Financial reporting priorities
A European Investor view

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pwc

Contents

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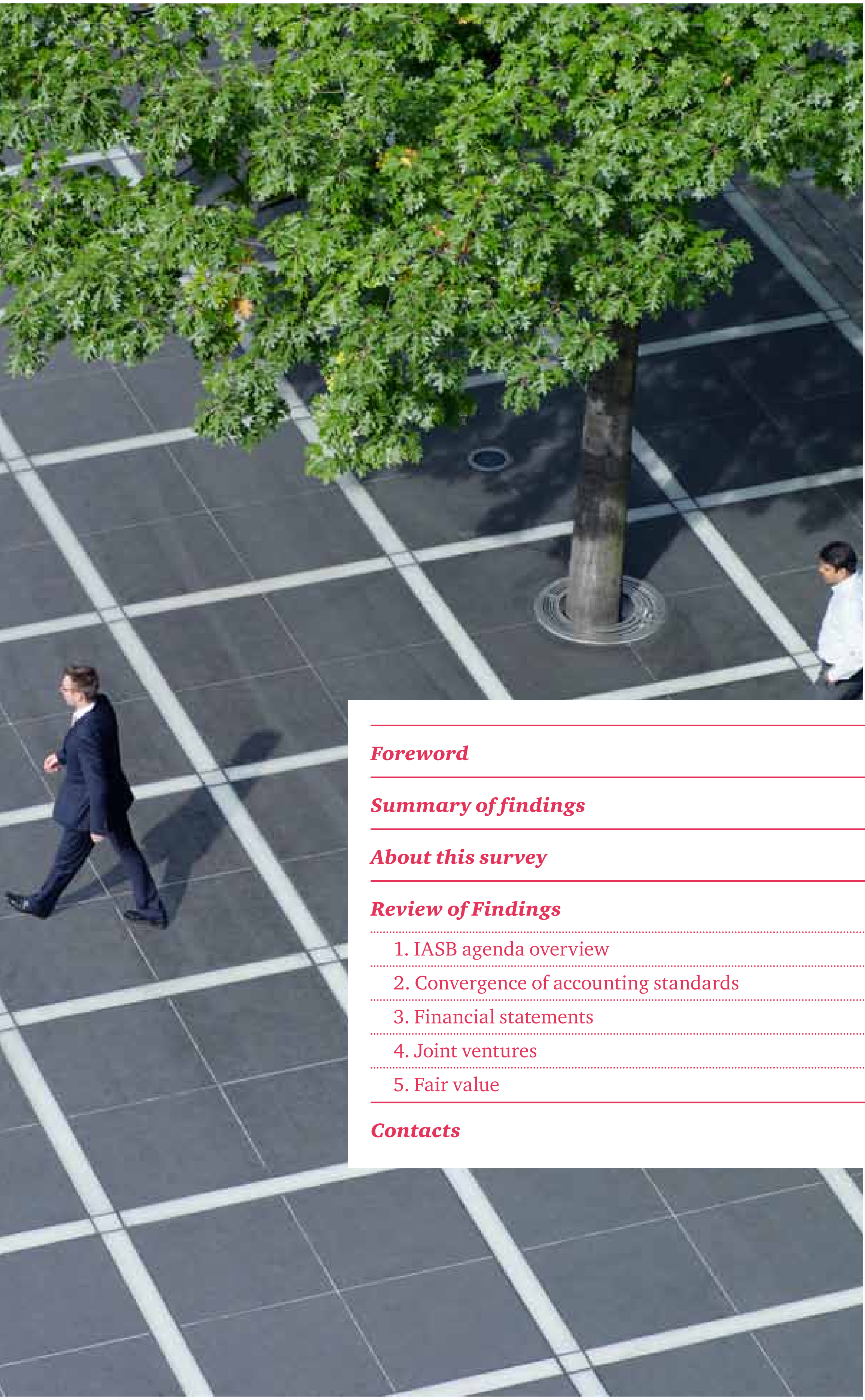

Foreword

The challenge facing financial reporting's future is huge. Entities have to keep on building investors' confidence. Their requirements have an important impact on the way entities report their financial information.

