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Financial Accounting Standards Board
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International Accounting Standards Board
F.a.o. Sir David Tweedie - Chairman
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Date: 2005-03-31

Re. Joint Project on Performance Reporting/Reporting
Comprehensive income

Dear Sirs,

We take this opportunity to write to you on the joint project of the FASB and the IASB that is intended to establish standards for the presentation of information in the financial statements of companies in order to enhance the usefulness of that information in assessing the financial performance and financial position of these companies. We support the decision of both Boards to combine their separate projects into one joint project for the sake of convergence. This project is subject to public consultation within the context of the International Working Group on Performance Reporting.

We welcome that both Boards have sought the opportunity to obtain input from various stakeholders in relation to this project. However we question whether the direction that the project is taking is appropriate and whether the resources that are being devoted to the project by both Boards are well spent. We recognize that there are concerns about certain financial reporting practices that may be obscuring the importance of net income and may lead to questions about the appropriate definition of net income.

With respect to net income we have to stress that this is a key measure of performance and an essential part of our communication with users of financial statements. It is obviously not the only relevant number but from regular contacts with investors and other users of our financial statements, we know that net income is used as a key metric to understand operating performance of a company. It is not perfect and can therefore be supplemented with additional information, however it cannot be missed. It must be stressed that financial information reported to outside investors should be, and remain, closely aligned with performance measures that are used internally in companies. This is not only efficient; it also allows alignment of the goals of management to the goals of outside stakeholders. If net income were lost, then that alignment between internal and external goals would be lost as well. Companies would be forced to have two sets of figures, one for managing their operations and another one for officially publishing their results. This would create a gap

between management information used for business decisions and outside information, the latter being based on theoretical concepts far from the business reality. There is a body of academic research that demonstrates that net income information contains a high level of predictive value for future profitability and cash flows, an additional argument why net income needs to be retained.

Net income has an important role because of its frequent use as a benchmark for incentive compensation. Net income is also used as one of the benchmarks for the distribution of profit to the shareholders. Such a distribution cannot be assessed on the basis of a comprehensive income that includes all fair value changes that represent paper gains or losses that can vanish after the balance sheet date.

In relation to the discussions in the International Working Group on Performance Reporting we express our concern with respect to the fact that certain important issues are not addressed in sufficient depth and that there appears to be too much focus on technical issues. The prime question is what do companies need to communicate to financial markets. This is not a technical question but a policy issue that would benefit from wide consultation with acting CEOs and CFOs. With respect to the question whether 4 or 5 statements are required, the view of preparers is that comprehensive income (or other changes in equity) provides valuable information that should be presented. However this is only one component of performance. It can be presented as prominently as net income but should remain clearly distinguished. Net income needs to be presented with meaningful subtotals, including operating income defined in accordance with the definitions internally used by companies (the management view).

This is particularly relevant with respect to the reporting of pro-forma earnings numbers. These numbers are currently not defined in accounting standards and the avoidance of misuse of such numbers is in the domain of enforcement agencies in our view. We note that the Securities and Exchange Commission has taken effective steps in recent years to remedy misuse of pro-forma earnings numbers.

In our view there is only limited need for new accounting standards to deal with performance reporting. To enhance the usefulness of the financial statements some further clarification of existing standards would be appropriate and the IASB should consider adoption of a standard that addresses reporting comprehensive income. We have developed some further thoughts on these issues that are outlined in the attached paper.

Sincerely,

Performance reporting: the way forward

For industrial companies

Characteristics of high quality performance reporting (1)

- Easy to use by non experts
- Clear segregation between:
 - Realized and unrealized performance
 - Sustainable and exceptional elements of performance
 - Operational and non operational performance
 - Certain and uncertain measurement
- Possible to:
 - Apply consistently over time
 - Identify cash flow consequences

Characteristics of high quality performance reporting (2)

- External financial reporting should be aligned with internal reporting. It is important for investors to view the business through the eyes of management.

Starting from concepts

- Two contrasting views of income exist:
 - Income as a **measure of performance**. It measures current operating performance to provide a sound basis for projection of sustainable profits and cash flows as well as insight into how managers performed their tasks
 - Income as a measure of **enhancement of value**. It measures what can be consumed in an economic sense during a period leaving the company equally well off at the end of a period

Both concepts are relevant: a synthesis is required

Arguments for a synthesis (1)

- Income as a performance measure is important for a large variety of users of financial statements:
 - For investors and shareholders:
 - Measurement of **realized** performance and hence distributable income
 - Measurement of **long-term cash flow prospects** of the company
 - Assessment of management's stewardship
 - Measurement of earnings per share
 - For management:
 - Basis for decision making and control
 - Reporting on it's fiduciary duty towards shareholders
 - Compensation contracting and incentives
 - For other third-parties in forming their economic decisions in relation to the company

Arguments for a synthesis (2)

