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Comments of the Association of German Public Sector Banks (VÖB) on the Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper entitled "The performance reporting debate – What (if anything) is wrong with the good old income statement?"

Dear Sir or Madam

We thank you for the opportunity to comment on the discussion paper entitled "The performance reporting debate – What (if anything) is wrong with the good old income statement?", issued by Pro-active Accounting Activities in Europe (PAAinE) in November 2006.

The Association of German Public Sector Banks (Bundesverband Öffentlicher Banken Deutschlands, VÖB) is a top-level association of the German banking industry, domiciled in Berlin. It represents 61 member institutions including the Regional Banks (Landesbanken) as well as the development banks owned by the federal and state governments. VÖB member institutions have a market share – calculated as their proportion of the total assets of the entire German banking industry – of 27 %. VÖB banks employ a total of nearly 100.000 staff. VÖB has also a bureau in Brussels opened in 1987, and is a member of the Brussels-based European Association of Public Banks (EAPB).

A. Fundamental Remarks

We expressly welcome the objective manner in which the PAAinE has initiated discussion on the continued development of performance reporting, and consider this a proven means, from a continental European viewpoint, of influencing the work of the IASB.

We are predominantly critical of the arguments for further development of performance reporting as presented in the discussion paper before us. In particular, we especially reject the unitary income statement put forward by the IASB in its Exposure Draft of Proposed Amendments to IAS 1 – Presentation of Financial Statements. This change would *de facto* lead to the current idea behind the revaluation surplus for the treatment of resulting in neither profit nor loss of certain valuation effects being abandoned. In our estimation, however, abandoning the important demarcation between result components affecting net income and those neutral as to net income would have a significant impact on how balance-sheet users interpret financial statements and the determination of business ratios. For, by showing results in terms of an overall yardstick, including both components that are affected and components that are neutral as to the result, the accounting income will be degraded to an interim sum that recedes behind the new “total recognised income and expenses for the year” and, thus, is no longer ostensibly visible to the user of the balance sheet. We emphatically reject such a complex way of presenting the profit and loss account, which the reader could only comprehend with some difficulty. Our view is that the current presentation of corporate performance ought to be retained as far as is at all possible.

B. Responses to the Questions

We would like to respond as follows to the individual questions posed in the draft discussion paper:

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?

The question of the need for a final, summary figure that describes the company’s performance is closely bound up with the question of whom the annual accounts are addressed to and a weighing-up of the information needs of the various users of financial statements.

The IFRS framework identifies as users of accounts: investors, employees, lenders, suppliers and other creditors, customers, governments and their agencies and the general public (F.9). Apart from having differing information needs (of which the IASB is aware, see F.10), these users of financial statements also have a different scope of perception and differing states of knowledge with regard to financial reporting. Furthermore, they are subject to different time restrictions for the appreciation and analysis of annual accounts.

In order to meet the requirements of the various users in question, financial statements are necessary, which take account of the limits on the various parties to appreciate what they are reading. This means that a starting point is

needed for the presentation of company's performance that can also be understood and compared by persons with limited knowledge of financial reporting and less time at their disposal. In our view, this starting point can only take the form of a key line under a profit and loss account, which expresses performance in terms of a figure. On the basis of this key line, however, it is possible to further break down this single value into further sub-categories and to expand the individual pieces of information that the single value comprises with further information (qualitative and quantitative), so that, where the user has a greater degree of knowledge and more time in which to perform appropriate analysis, he will be able to gain a broader insight into performance, and thus reconfigure the company's result from his own individual point of view.

An extreme example of the different users might be the general public or press, with a fairly shallow understanding of accounts, and credit/rating/equity analysts, with their very high degree of understanding of accounts. Whilst the general public and the press frequently make improper comparisons amongst net income, comprehensive income and management ratios like EBIT or EBITDA, resulting in non-objective discussion, analysts, e.g. on the basis of their own experience, calculations and internal corporate precepts, reconfigure performance or divine figures that have only a partial connection to the performance of the company. Hence, we advocate a key line in a "P/L account" as the starting point for further analytical possibilities.