In July 2011, the IASB launched its first formal public agenda consultation on its future work plan. As this has produced a debate on financial reporting priorities, we consider it is important that investors tell us what their needs and expectations are in financial reporting. We decided to ask them for their views on some critical financial reporting matters including: the IASB's agenda, the convergence of accounting standards, financial statements, accounting for joint ventures and fair value.

This survey complements our Investors fair value survey issued in 2010 ("What investment professional say about financial instrument reporting").

We would like to thank all the investment professionals who kindly gave their valuable time and insights to this survey. There are exciting opportunities for change in the future but they have to be prioritized. We hope that the findings will provide a useful contribution to the continuing debate over the future of reporting.

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Summary of findings

During our interviews, we heard a number of different opinions from investment professionals which are presented in the next pages. There were some powerful observations for each of the survey 5 topics.

1

All but one investors interviewed ask for a period of calm in accounting standards.

IASB agenda overview

2

The majority of participants do not want convergence with US GAAP at any cost and consider that quality is more important than convergence.

Convergence of accounting standards

3

93% of the respondents believe that non-GAAP measures are important for understanding companies' performance.

70% of investors consider the ratio relevance-materiality-and-volume of disclosures is not set correctly.

Financial statements

4

The proportional method is the preferred method of accounting for joint ventures, but there are significant differences in view between countries.

Joint ventures

5

The financial crisis has highlighted problems in applying fair values. For financial instruments, there is an overwhelming support for the mixed measurement model.

Fair value

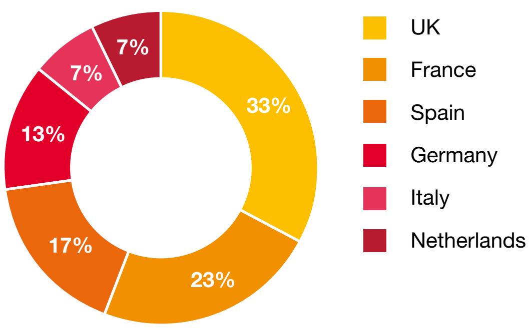
About this survey

For a number of years, PwC has conducted research with investment professionals and companies to improve the understanding of their views on reporting issues and highlight key topics deserving further debate.

In the winter of 2011/2012, PwC carried out in-depth interviews with 30 investors and analysts from six European countries: United-Kingdom, France, Spain, Germany, Italy and Netherlands. Almost all the interviews were conducted face-to-face, allowing interviewers to explore the rationale for any given reply and to ensure a consistent interpretation of accounting terms used.

The results should not be considered to be statistically valid. Furthermore, a majority of interviewees were English or French (over 50%, see figure 1 below). That is the reason why the regional analyses do not systematically present all the countries involved in the survey. However, the consistency of views expressed provides valuable insight into what investors need in financial reporting.

Figure 1 Respondents by territory



Review of Findings

1

IASB agenda overview

As might be expected, all but one of the investment professionals interviewed agree that a period of stability in accounting standards will be welcomed once all of the current projects (revenue, financial instruments, leases, insurance contracts) are completed and the new standards have come into effect.

It appears clear that investors need more comparability, which constant changes do not allow. A period of calm would help.

However, many of the survey participants say this should not stop ongoing improvements in standards.

"A period of calm will be great. But this should not jeopardize ongoing improvements in reporting."

"Getting the implementation of current standards more consistent is more important than producing new ones."

