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Le Président

JFL/PB/SN

N°1

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Mr Stig ENEVOLDSEN
Chairman
EFRAG
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Dear Stig,

I am pleased to provide you with the CNC's comments on the above-mentioned PAAinE discussion paper (DP) which are set out in detail in the Appendix.

The paper provides useful analysis on the current state of play in the accounting framework, including inconsistencies in the determination and (non-)recycling of Other Comprehensive Income (OCI) items and the lack of definition of the notion of performance. Referring to academic conflicting views and to diverse ways of reporting performance, the discussion paper rightly highlights the fact that it addresses a controversial issue and that assessment of performance cannot be reduced to one figure. It appropriately notes that this requires the use of non-financial elements.

However, the paper states that because one cannot agree on the notion of performance, other things such as bottom lines are not significant issues. Disaggregation would therefore be the most important issue and the question of recycling would be a secondary issue related to the disaggregation criteria chosen. We are not convinced by these latest conclusions and we believe that the main issue is to determine what should be in or out the performance statement, a question linked to the definition of incomes and expenses in the Conceptual Framework and objectives regarding representation of performance. Once performance is defined, the bottom line is as a consequence one of the most important key lines, as it will indicate the dividing line between elements assessing performance and elements that do not. The bottom line is also key in achieving the understandability criterion of financial statements, as it represents an easy reading and synthetic information of performance on which users of financial statements will first focus. For example, it is the basis for the Earning per share information, which is scrutinised by investors.

Besides, we think it would be of great interest to develop further some of the discussion paper analyses especially on the impact of business models, on the notion of realisation and on recycling.

As the notion of business model that an entity applies has recently gained broader support when elaborating new accounting standards, we believe that there is a need to determine to which extent performance reporting should be linked to the business model. We are convinced that the understandability of the performance first and foremost depends on the understandability of the business model, especially on the capacity of the business model to generate net cash inflows during the cash conversion cycle that characterizes it[1]. Therefore, it is important that timing recognition and presentation of elements of income or expenses in the performance statement are consistent with the business model and appropriately reflect the expectation of future cash flows generated through an ongoing business model. Interrelations between the business model and 1) timing recognition of elements in the performance statement, 2) presentation of these recognized elements within the performance statement using disaggregating criteria, should be analysed further. In this perspective, performance reporting is to be examined together with the measurement model implied by the business model and with the notion of stewardship.

Another consequence of our above-mentioned comments is that we consider that recycling is important and should also be analysed further, as a clear distinction between elements that are part of performance and those which are not (yet). This makes it necessary to include the latter elements in the performance statement when (and if) they become part of the performance. We therefore see recycling rather as a recognition issue than as a presentation issue.

In this respect, the notion of realised/unrealised elements will necessarily be a distinction criterion between elements that are part of the performance and those which are not. The notion of realisation should be understood differently from a cash settlement. In our view, it would generally correspond to elements that within the cash conversion cycle of a business model become certain or almost certain[2], for example as accrued interest in a banking activity or as a fair value change on a held-for-trading financial asset listed on an active market. However, some elements could be considered as realised although they do not result from the normal process of the business model, such as gains or losses realised in cash on an unusual sale of assets.

Then, the business model approach and the notion of cash conversion cycle would be combined with other criteria that would distinguish between elements related to the performance under the business model and other realised elements that would be presented separately within the performance statement depending on the disaggregating criteria used.

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[1] As explained in the Paper « the subject matter of financial accounting ; the conflict between cash conversion cycles and fair value in the measurement of income", Andreas Bezold, May 2009, Columbia Business School

[2] the notion of certainty/uncertainty has been explained in our note on « Definition of Business Models applicable to the third accounting category of financial instruments". Especially, the part "What is the rationale for measurement at fair value through "OCI"" of this note describes how the criterion of certainty distinguishes what should be recognised in the income statement and what should remain outside (in OCI).

Nevertheless, further analysis might be necessary to bring about proposals regarding dividing lines between elements that should be considered as unrealised or realised. Therefore, we consider that research on the topics discussed above should be continued by EFRAG.

Finally, it may worth analysing the segment reporting issue which is complementary to the representation of the performance of the entity as a whole based on the business model approach. Entities may have different business activities which may be significantly different from one another, with significantly different related business models. Segment reporting will provide additional useful information to users that may help to distinguish the effects on the total performance of the different business models applied to the different activities.

