SwissHoldings

Verband der Industrie- und Dienstleistungskonzerne in der Schweiz
Fédération des groupes industriels et de services en Suisse
Federation of Industrial and Service Groups in Switzerland

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EFRAG
European Financial Reporting Advisory Group
13-14 Avenue des Arts
B-1210 Brussels

Dear Sir / Madam

Comments on PAAinE Discussion Paper 2, "Performance Reporting: What (if anything) is wrong with the good old income statement?"

SwissHoldings (formerly Industrie-Holding, the Swiss Federation of Direct Investors) represents 42 Swiss groups, including most of the country's major industrial and commercial firms. We very much welcome the opportunity to comment on the above draft, and our response below has been prepared in conjunction with our member companies.

As an initial remark we would like to stress that the issues addressed in the Discussion Paper are closely connected with the objectives of financial reporting, on which the IASB is still deliberating. Performance reporting should in our view distinguish clearly the entity's own performance, the base of which future earnings and cash flows can be assessed, from the variation of its asset and liability values arising purely from hypothetical transactions.

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?

Yes, there is a need:

- in industrial / commercial companies at least, for an **"operating profit"** measuring the entity's success in creating valuable output over and above the value of the *matched* input consumed in doing so (measured in terms of the cost of acquiring the input). This should be in the context of its continuing operating activities, before taking into account the costs of financing the net assets held for operations and – for practical reasons – before income taxes. This is an important measure for analyzing and predicting that part of the entity's value creation which is produced from its operations.
- furthermore, for a **"net income"** to measure the surplus generated *and secured* for the shareholders, taking into account:
    - the operating profit
    - income / expense related to discontinued operations
    - the external costs of financing the net assets held
    - the tax effects of all the above together

  and excluding the effects of hypothetical transactions the results of which have not yet been secured for shareholders and which are of low predictive value.

In addition to these two mandatory key lines, entities should still have the freedom to include such further subtotals as, in their view, help the user to understand the entity's performance, on its various levels, during the period.

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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?

For industrial / commercial companies there are basically **three minimum levels** on which performance needs to be looked at and which each require a distinct nomenclature.

1. The entity's **operating performance** in its continuing operating activities (see question A above);
2. the entity's **global performance** in generating *and securing* a surplus for shareholders (see also question A above and question C below); and
3. the overall increase / decrease in the entity's **net assets** during the period, excluding transactions with owners.

It is important to bear in mind that no single performance measure serves unambiguously to explain the performance of an entity: the above levels are tools for digging into that analysis. "Key lines are important because of the questions they provoke, rather than their own information content".

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?

Yes, it is both **meaningful and necessary,** as *one* of the key measures for starting performance analysis. That it is a critical one is supported by the statements of various users that, if it were to be eliminated from the required format, they would have to derive it themselves. We believe its importance lies primarily in the exclusion of various hypothetical transactions which standards require to be recorded as income / expense but whose ultimate occurrence as real transactions is so distant or uncertain - or is based on assumptions which differ significantly from the way the business works - that their inclusion in the performance measure would give a misleading impression of the surplus actually generated and secured for shareholders in the period. Such items therefore have a low predictive value.

For instance, on a going-concern basis, cumulative translations differences are not going to flow to or from shareholders in the foreseeable future, unless the business to which they relate is divested – in which case they should be considered in analyzing performance. Also on a going-concern basis fluctuations in the market value of an industrial entity's production plants which are going to be used for the operations for the next 20 years are not particularly helpful information when confirming or predicting the operation's cash flows: the transaction hypothesized will not take place.

The **term "secured"** above is also meant to emphasise the desirability of separating out those elements of performance which, in an economic sense, are not sufficiently certain as to be "bankable" or distributable. It is appreciated that profit distribution and other funds available to shareholders are subject to local laws and regulations for the parent, but it is important to have an indication of the achieved surplus which in economic terms could be more freely available.

It has been suggested that **net income** might be generically defined as:

- the overall increase in net economic benefits generated by the entity's activity during the accounting period which have generated, or will generate, cash inflows and outflows most of them within the entity's operating cycle,
- less any consumption of, or loss on, capital engaged (employed) recorded during the period (e.g. depreciation and impairment losses.)

This would reflect the **return on capital** derived from the business cycle of the company during the period and, with its components, would form the basic element for predicting future cash flows. It would exclude value variations on long-term assets and liabilities not traded on liquid markets which will not result in cash flows in the short term.

The exclusions would be something like those items of income / expense which derive from **hypothetical transactions** from revaluations of assets and liabilities where

(1) no active markets where prices are observable at regulated exchanges exist or
(2) valuations are based on disposal or settlement scenarios which are unlikely to occur (in the foreseeable future) because they would be contradictory to the entity's going concern strategy and course of operations or would suggest immediate replacement scenarios the financial consequences of which are not considered in the valuation.

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?

As seems to be corroborated by academic research, there is apparently some marginal tendency for users to pay more attention to a **"bottom line".** It is, however, disputable whether the focus is simply by virtue of it being at the bottom. While many users are under time pressure when using financial statements and may therefore take a "bottom line" as an easy starting-point, most intelligent users – especially those with competent technical support – would be highly unlikely to have such a focus if it wasn't giving them what they needed. Current investors can more easily assess from "the bottom line" (net income) what the entity has actually achieved and secured for them with the funds which they have invested, without the effects of hypothetical surpluses and deficits which might have been achieved if somebody had picked up the phone on December 31. And since many (most?) other users wouldn't attribute much predictive value to items currently reported below "the bottom line" (OCI items) it presumably helps them to have a distinct line where such items are excluded. Furthermore, since preparers generally exclude OCI items for their internal analysis of business performance and focus on "the bottom line" of the current income statement, preparers and users are able to enjoy a **common basis for communication.**

With regard to the **number of statements,** some IASB members have stressed that it is "just a matter of a page-break" – without explaining why, if it really is such a trivial matter, they are so insistent on not having a page-break. While theoretically some clear presentation on one page of income excluding OCI (net income) and comprehensive income is quite possible, many preparers are reluctant to accept such a move as it would facilitate the dropping of that presentation of net income at a later date – now the declared objective of the Boards. It is symptomatic of many preparers' loss of confidence in the IASB that they wish to reduce the scope for such a development by insisting on two separate statements. Indeed, these doubts have been given substance by the IASB's meeting in December 2006 where four presentation options were considered and those which would in effect have just involved a page-break (C and D) did not find sufficient support.