Changes that should be made to accounting standards

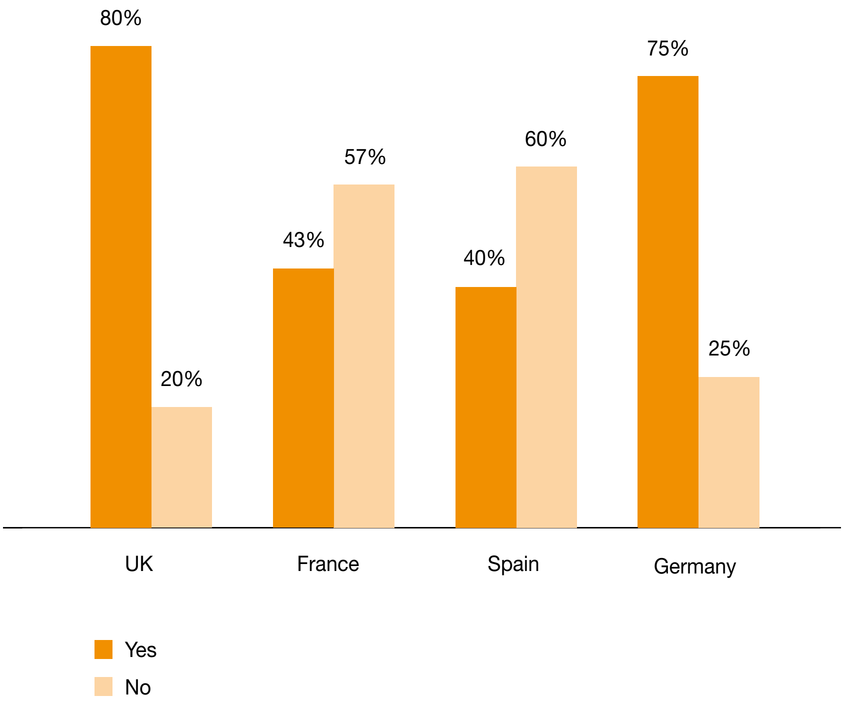
Only 10% of the investment professionals interviewed think there is no need for any changes.

Major Changes

62% of the respondents believe there are a number of significant changes that should be made, in the futur, to accounting standards. As illustrated by figure 2, a regional analysis of responses shows mixed views.

Most of those interviewed indicate that the IASB should improve financial statement presentation and develop a disclosure framework. They are also concerned by specific industry issues, especially in the banking and insurance industries.

Figure 2 **Do you believe that significant changes should be made to accounting standards?**



"New standards are needed to address financial statement presentation and a disclosure framework."

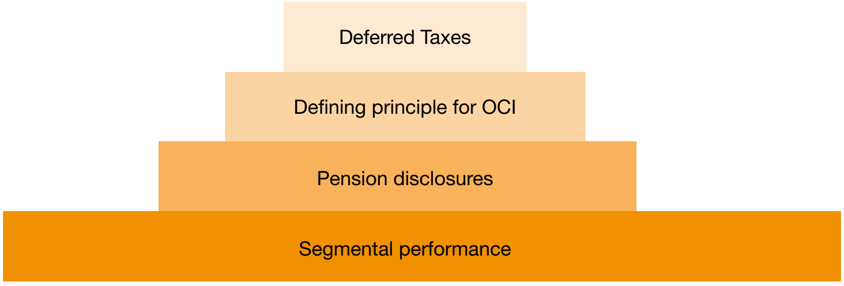
Other Changes

Beyond the major changes, many of those interviewed (65%) express a desire for other changes (see figure 3).

Investors mainly mentioned pension disclosures, which they see as rather opaque, deferred taxes, a defining principle for Other Comprehensive Income (OCI) and more information to assess segmental performance.

Financial services respondents are more concerned by the perceived lack of consistency for banks in netting derivatives and in liquidity disclosures (current liquidity information is largely given in the MD&A and lacks comparability).

Figure 3 Which other changes should be made to accounting standards?



"Deferred tax needs revising as no one understands the current standard."

Integrated reporting

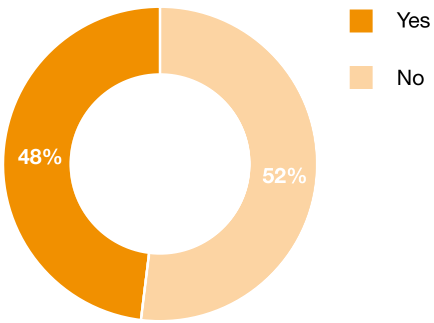
Integrated reporting is a holistic and integrated account of a company's strategy and its financial and non-financial performance.