Since, within the discussion surrounding performance reporting in the present discussion paper, the themes of "recognition" and "measurement" are consciously excluded (see para. 1.7 of the discussion paper), the term "key line" can basically only concern the "profit/loss for the period" as determined under the current IFRS or the "total recognised income and expenses for the period". Whilst the "profit/loss for the period" takes account just of all items having an effect on net income, the "total recognised income and expenses for the period" encompasses all items having an effect on the net result together with those that are neutral in that regard (i.e. all changes in equity that cannot be attributed to transactions with the equity-holders).

We regard the non-systematic determination of certain items into various equity components (retained earnings, miscellaneous reserves) and their non-systematic consequential treatment (recycling, no recycling) as an aberration of IFRS financial reporting. The basic inclusion of certain items directly in equity is also questionable. The development of the concept of the balance sheet under IFRS towards a fair-value balance sheet leads to changes in valuation that require a contra-entry in the context of double-entry accounting but demonstrate no relationship to performance of the company and, hence, ought not to be integrated into the equity positions "balance sheet profit/loss" or "net profit/loss".

This would make results-neutral capture in equity into a "balancing valve" for two contradictory objectives within double-entry accounting: a presentation that reflects performance and a presentation that includes the fair values of

the assets and liabilities. Without questioning recognition and measurement in their current forms, it is impossible to resolve this contradiction. In this respect, it is for instance conceivable to renounce fair-value valuation in the balance sheet in the case of certain items and to draw up a schedule of notes that shows all the reserves and charges not reflected in the balance sheet or to introduce a separate value alongside equity and debts on the liabilities side of the balance sheet. However, this would be to exceed the defined scope of the present discussion paper.

As long as the contradictions in the expression of equity, as outlined above, continue to exist under IFRS, it is in our view advisable to leave the "profit/loss for the period" as the "key line" for the company's performance in order to ensure that the annual accounts remain understandable to a multitude of users. Only once the foregoing contradictions are resolved, in our view, a drive can be made to finding a new definition of the key line for performance.

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?*

In our opinion, the meaning of performance can only be found in the IFRS themselves. Performance has to be an aggregation of all account items in IFRS financial reporting that are graded as performance-relevant within the IFRS regulations. Whether facts are performance-relevant is a matter that in our view needs determining separately depending on the individual circumstances.

The IFRS framework concerns itself with two concepts of capital maintenance (F.104 to F.110). These are the concept of "financial capital maintenance" and the concept of "physical capital maintenance" (F.104). According to the concept of "financial capital maintenance", increasing prices for assets constitute profit (F.108). Vice versa price reductions for assets constitute losses. Apart from that, the opposite should thereby apply with debts. According to the concept of "physical capital maintenance", price changes for assets and liabilities are regarded as capital maintenance adjustments and not treated as profit (F.109). According to F.110, the Board of the IASB (the Framework still refers to the IASC) currently has no intention of requiring any specific model.

Only once the Board has laid down a given model this will, in our view, result in individual items being capable of being examined in relation to their performance-relevance. If these steps are gone through, this will have the consequence of producing a definition of performance. We reject parallelism amongst various types of performance, since can lead to arbitrariness in external presentation and corporate communication. This also entails a rejection of the management approach for expressing operating segments, which has already been implemented by the IASB in IFRS 8.

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?

We regard a “net income” that is equated to “profit/loss for the period” as the most significant and important variable in a set of annual accounts. For that reason, net income should also constitute the key line in a performance account. As to the meaning of a key line for IFRS accounts, we refer to what we say under question 1. As to the determination and significance of net income, we refer to our response to question 2.

4. 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?

We have already spoken in questions 1 and 3 in favour of a key line that is to be found at the end of performance accounts. We are of the opinion that, in so far as possible, the key line should be placed at the end of performance accounts so that users recognise the key line at the first glance.

