JIG - Performance Reporting
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Deutsche Telekom’s experience with “performance reporting” (1/2)

- Change from German-GAAP to IFRS beginning with Q1/2005 (IFRS-numbers published for two prior years).
- Due to merger with T-Online (based on discounted earnings valuation for T-Online and Deutsche Telekom), a detailed ten-year business plan, including P&L for all business segments and detailed information regarding underlying assumptions had to be published (showing all material differences between fair values and book values of assets and liabilities).
- Many analysts and press conferences to explain ten-year plans and IFRS-conversion.
- Two-day shareholder meeting with 1,200 questions regarding the merger and the valuation.
Deutsche Telekom’s experience with “performance reporting” (2/2)

- Analysts, investors, creditors, press and shareholders did not ask for
  a) available-for-sale-securities,
  b) currency translation adjustments,
  c) cash flow hedges or hedge strategy,
  d) revaluation of PP&E,
  e) minimum pension liabilities

⇒ OCI-items obviously not regarded as relevant performance measures for Deutsche Telekom.
Deutsche Telekom’s relevant performance measures

- **Sales**, i.e. market share, price development, products and similar KPIs that drive sales.
- **EBITDA** and **EBITDA-margin** (i.e. customer acquisition cost, personnel cost, operating expenses, marketing, etc.).
- Capital expenditure for intangible and tangible assets (i.e. bandwidth, licenses, new technologies) to determine
  - free cash flow, and
  - discounted cash flow.
- **Net Income** mainly used for dividend purposes.
Deutsche Telekom’s conclusion on “performance reporting”

⇒ We strongly recommend the Boards to reconsider their April's tentative decision to require a single statement of Comprehensive Income that presents only a subtotal for Net Income.

- Term Comprehensive „Income“, which presents the bottom line of this performance statement, misleading.
- We highlight that Deutsche Telekom does not mind presenting OCI, however, we question its benefit for users.
Concept first - application second!

Before assessing, whether specific transactions/events are properly categorized under OCI, criteria/characteristics for segregation should be determined conceptually.

→ Q2 first - Q1 second.
Q2: What criteria/characteristics would you use to determine if a transaction or event should be included within net income or outside of net income? (1/3)

- The Sarbanes-Oxley-Act and the SEC urge principles-based accounting standards. However, clear-cut, operable conceptual criteria cannot be determined. → Net income cannot be defined satisfactorily for accounting standards.

- History shows that clear-cut, operable conceptual criteria cannot be determined,
  a) not for OCI (see basis for conclusions SFAC 5, SFAS 52, 115, 130, 133, IAS 39),
  b) not for “extraordinary items”, and
  c) not to segregate “revenues & expenditures” from “gains & losses” (SFAC 6).
Q2: What criteria/characteristics would you use to determine if a transaction or event should be included within net income or outside of net income? (2/3)

⇒ OCI-items generally to be identified according to rationale of (1) “unrealized” and (2) “non-core-business related”.

- Both criteria appear more appropriate than others with respect to
  (1) providing information that builds a basis for assessing timing and certainty of (future) cash-flows,
  (2) to identify a distributable figure as Net Income, and
  (3) separate valuation adjustments from income flows.
- But: Specific OCI-items to be identified explicitly by standard setters (rules-based).
Q2: Conclusion (3/3)

- Focus should be on transparency: OCI-items to be shown separately, appropriately titled and (a) nature and (b) status of realization explained within notes.
- Identical (rules-based) categorization of FASB and IASB of paramount importance in order to compare and benchmark international companies.
- FASB’s and IASB’s terminology of Net Income, OCI and Comprehensive Income to be identical.
Q1: Why is it useful to financial statement users to present the following items outside net income? (1/3)

a. unrealized gains and losses on available-for-sale (AFS) securities
   - Useful as not realized (yet).
   - No transaction has actually taken place. Such gains/losses might vanish after the closing.
   - Contrarily, recognition of interest/dividend income within Net Income is appropriate.

b. gains and losses resulting from foreign currency translation adjustments
   - Useful as not realized (yet).
   - “Going concern”-basis for preparation of financial statements under US-GAAP and IFRS.
   - Does not result from (operating, financing or investing) activities of an entity.
Q1: Why is it useful to financial statement users to present the following items outside net income? (2/3)

c. revaluations on PP&E
   - Useful as not realized (yet).
   - PP&E is, in contrast to investment property, not under consideration to sell (due to market price fluctuations). Transformation into cash (equivalent) generally not expected.

d. minimum pension liability adjustment
   - Undecided, as status of realization debatably.
Q1: Why is it useful to financial statement users to present the following items outside net income? (3/3)

e. gains and losses resulting from cash flow hedges or foreign currency hedges.