- Separate measurement of value enhancements other than net income is important because:
 - Changes in net assets that result from holding gains and losses provide useful information with respect to changes in the entity's exposure to risks and opportunities
 - It is key in understanding the interrelations between the the different financial statements presented by the entity
 - It provides information with respect to value changes that are outside management's control

Arguments for a synthesis (3)

- There is no conclusive support for the superiority of either approach:
 - Evidence for the usefulness of comprehensive income is conflicting (e.g. Hirst and Hopkins 1998 vs Dhaliwal et al. 1999)
 - Expressing a preference for either approach disregards the existence of multiple roles for financial reporting (as argued by Holthausen and Watts 2001)
 - There is empirical support for the current FAS 130 approach (Biddle and Choi 2002)
- Therefore, there is a need for a set of financial statements that provide the complete picture, each of these statements being devoted to a specific measurement

Conclusion

The future direction for performance reporting needs to be a mixed model that makes it possible to meet the requirements of both **income** as a measure of performance and as a measure of **value creation**.

This is best achieved in a reporting framework that is based on an income statement as the basis for performance measurement and a **separate statement** of changes in equity/comprehensive income that provides relevant incremental information on wealth creation. Such a framework requires **recycling**.

The income statement

- Should result in a net income number that is the basis for the measurement of earning per share and for communication of performance both within entities and to the markets
- Should be a single column statement with subtotals which are relevant for transparent and effective for communication in an industry
- Presentation and definition of subtotals should be harmonized for the sake of comparability and transparency, additional sub-totals can be added to enhance the users understanding of sustainable earnings but within the boundaries of the standard format

The proposed income statement offers

- A concept of business income that closely approximates sustainable income
- A focus on income in the period that arises from transactions in the period
- Information about the cost of net debt
- The possibility to choose for a presentation of costs according to their nature or function

The proposed income statement (1)

Revenue	XXX	
Cost of sales 1.	(xxx)	Including inventory impairment/write-down
Gross profit	XX	
Research and development expenses 1.	(xx)	
Distribution expenses 1.	(xx)	Including receivables write-down
Selling and administrative expenses 1.	(xx)	<div style="border: 1px solid black; padding: 5px;"> <p>1. Each function includes related changes in provisions and pension costs</p> </div>
Operating income	XX	
Gains and losses on disposal of fixed assets	+/- x	
Impairment charges	+/- x	
Income from associates	+/- x	
Other business income or expense (non-recurring)	+/- x	
Other business income	X	
Business income	XX	

The proposed income statement (2)

Business income	XX	
Return on equity investments	X	Including impairments and results on disposal
Other financial income	X	
Fair value gains and losses on trading	X	
Financial income	X	
Cost of net debt (excluding discount unwind for operational items)	(X)	Realized gains and losses including changes in estimates
Cost of financing	X	
Income tax expense	(x)	
Discontinued operations	+/- x	Net of tax
Net income	XX	
Group	X	
Minority interests	X	

The statement of changes in equity

- An additional statement presented as prominently as the income or cash flow statement
- Describes all changes in equity from non-owner sources
- Allows clearly separating valuation adjustments from income flows
- Provides meaningful sub-totals for reported fair value changes

The proposed statement of changes in equity

Net income	XX	
Fair value gains and losses on investment property	X	Additional items related to share-based payment transactions and pension accounting could be added under suitable captions
Revaluations	X	
Fair value changes of cash flow hedges	X	
Currency differences on net investments in foreign subsidiaries	X	
Gains and losses related to business activities	XX	
Fair value changes available for sale securities	X	
Fair value changes debt instruments	X	
Gains and losses related to financing activities	XX	
Related tax effect	X	
Total gains and losses in fair value, net of tax	X	
Change in equity other than from transactions with owners	XX	

What about derivatives?

- Financial trading positions that are managed by treasury departments and related fair value changes are reported in cost of net debt in industrial companies that do not have an identified trading activity
- (Effective) Hedging transactions are reported in the same category as the exposure being hedged:
 - Operating income for revenue and costs items that are part of business operations
 - Cost of net debt for items relating to treasury operations

What about cash flows?

- The indirect method that is predominantly applied provides investors with the information they require for decision making
- The direct method is highly impractical and costly to implement, especially for large international groups
- As there is no user-benefit from moving to the indirect method and considerable additional costs and effort for preparers from such a move the indirect method needs to be retained

Some closing remarks

- Recycling needs to remain possible to allow distinguishing realized/certain from unrealized/uncertain value changes
- These proposals are based on current IAS/IFRS
- The treatment of discount unwinds for operational items should be part of operating income (a revision of IAS 37 is needed)
- The allocation of pension costs can be either in total or split between in an operating and financial component provided that the chosen option is consistently applied
- The structure of the notes to the financial statements could also be revised in order increase the prominence of performance related information and ease of understanding

This approach provides a principles-based solution for reporting financial performance that is aligned to the needs of the various users of financial reports