banking book assets unless they are part of the contractual terms of the instrument.

Therefore any requirement to measure banking book instruments at fair value[2] would, according to the business model, command the segregation of the change in value into two components. Only one of the two components would be relevant to the one performance indicator of the entity.

As indicated in our answer to question 8, we believe that recycling has a key role to play to make disaggregation based on the business model fully relevant. In our view:

[2] This is meant as an illustrative example. We do not believe that fair value should be used to measure banking book instruments, except for some embedded derivatives.

- Recycling helps serve the stewardship objective:
    - Report performance consistent with the entity's business model and strategy
    - Report income and expenses as they result from transactions made by management

- Recycling helps forecasting future cash-flows
    - Bringing the measurement of performance with the entity's business model/ strategy/ scenario provides information in anticipation of cash flows as they are expected to occur

- Recycling helps enrich performance reporting
    - Performance measured on the basis of cost-based measurements remains available, while information provided by revaluations is also available.

We can illustrate the above on the basis of two examples:

- <u>Recycling of actuarial gains and losses in net pension liabilities:</u>

  The reporting of pensions is one area where measuring plan liabilities and assets at the reporting date – although necessary to present the financial position of the entity *at that date* fairly - may conflict, from the perspective of performance reporting, with the long-term horizon of those assets and liabilities.

  In that case, actuarial gains and losses arising from changes in discount rate and plan assets changes in value are better analysed as a second step in the financial analysis, i.e. should be shown separately from the income statement. Nevertheless those actuarial gains and losses may impact the entity's performance in the long term. Recycling has therefore a role to play in order to ensure that erratic changes from period to period are not reflected in the performance of the entity while long-term trends are.

- <u>Recycling of changes in value of hedging instruments in cash flow hedges:</u>

  While all derivatives are measured at fair value for financial position reporting purposes, there is valuable information content in reflecting fairly the effectiveness of cash flow hedging relationships in the performance statement. Sound risk management is indeed part of sound stewardship.

  This is another area where recycling proves useful. To ensure relevant performance reporting, changes in value of hedging instruments should be reflected in the performance statement in the period in which hedged forecasts or commitments do.

Combination of various disaggregation approaches

The business model approach applied to the disaggregation of changes in assets and liabilities and segregation thereof for performance reporting purposes would, in our view, be valuably combined with the operating-financing-investing category approach proposed in the joint IASB-FASB discussion paper on the presentation of financial statements. These categories facilitate the reporting of key financial ratios.

In addition to the above, we believe that disaggregation by function and nature, and highlighting (within current performance indicators) items that are unusual in nature or amount, further help enhancing the usefulness of the performance statement to users.