We hope that you find these comments useful and we would be pleased to provide any further information you might require.

Yours sincerely,

Jean-François Lepetit

APPENDIX

Performance Reporting

A PAAinE discussion paper

Chapter 2 summarises the existing performance reporting model as prescribed in current accounting standards—including how net income is segregated from other items of income and expense—and how those standards have developed.

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?

We think that the reminder of what constitutes the present condition of the income statement in IFRS should be further developed. For instance, the analysis of inconsistencies in OCI items in chapter 2 should be carried on in detail in order to provide a clear understanding of the different approaches used, as well as of the rationale and criteria that justify them. Thus, the analysis would help to identify and envisage solutions to harmonise them.

We think that the paper could further develop analyses that would present:

- the definition of income and the related recognition criteria in the framework, as well as the underlying thinking; more precisely, the reminder in chapter 3 of what standards and the Framework say about performance should be a part of chapter 2 and be further developed;
- the current use of business models in some standards that determines recognition and measurement criteria and therefore the presentation of performance;
- the consequences of the introduction of current values on the distinction between Profit and loss and Other comprehensive income;
- the reasons for requiring recognition in or out of Profit and loss or Other comprehensive income;
- an analysis of the homogeneity of the split between items recognised in Profit and loss or Other comprehensive income;
- the present policy on recycling in more detail.

Chapter 3 considers whether there is agreement as to what 'performance' does or should represent.

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.

Chapter 3 intends to assess the meaning of performance through the presentation of a general discussion on its meaning in practice, the results of a survey and the presentation of academic surveys on how users view performance. We regret that the structure of this chapter lacks cohesiveness and that the different parts are not sufficiently linked with one another.

We would favour a more positive and voluntary analysis of difficulties in assessing the definitions of performance and OCI, as well as in determining the preferred communication tools in such perspectives. We would encourage work to be undertaken on their definition and selection and on ways to harmonise practices.

We agree with the statement in the paper that performance corresponds to a complex notion and encompasses items that may be financial or not, and that may be disaggregated in different manners, emphasis being put on key figures or events according to the financial statement users status, the entity's business model, or other criteria. However, such a statement should not preclude from providing efforts to achieve the identification of key figures that should be in the income statement.

The IASB framework says indeed little about performance and so do the standards, but different requirements such as the dividing line between profit and loss and other comprehensive income conveys assumptions and underlying thinking about elements of performance. We think the paper should analyse these elements further.

Besides, in our view it would be worthwhile to complete the survey which is described in § 3.17 to § 3.27 in order to achieve a more balanced representation, as the sample currently represents mainly Spanish firms and does not include for example, enough banks and insurance companies. We suggest the sample be expanded and be more representative of the diversity of preparers of IFRS financial statements. Once the review of how companies report performance is completed, it would be useful to analyse findings in comparison with income statement presentation requirements and related dividing lines, and with views expressed by stakeholders regarding the actual condition of the income statement.

In Chapter 4 we consider the necessity and importance of key line(s) and bottom line(s), the number of statements of income and expense that might be needed and the extent of recycling of items of income and expense between categories of statements that might be necessary.

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.

Of course key lines are useful and they are not only useful but also necessary for primary financial statements that should aim at being read and understood quickly.

As a tool aimed to allow users to assess their actual or future investment with synthetic information, financial statements should highlight major changes undergone by an entity as well as major components of its wealth.

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).

Along with understandability, we advocate that comparability remains an essential objective of financial presentation requirements which implies that key lines be standardised to a fair degree.

The range of approaches described in Chapter 4 is a good starting point for analysis.

In order to complete the analysis of the discussion paper, we think it would also be useful to recall the benefits or disadvantages of present requirements and the extent to which preparers' and users' needs are taken into account or could be better served.

We also have some reservation regarding option D where the standard setter would identify certain key lines but would allow preparers to use others instead. The relevance of such identified key lines would be questionable in such a perspective.

Nevertheless, our major remark is that we would have preferred a more thorough analysis of the implication of a presentation that really fits with the business model of entities. We are indeed convinced that the most relevant flexibility is the one that allows for a presentation in line with the business model, with the objective to appropriately reflect its capacity to generate net cash inflows through a cash conversion cycle. Once general requirements are set to fairly take into account the business model's implications, further flexibility may not appear so necessary or relevant for the definition of key lines.