It is in line with the usual Anglo-American and continental European culture of story-telling or presentation there exist a finale or closing shot. Performance accounts should take cognisance of this story-telling culture, since they relate a story covering a defined period of time – the reporting period – and hence accord with the cultural background of an Anglo-American or continental European user and comply with his expectations. Furthermore, in mathematics, the result is always to be found at the end of a calculation. This, too, accords with the usual viewpoint of users of income statements. Accordingly, in our view, there should exist only one single performance statement. As to the issue of several parallel performance accounts, we refer to what we say under question 1.

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

Under the question as to whether to implement recycling, a response is needed in terms of the capital maintenance concept (see question 2). According to the concept of financial capital maintenance, recycling is a necessary condition. If price changes were not to be recorded as profit or loss upon realisation, this would be a breach of the concept of financial capital maintenance (F.108). Under the concept of physical capital maintenance, recycling cannot take place, since the valuation of assets and liabilities constitutes capital maintenance adjustments and is not to be counted toward the performance of the company. At present, both capital maintenance concepts find their way

into various standards. Whilst, for instance, in the case of AfS financial instruments and cash-flow hedges, the financial capital maintenance concept enjoys priority, the treatment of, say, actuarial profits and losses from performance-oriented obligations and the revaluation of fixed assets follow the concept of physical capital maintenance. We basically view this mishmash of the two concepts critically. In our view, in future, IFRS financial reporting should exclusively follow one of the two concepts or a fundamental election ought to be introduced for the drafter of annual accounts to opt for one or another concept, and then to use that for the entire financial statements.

6. 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. accrual;***
- ***Re-measurement vs. before re-measurement;***
- ***Holding gains and losses vs. non-holding gains and losses.***

Disaggregation by function/disaggregation by nature:

Both the cost of sales method (by function) and the total cost method (by nature) lead to identical performance. In our view, there are no pros or cons when comparing to the two methods. Fundamentally, it is in future possible to codify only one method in the IFRS as a possible presentation. Since neither method can be deployed in the banking sector, there is no further need to comment in this regard. However, it is furthermore clear from this that either wide-reaching freedoms in performance disaggregation have to be possible or sector-specific disaggregation has to be laid down.

Fixed vs. variable:

The differentiation between fixed and variable is only possible in the case of a few, individual items (e.g. interest, public appropriations, fixed margins). Hence, such differentiation can only make sense in special cases. In the case of financial instruments, we do not consider that such differentiation makes sense. Especially the synthesising of differing fixed and variable payment flows and combining them and consciously separating them are a significant factor in financial engineering. Differentiation would virtually certainly contribute to inappropriate presentation of performance.

Recurring vs. non-recurring:

The delineation between recurring and non-recurring can only possibly be done in individual cases by particular companies and given their individual situations. Hence, this criterion is in our view fundamentally unsuited for disaggregation.

Certain vs. uncertain:

“Uncertainty” is as a rule inherent in economic activity. Basically, only the so-called “riskless interest rate” is certain. Hence, this criterion is in our view unsuited for disaggregation.

Realised vs. unrealised:

Differentiation into realised and unrealised is in our view of central significance when assets and liabilities are not valued at the attributive market value such as to affect net results. However, in the case of assets and liabilities valued at the attributive market value such as to affect net results, this differentiation is meaningless, since no difference results for the presentation of performance.

For disaggregation, thus, differentiation into “realised” and “unrealised” is only meaningfully applicable in the case of reductions in value affecting net results and value increases affecting net results – albeit here of great importance for the users of the accounts – since this offers an important insight into the asset situation and the quality of the assets of the reporting company.

Core vs. non-core:

Differentiation into core and non-core can only be done individually by each company. In the absence of comparability and given a far-reaching possibility for arbitrary determination

Operating vs. non-operating:

We regard the current rule under IAS 1 as appropriate. In our opinion, we consider that all performance effects are brought about by a company’s economic activity. Defining items as non-operating can virtually only be done on an arbitrary basis.

Sustainable vs. non-sustainable:

We consider differentiation into sustainable and non-sustainable to be a form of disaggregation that is relatively arbitrary and individual to the company concerned, and hence to be unsuited.