It is currently promoted by the IIRC (International Integrated Reporting Committee) and the GRI (Global Reporting Initiative). We explored with investors their views on the role the IASB should play in the development of integrated reporting.

There are mixed views with interviewees (see figure 4). Most participants are supportive of the integrated reporting concept even if they don't believe that the IASB should be responsible for it.

In general, most of those who don't believe that integrated reporting should be the responsibility of the IASB, nevertheless think that the IASB should monitor the project.

Figure 4 Do you believe that integrated reporting should be considered by the IASB?



"The IASB should monitor and get involved with IIRC, but not lead the project for Integrated Reporting."

"Amounts connected to sustainable development are growing. One has to take up the issue."

2

Convergence of accounting standards

There is a broad consensus that convergence with US GAAP is not an absolute priority. Convergence is important for the majority of investments professionals (66%), but not over the quality of the standards.

Some of the respondents warned that continuing with convergence runs the risk of too many suboptimal compromises being made.

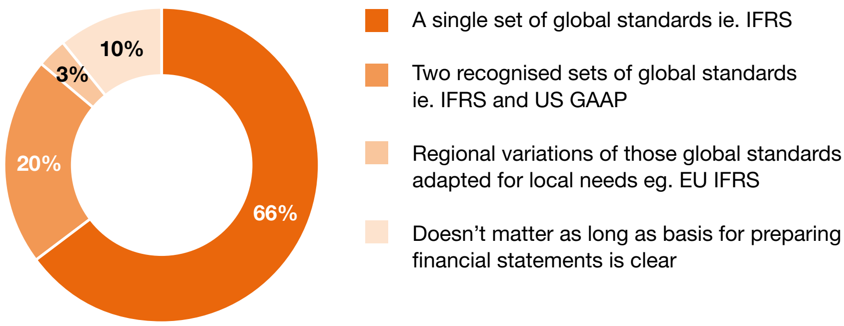
"Convergence is not an overriding priority."

"The main thing is getting the accounting right. Then link to US GAAP."

The majority of investors and analysts professionals surveyed would prefer IFRS as a single set of global standards (see figure 5).

However, most of them would not want this single set at any cost. Most participants say that improvements and quality of IFRS are more important than convergence.

Figure 5 Which of the following standards or set of standards would you prefer?



Financial statements

The purpose of this section is to assess the usefulness of information provided in financial statements for analysts and investors.

"IFRS have introduced a step-back in income statement analyses. The P&L has been ignored."

"A standardised operating profit line would be valuable."

Income statement

When asked if the income statement – as the primary statement designed to reflect a company's financial performance – is adequate to their needs, investment professionnals' opinions are divided.

Regarding **operating profit,** 53% of investors find its definition inadequate (see figure 6). This is no surprise as IFRS does not provide a clear definition of operating profit but rather specifically identifies components that should be outside it (finance costs, income taxes,…).

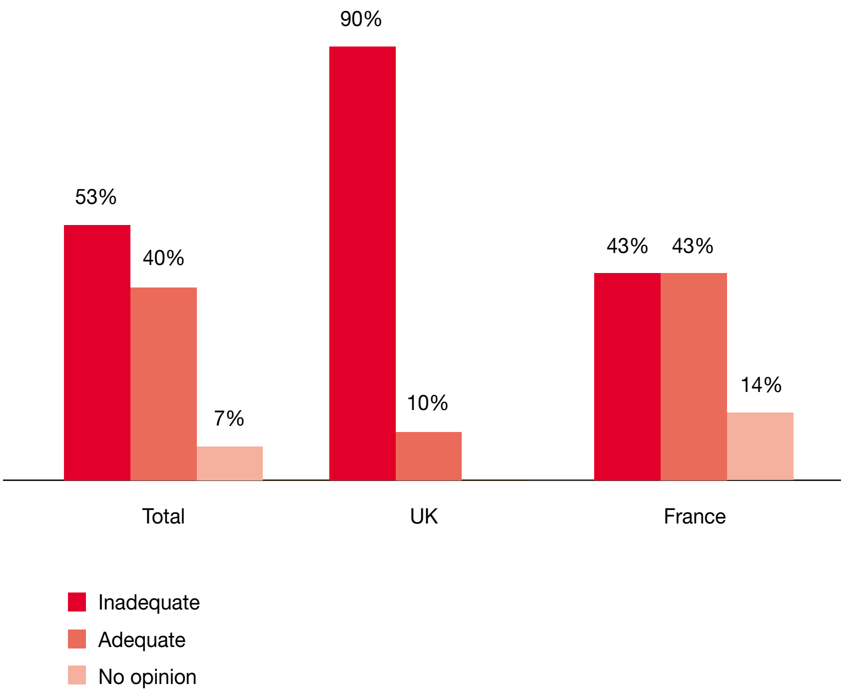
This view is very much stronger in the UK (90% of respondents) than in France (43% of respondents). French investors'views might be explained by the existence of a presentation framework issued by the French standard setter, which reduces diversity in practice.