- Useful as not realized (yet).
- To be recognized in Net Income when the transaction crystallizes (→ recycling).

Empirical support for the current SFAS 130 approach (Biddle/Choi 2002) and its OCI-components.
Q3: Are there other transactions or events that are currently included within net income that would, according to the explanation given in response to Q2, provide more useful information if they were presented outside of net income?

- No.
Q4: Does the reclassification of items from OCI into net income provide value-relevant information and, if so, why? (1/2)

- Under the assumption that dual concept of Net Income and OCI is based on rationale of “realization”
  ⇒ “recycling” remains indispensable mean to communicate process of subsequent realization as it provides relevant information about timing and (un-)certainty about (future) cash flows.
  = “Inherent feature”.
- Often referred to “holding tank view”.
- Provides feedback value.
- Ensure, that trigger for realization/recycling refers to change in status of cash flows opposed to be subject to manipulation of management.
  (This is out of scope of “performance reporting”-project.)
Q4: Does the reclassification of items from OCI into net income provide value-relevant information and, if so, why? (2/2)

Disclosures within accounting policies:

a) Nature of underlying event/transaction.

b) Triggering event (as defined by specific accounting standard) for recycling.

c) Reference to corresponding line item in Net Income respectively OCI (identifying “twins”).
Appendix

2. Re. Q2: Conceptual vs. practical approach
3. Re. Q2: Definition-based OCI-classification not feasible: Analogies
4. Re. Q2: Alternative criteria to determine OCI-items
“Financial accounting” vs. “business reporting”

**Financial accounting**
- Communicated by statements of
  - a) financial position,
  - b) earnings,
  - c) changes in equity, and
  - d) cash flows
- should primarily present **quantitative** information
- that depict (realized) result/status of **past** period(s).

**Business reporting**
- Communicated within notes and MD&A
- to **supplement** the “numbers” by
- providing additional quantitative and **qualitative** information about fair value fluctuations and unrealized transactions to enable user to assess financial **perspective**.
Conceptual vs. practical approach

As

(1) comments from users and preparers of financial statements,
(2) feedback from JIG, and
(3) FASB/IASB’s April 2005 tentative decision

indicate, the established measure of Net Income should not be abolished.

→ “Revolution” of a consequent application of the “realization”-criteria appears inappropriate. E.g. goodwill-impairment should remain a component of Net Income.

Consider: Status of realization depends on subjective judgment. → Strict application on “realization”-approach would not eliminate discretion.
Definition-based OCI-classification not feasible: Analogies

- Concept of “revenue & expenditures” vs. “gains & losses” as defined in SFAC 6, (“ongoing, major, central” vs. “peripheral, incidental”) imprecise and not consistently applied in practice.

- Concept of definition-based “extraordinary item”-category (1) abolished under IFRS and postulated to abolish under US-GAAP (“Jenkings Committee’s report” 1994) and (2) results in debatable results (e.g. EITF 01-10).

- Reference to e.g. EITF 03-1: Objective-based approach to define “other-than-temporary” appears not to be operable (see comments letters and subsequent FASB Staff Positions).

- Many attempts by international standard-setters, rating agencies, investment professionals in last 30 years failed to conceptually explain/justify OCI-recognition of items.
  - See basis for conclusions, e.g. SFAC 5, SFAS 52, 115, 130, 133, IAS 39.
  - Rationale always remains short and vague.
Alternative criteria to define OCI-items (1/2)

1. Under control of management (“management approach”):
   - “Currency translation adjustment-example”: Currency volatility not directly controllable by management, however someone could argue:
     1. Selection of advantageous countries.
     2. Assessing management's decision and their effectiveness in (not) using hedging strategies.
   - Unclear, where boundaries of management control lie.
     - E.g. changes in interest rates cannot be controlled. → Clear and direct effect on entity's fixed bonds, however an indirect effect on equity securities, prices on company's products, etc.
   - Heterogeneous views: Is management finally responsible for both, Net Income and Comprehensive Income?
Alternative criteria to define OCI-items (2/2)

2. Recurring vs. non-recurring:
   - Segregation too arbitrary!
   - E.g. organizational change vs. one-off restructuring.
   - IASB (2004), rationale, why “extraordinary item”-category abolished: “The nature or function of a transaction or other event, rather than its frequency, should determine its presentation.”

3. Other criteria:
   - (1) Volatility of item, (2) usual vs. unusual, (3) active vs. passive, (4) exchange transaction vs. other event, etc.
   - See G4+1’s (1998) catalogue of 29 criteria and their critics: Too arbitrary or irrelevant to build principles-based cut-off line.
   - Remark re. volatility: “Corridor approach” (SFAS 87, IAS 19) to decrease volatility in Net Income. → Conceptually debatably.