Operating vs. financing vs. other:

Differentiation into operating and financing is already done as a consideration in an earlier form of the performance reporting project. In this regard, it was shown that this presentation is fundamentally possible for manufacturing companies and trading companies. In the case of a bank or insurance company, this differentiation results in a defective presentation of performance. Hence, this differentiation is only applicable in specific sectors.

Controllable vs. non-controllable:

For this form of disaggregation, we consider that our comments in relation to core v. non-core, operating v. non-operating and sustainable v. non-sustainable equally apply.

Based on actual transactions vs. other:

For an appraisal, a precise definition of "actual transaction" is necessary. Basically, no difference can be appreciated between this and realised v. unrealised (assumption: realised = the result from an actual transaction; unrealised = result from a valuation).

Cash flow vs. accrual:

We consider that the capital flow account already offers an adequate presentation of the payment flows.

Re-measurement vs. before-re-measurement:

By analogy to the differentiation in "operating v. financing", this likewise concerns a differentiation from the early phase of the performance reporting project. In this regard, in our view, the issue has arisen that the change in valuations and the assumption of valuation risks partly forms an integral aspect of the business model of certain sectors (e.g. banks and insurance companies). Hence, this differentiation would only seem apt in the case of specific sectors.

Holding gains and losses vs. non-holding gains and losses:

In this case, no clear delineation from "realised v. unrealised" is possible (unrealised = holding gains and losses? realised = non-holding gains and losses?).

Fundamentally, we consider that sector-specific disaggregation would be appropriate, such as is for instance required by the Credit Institutions' Financial Reporting Order or the Insurance Companies' Financial Reporting Order in financial reporting under the German Commercial Code.

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?

In our view, there arises no need for change or improvement regarding the netting regulations in the profit and loss account under current IFRS.

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? 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?

Financial reports which are not based on current accounting figures are, in principle, not made available to market participants, unless they are requested by important parties. This concerns in particular rating agencies. Adjustments are made on behalf of rating agencies. At the moment, there are no non-GAAP measures which, in our opinion, should be included in IFRS.

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 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?

With IAS 30 having been superseded by IFRS 7, the IFRS reporting requirements have been further relaxed so that, at present, only the extremely restricted reporting requirements contained in IAS 1 are contained in the IFRS. However, for various sectors, these are not sufficient. This is particularly true of banks and insurance companies. As a result, a variety of initiatives have come to the fore in recent months aimed at filling these regulatory lacunae, so that comparability between sets of accounts can be achieved.

In this connection, for instance, we might name RIC 1 from the German Accounting Interpretations Committee and FinRep (financial reporting) from the CEBS (Committee of European Banking Supervisors). This shows that great public pressure exists for the creation of reporting formats. The IASB should in our view maintain its leadership in this regard, in order to obviate disparate measures being taken at national levels.

We therefore recommend that sector-specific reporting formats be laid down by the IASB, at least for industrial and trading undertakings, banks and insurance companies, as have already been set down in national legislation by

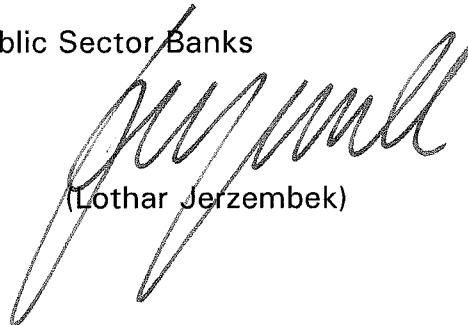
means of appropriate directives within the EU. We consider that there are limits to standardisation in the case of mixed groups that bring together companies in each of the three aforementioned sectors. This includes for instance full-range financial groups, active in banking and the insurance sector, or industrial companies with affiliated banks and/or insurance companies. Nonetheless, guidelines from the IASB as to how to integrate these various sectors in group accounts would be desirable. We are of the elementary view that a unitary reporting format for all sectors cannot feasibly be implemented since there are fundamental differences in the business models, particularly of the three aforementioned sectors.

For further questions and discussion, we are at your entire disposal.

Yours sincerely,
Association of German Public Sector Banks



(Karl-Heinz Boos)



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