Overall, all the investment professionals interviewed consider the definition of profit measures should be a priority for the IASB.

Regarding the impacts of **one-time events such as sale of businesses** in the income statement, a small majority of survey participants believe they are adequately separated out in the income statement. This view is stronger in France (71%) than in the UK (30%) and Germany (25%).

This might also be explained by the French standard setter allowing the separation of «current» and «non-current» operating profit components.

Figure 6 Do you judge as adequate or inadequate the definition of operating profit in the income statement?

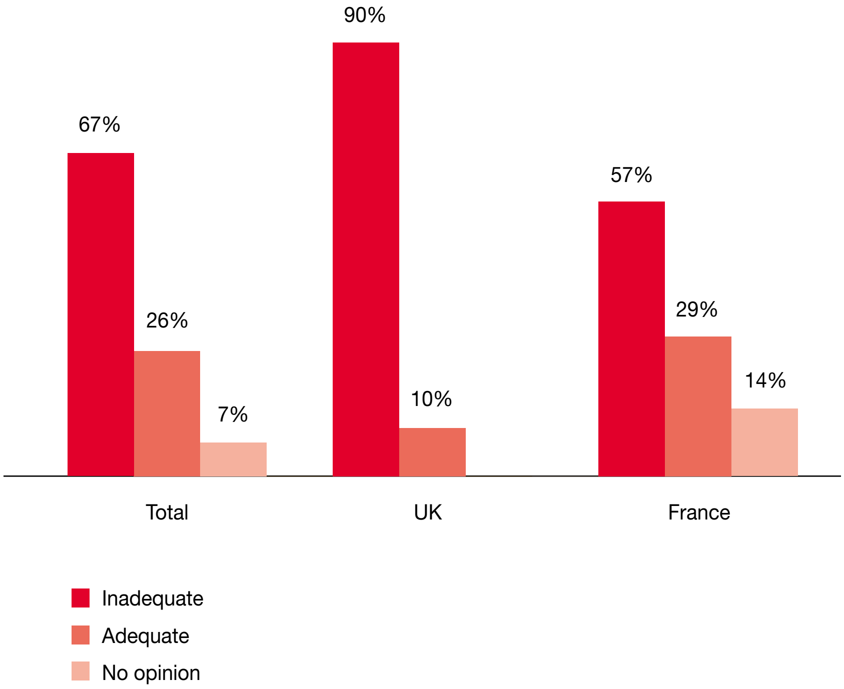


"I don't place much reliance on what is disclosed in the income statement about one-time events but instead make my own judgement based on supplementary information from conversations with management."

Regarding the impacts of **fair value movements** such as changes in value of derivatives, 67% of respondents think they are inadequately presented in the income statement. UK participants are the least satisfied with the current approach as 90% of them believe it is inadequate.

In the other countries, answers are more spread but all of them show a majority of investors saying the separating-out of fair value changes in the income statement is inadequate (see figure 7). This could be addressed by better disclosure.

Figure 7 Do you judge as adequate or inadequate the presentation of fair value movements in the income statement?



Non-GAAP measures

The majority of those interviewed agree that accounting standards generally allow companies to present fairly their **performance**. This view is shared across territories (see figure 9).