We would also recall our general comment that performance reporting schemes should be adapted to particular business activities, mainly to the banking and insurance sectors.

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 our answer to question 4.

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.

Although we agree that one specific key line cannot encapsulate "performance", we do not share the view expressed in the discussion paper (especially § 4.20 to §4.23) according to which bottom line figures are not important. Such statement denies the purpose of the financial statement preparation process which is not only to display disaggregated amounts in very detailed schedules but should mainly aim at summarising numerous events in a useful manner for users.

As stated in our comment letter to the IASB's Discussion Paper on financial statement presentation, we also think that the primary financial statements need to remain synthetic and understandable. Therefore, the bottom line figure needs to be a key line to allow users to have a quick understanding of the entity's performance. One of the key information users are all the more interested in is the net income resulting from realised elements of income and expenses (for the definition of 'realised' please refer to our cover letter).

Moreover, the question on the number of performance statements should not be oversimplified as it is linked to the "what is performance and what is not performance" question. Once one agrees on a definition of performance that should be usefully provided to users of financial statements, the bottom line becomes a key line because it represents the net income. The net income should exclude elements that are not considered as part of the performance in the related reporting period.

It follows that we are indeed still opposed to the presentation of a single statement of comprehensive income encompassing the income statement and the other comprehensive income (OCI) items.

For reference, we have included in italic below extracts of our comment letter to the Phase A of the financial statement presentation project (dated July 2006) which resulted in amendments to IAS 1. These comments were also included in our comment letter to the financial statement presentation DP dated April 2009 (answer to question 14).

« We do not agree with the proposal of suppressing the income statement. The income statement should be kept as a separate statement. If the Board wants to enhance information about "other recognised income and expense (=OCI)", these components should be presented separately from the income statement. Different presentations should be authorised (see SFAS 130 for instance).

We do not agree with the wording "profit or loss" to replace "net income" and propose to keep "net income" in order to respect the Framework and use similar wording as in SFAS 130.

In the Basis for conclusions of the Exposure Draft, among of the determining reasons for pushing forward one single statement instead of two are:

- Income and expenses are defined in the Framework,

- Components of Profit or loss (or net income) are not,

- There are no clear principles or common characteristics that can be used to separate items into two statements.

We do not subscribe to this rationale:

- Paragraph 71 of the Framework specifies that "the definition of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement",

- Main recognition criteria for components of income and expense are the following:

- More probable than not (Framework paragraph 83),

- Reliable measurement (Framework paragraph 83).

- Other recognised income and expense have in the past been excluded from net income and recorded directly in equity because they were not considered to meet the recognition criteria,

- Nor were they considered as part of the entity performance in accordance with Framework § 69.

- Even if there are no common characteristics for these components, it has been considered relevant to exclude them from net income by implementing specific accounting standards.

We are not dealing with a mere presentation issue, but with a major conceptual change involving both conceptual and recognition issues:

- Conceptual issue: the definition of income and the definition of performance should be dealt with within the Framework project,

- Recognition issue: the Revenue recognition project will determine if components of the proposed "statement of recognised income and expense" are actually income and expense.

There will be ample time when current projects on Framework and Revenue recognition are coming to an end, to decide whether one or two statements are necessary.

For the time being, a straightforward rule to determine which components should be excluded from net income is to apply existing standards."

The CNC considers that most of the reasons above are still valid and, current standards being what they are, prefers retaining the choice of presenting one or two statements as currently proposed under IAS 1.

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.

As we are against the underlying assumption that the “bottom line” does not have to be a key line (see our answer to question 6), we are against one global performance statement which would mix elements we consider as realised (as defined in the cover letter) that would constitute the net income (which would be the bottom line of the said performance statement) with unrealised elements that should not be recognised in the net income, even if they are recognised in the statement of financial position (as OCI).

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 discussion paper puts an emphasis on the disaggregation issue and considers the recycling issue in such a context, whereas we would rather favour a discussion firstly about how the performance concept should be defined and secondly how (financial) performance should be recognised, measured and presented in the financial statements in line with general objectives (comparability, understandability, stewardship). Recycling then would become a recognition (in the performance statement) issue, i.e. a significant issue dealing with timing of recognition. This would especially be the case if the income statement is defined to reflect the performance of the business model and the result of related cash conversion cycles as a priority. This would make the notion of realised/ non realised elements, as defined in the cover letter, a key notion related to the recognition issue.

