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Re : **"EFRAG Discussion Paper 2 – The performance reporting debate"**

Dear Sirs,

We are pleased to respond to your request for comments on the "EFRAG Discussion Paper 2 – The performance reporting debate".

1. Introduction

Most users of financial statements issued by public companies are particularly keen on value relevant information, which encompasses both financial and non-financial information. Financial information usually takes a central role in determining what a company is worth whereas non-financial information complements and confirms the conclusions stemming from the analysis of the former.

Traditionally, the focus of financial statements has been on the income statement and the measure of a company's annual performance – based on the historical cost convention – as defined by the applicable accounting standards. In that context, conclusions about the value of company could be obtained by applying valuation approaches based on adjusted earnings or revenue multiples.

More recently, and this is especially true of IFRSs, the focus of financial statements has shifted towards the balance sheet and the measure of a company's worthiness based on the year-end net equity. The most recent IASB's standards and discussion papers clearly aim at broadening the scope of measurements of assets and liabilities at fair value, thus bridging the gap between a company's net equity and its market cap. Under an approach focused on the balance sheet, the income statement would merely give a measure of the value created or destroyed during a given period.

We are not aware that a thorough debate about what the preferable approach is has taken place and would definitively support it.

To add to the confusion, the current measurement model in IFRSs is mixed and allows for certain assets and liabilities to be carried at cost and for others to be measured at fair value. Furthermore, IFRSs have significantly increased the number of items of income and expenses to be presented within net equity, mandating, allowing or prohibiting recycling without offering a clear rationale for it.

Within the constraints of the mixed measurement model in IFRSs and the focus progressively shifting towards the balance sheet, without the support of a previous debate about whether this is indeed preferable, we believe that a discussion on performance reporting could be extremely difficult and ultimately prove vane.

Our view on the specific issues raised in the discussion paper are provided below. The answers are provided with the consolidated financial statements of non-financial institutions in mind. Our comments may be not be relevant to financial institutions and to separate financial statements.

2. Answers to the specific issues raised in the Discussion Paper

Question 1 – 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?

Comparability calls for having key lines in the statement of income and expenses and for defining strict presentation criteria to ensure such key lines are consistently arrived at.

However, we do not believe that a rigid income statement format could satisfy the reporting needs of companies across industries and within a given industry when different business models are adopted.

We believe that a degree of flexibility is required, provided it is counterbalanced by sound and clear underlying principles that call for a fair and neutral presentation of the company's performance.

Question 2 – 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?

There cannot be a common view as to what performance is because performance must be assessed within the broader context (e.g. the industry a company operates in, the position of the company in the market, the phase of the business cycle it is facing, etc.)

Indeed, financial statements show a measure of how a company performed during the period, whether that is the net income for the period or the increase in net equity, but such measure is a conventional indicator of performance and must be interpreted through the glasses of the applicable accounting framework.

Question 3 – 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?

Net income may be or may not be relevant depending on what we believe the purpose of the financial statements be. A traditional approach focused on the income statement put a bigger emphasis on net income than a balance sheet approach does.

The current IFRSs notion of net income is voided of meaning by the many presentation options available and recycling requirements which lack an economic rationale. Also, they provide opportunities for arbitrages between what is shown in the income statement and what is presented within the statement of changes in equity, thus reducing comparability and the usefulness of the bottom line of the income statement.

Question 4 – Does the bottom line of a statement of income and expense bear more weight and significance than other lines of the statement(s) simply by virtue of being at the bottom? Consequently, how many statements of income and expense should there be and why?

Net income has been traditionally understood as a key measure for the financial success of a company.

That cannot be hold true anymore due to the many presentation options available, the opportunities for earnings – as shown at the bottom of the income statement – management, and the lack of a sound rationale for the requirements in the various accounting standards.

Question 5 – Is recycling needed? If so, what should it be used for and on what criteria should it be based?

Recycling is not needed. No sound and verifiable criteria can be envisaged to decide what must be presented in the income statement and what within equity. The lack of rationale for recycling in existing IFRSs, the difficulties in developing a principle to award a different presentation for certain items of income and expenses, and the opportunities for arbitrages, suggest it is better to get rid of it.

Items of income and expenses must be shown within one statement and changes in equity – other than those due to the net result for the period – must only come from transactions with owners.

Question 6 – Which of the following disaggregation criteria have both 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 this disaggregation principle?

The answer to this question depends on the conclusion reached on whether the focus of the financial statement should be the balance sheet or the income statement. Furthermore, the current mixed measurement model makes it harder to develop disaggregation criteria.

Among the criteria proposed in the paper, we believe it to be more useful to users of financial statements to tell items of income and expenses that resulted in actual cash inflows or outflows or are near to turn into cashflows from those whose nearness to cash is more remote. Whether that is achievable in practice and could be audited is debatable.

Question 7 – 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?

The problem with the current netting requirements is the lack of consistency between the criteria that must be fulfilled to offset items in the income statement and those that required for items in the balance sheet. For example, interest income and expenses are often presented net; however, interest-bearing financial assets and liabilities may be offset when stricter criteria are met.

A more pervasive inconsistency between the presentation of the income statement and the balance sheet is that the former typically distinguishes operating and financial items, whereas the latter only shows current assets and liabilities separately from non current, irrespective of their nature.

Question 8 – 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? 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?

Reporting non-GAAP measures is common practice and that is a sign that companies need a certain degree of flexibility to be able to communicate what are deemed to be the most relevant performance indicators for the period.

Most common adjustments relate to non recurring items (although it might be argued that a non recurring loss is more likely to be stripped out of net income than a non recurring gain), non-cash items such as depreciation and amortisation.

Incorporating non-GAAP measures into the IFRS financial reporting model could be desirable to achieve comparability of such indicators of performance. However, a balance must be found between comparability and flexibility. If standardisation of non-GAAP measures reduces the scope of flexibility, the final result could be the development of new aggregates and sub-totals.

Question 9 – 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 general 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?

We believe that the right balance between comparability and flexibility could be achieved as follows:

(i) a clear objective of performance reporting must be developed; for example, the objective could be the one of communicating value relevant indicators;

(ii) broad but on-the-point principles must be developed to guide the presentation of items of income and expenses to achieve the objective in (i); for example, performance must be presented in a neutral and fair way, …;

(iii) a detailed reporting format, including a strict definition of sub-totals and aggregation criteria must be developed; however, such format must be recommended and under no circumstances be mandatory;

(iv) departures from the recommended format must be disclosed together with an explanation of what those departures are and how they better allow to achieve the objective in (i).

Yours sincerely

Prof. Angelo Provasoli

(OIC – Chairman)