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

So long as key lines or subtotals are reported, recycling is **absolutely indispensable** to maintaining their integrity and meaningfulness. With regard to the two principal items where recycling is at present not permitted:

- It is not clear why actuarial gains and losses taken direct to equity are not recycled (as required by the latest FASB rules) as legitimate **pension costs** – positive or negative – thus by-pass operating expenses.
- Revaluations of **PP&E and intangible assets** were foreseen as allowed alternatives to historical costs for entities favouring a current-cost regime. However, these are practically irrelevant as the number of entities taking this route is minimal.

As defined under C above, **certain items** of income and expense meet criteria for recognition as such but may not (yet) meet all the tighter criteria for recognition in net income. Recycling needs to take place once those tighter criteria are met, e.g. through realization.

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.)

- **Disaggregation by function;**
- **Disaggregation by nature;**
- **Fixed vs. variable;**
- **Recurring vs. non-recurring;**
- **Certain vs. uncertain;**
- **Realised vs. unrealised;**
- **Core vs. non-core;**
- **Operating vs. non-operating;**
- **Sustainable vs. non-sustainable;**
- **Operating vs. financing vs. other;**
- **Controllable vs. uncontrollable;**
- **Based on actual transactions vs. other;**
- **Cash flow vs. accruals;**
- **Re-measurement vs. before re-measurement;**
- **Holding gains and losses vs. non-holding gains and losses.**

Function vs. nature	We'd leave the present flexibility. Industrial companies will probably stay with function plus statistical by-nature information, while (e.g.) banks will probably go by nature. This reflects the way the businesses work and has higher predictive value.
Recurring vs. non-recurring Sustainable vs. non-sustainable Controllable vs. non-controllable	Nice ideas but not very realistic or practical to build into the fixed structure. We prefer the present pragmatic approach of indicating what the preparer believes are "unusual" or "non-recurring (well, er, not very often!)" etc. in a relatively free form, based on his judgment of what is necessary for understanding the performance of the period, then leaving the user to make his own judgment on the usefulness / reliability of that information for his own purposes and for assessing what are future sustainable earnings.
Fixed vs. variable	Could lead to practicability issues since no expenses are either fully fixed or fully variable. We do not believe that meaningful information could be obtained across enterprises.
Core vs. non-core	As for the 4 categories above. However, the similar "continuing vs. discontinued" dichotomy – as embodied in IFRS 5 – is useful and workable, as an additional element to consider in forecasting.
Cash flow vs. accrual	We can understand that this would be useful for users, but it would be very cumbersome to include in the main financial statements (yet another dimension) and very difficult for preparers to actually segregate (you don't run the accounts separately, and the cash trail rapidly vanishes through payables, inventories, PP&E, etc.). If the information is felt to be crucial, we need to look – perhaps using the example of how cash paid for a machine flows through eventually into cost of sales – what precisely we are trying to separate: here too a more pragmatic approach with statistical information on critical positions might be more practical (see also question I below).
Certain vs. uncertain Realised vs. unrealised Hypothetical transaction vs. other* Re-measurement vs. before re-measurement Holding gains and losses vs. non-holding G&L	All of these are closely related and connect with the idea of a net income as opposed to a comprehensive income – please see question C above.

** re-wording*

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?

By and large, there is **no need for change.** The current principles work – which is the most important thing.

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?

From the information assembled by the PAAinE group we have the impression that, in Europe at any rate, the adjustments made by preparers when reporting **non-GAAP measures** are intended to identify (1) special, infrequently occurring items – whether income or expense – and (2) non-cash effective items (e.g. intangibles amortization and impairments) to help the users, especially analysts, to discern the underlying performance of the continuing business as a basis for forecasting the future earnings and cash flows of the entity. (It would be naïve to believe that there is never a “preparer’s agenda” behind the choice of items, but where year for year a consistent explicit approach is applied it is our experience that the additional information is appreciated by users, who can make their own interpretation of it).

We believe that the IFRS financial reporting model should consist of a **minimum reporting format** (see below) and freedom to the entity to represent within that format information which it believes is helpful to users to understand the entity’s performance in the period. In view of its widespread use, a standardized definition and disclosure of EBITDA might be worth considering (similar to – but hopefully much less complex than – EPS).

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?

A **minimum format is necessary.** IAS 1 seems to work reasonably well and can be taken as a practical basis, though the elimination of “operating profit” in the “improvements” project was a retrograde step. Further, IAS 1 should take more account of the accounting process when it requires by-nature information on operating expenses, since it is extremely difficult in accounting and reporting systems which are based on functions to determine (e.g.) personnel expenses reflected in P&L when their separate identity has been lost on the way through inventories and, with self-constructed assets, PP&E and intangible assets. Otherwise, preparers should retain the **flexibility** within the minimum format to structure the data in the most informative way to permit understanding of the entity’s performance in all its diversity.

Yours sincerely

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