Chapter 5 considers some models for disaggregating income and expenses and some of the issues that would arise in relation to those approaches.

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, because we do not favour a disaggregation approach but we consider the definition of the notion of performance and the resulting timing recognition in the performance statement based on the notion of realisation as the first step of the reasoning. The recycling issue is linked to this recognition approach rather than to disaggregation criteria. Disaggregation will therefore deal with presentation issue within the performance statement in order to distinguish realised elements that are related to the normal process of the business model from realised elements that are not related to it. Unrealised elements should remain excluded from this performance statement and should not be mixed with realised elements in one global income statement. Otherwise the perception of the performance of the entity may be obscured.

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?

Recurring/ non recurring
It may be questionable that restructuring costs are considered as recurring ones.

Realised/ unrealised

We disagree with the distinction between realised and unrealised being interpreted as a distinction between cash and non-cash. For example, distinguishing cash events in some cases (especially in the held-for-trading activities) would have no relevance to assess the performance of an entity. Moreover, in the banking book (loans and receivables, HTM), interests accrued may be considered as realised (legally owned, certain).

We think it would be useful that EFRAG analyses further the notion of realisation when some specific issues, such a employees' benefits or impairment are concerned

Core/ non core
In the core/non core model, it may be mentioned that financing cost should be included in "core earnings" by banks. More generally, it should be reminded in this Chapter that the proposed models should be adapted to the specific case of banks and insurance (financial) industries.

Other
The cash flow statement is complementary information that helps users understand and assess performance also in the future. This could help address users' needs. Additional analysis of cash flow information needs should be undertaken as well as their inter-links with the structure of the income statement.

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

The advantages and disadvantages appear similar between different disaggregation models, and disaggregation criteria are often qualified as subjective. This makes it difficult to assess what the key advantages/ disadvantages are that could really make the difference between the proposed models.

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?

As noted in the cover letter, we favour the preliminary application of a business model approach to determine what the main component of the entity's performance is. In our view, the business model should be understood rather as a recognition issue than a disaggregation one as it will allow a consistent representation of the entity's economic performance, in particular its capacity to generate net cash inflows through a cash conversion cycle. It is important information for users, as the financial statements should provide information regarding the entity's capacity of generating cash flows. It could also appropriately provide information in order to assess the management's stewardship. This approach should be completed by the recognition of elements that could be considered as realised although not related to the normal business model, as explained in our cover letter, in order to portray the performance of the entity related to a reporting period through its net income.

A business model describes and determines the operational process for a certain type of activity covering a certain number of transactions. Therefore, it implies a specific pattern of the performance realisation. According to such patterns, elements that cannot be considered as part of the income statement should not be recognised in the performance statement, even if they are recognised in the statement of financial position (as OCI). Recycling in the income statement will occur when elements become realised as defined in our cover letter.

The business model would therefore determine what should be recognised as the most significant element of the performance and the related timing recognition before considering how presentation of performance should be structured within the income statement in order to distinguish between performance related to the business model and performance that does not relate to it (through disaggregating criteria).

Besides, we think that measurement bases should be determined by reference to business models used in managing the entity resources.

Operating/ investing/ financing

We would see this disaggregation as the primary split once the business model implications in terms of timing recognition and identification of most significant elements of performance have been identified. These significant elements would normally be those classified as part of the operating income. Such a split consistent with the economic asset valuation model widely used by the financial markets and to the extent that it is suited for the entity (it may not be the case for financial and insurance companies) would be a major progress in terms of both form and substance.

Recurring / non recurring

We believe that the second split should remain based on the recurring/ non recurring criterion which is:

- in line with the operating cycle of the entity and with the ‘business model’,
- well understood and accepted criterion amongst users,
- relevant for making assessments about future cash flows.

Non recurring revenue and expenses are those that may distort the interpretation of financial statements. By reference to the framework (§28), such revenue and expenses may correspond to unusual, abnormal and infrequent items identified separately in the income statement so that the understandability of financial statements is enhanced and the forecast of future net income is easier. Such items may be :

- a gain or loss on an asset disposal, or an impairment on non current assets, of a significant amount and unusual occurrence;
- some restructuring costs,
- other revenue and expenses related to a provision on litigation which amount is particularly significant.