However, 93% of respondents also believe that non-GAAP measures are important for understanding companies' performance. Nonetheless, most of those interviewed (57%) have concerns about the way non-GAAP measures are used in management communication of performance (see figure 8).
They note that they are not always reconciled with financial statements.

Figure 8 Are you concerned with the widespread use of non-GAAP measures?

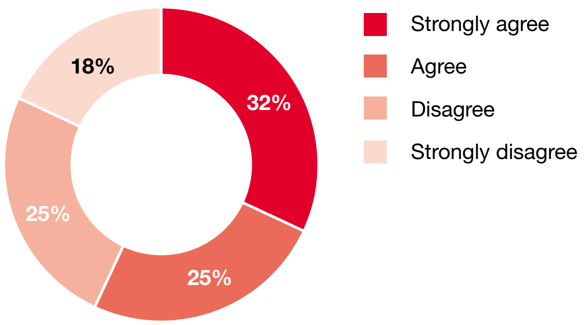
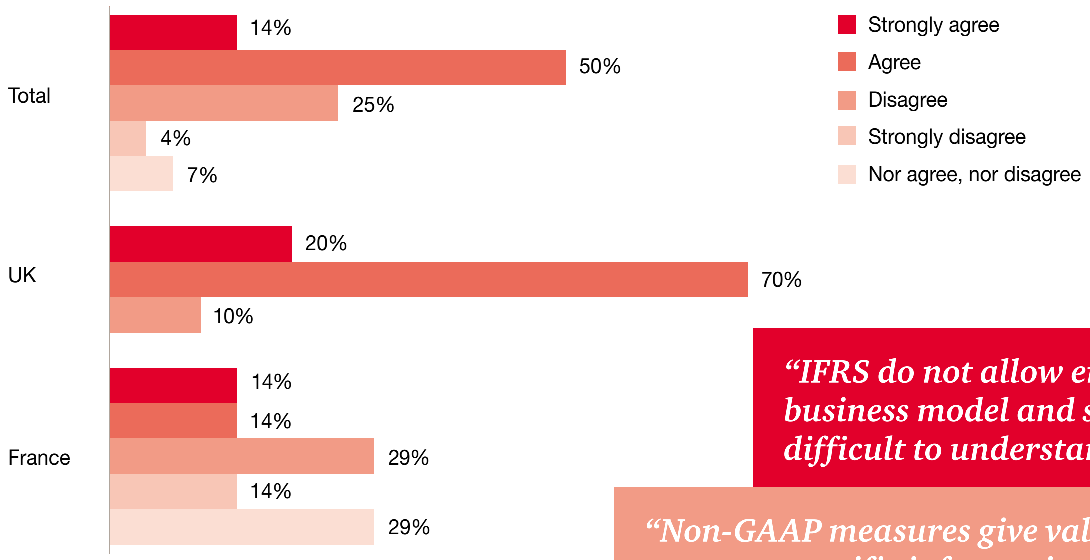


Figure 9 Do you believe that IFRS allow companies to fairly present their performance?



"IFRS do not allow entities to follow their business model and so it's sometime difficult to understand their performance."

"Non-GAAP measures give valuable company specific information."

"Non-GAAP measures are often inconsistent. I use them as an alarm that something needs to be closely looked at."

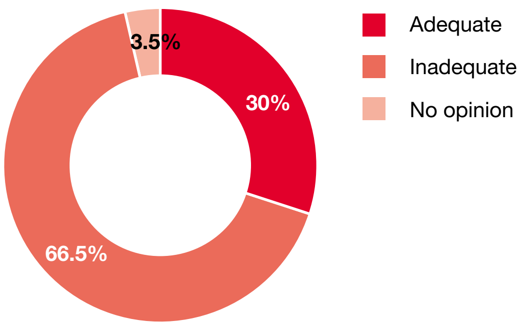
"The problem with non-GAAP is the lack of comparability. Take for example the operating profit: no one has the same definition!"

Segment reporting

Segment reporting still generates a heated debate among investors.

As shown in the figure 10, two participants out of three believe segmental information is inadequate to meet their needs. This is more apparent within the UK respondents (80%) than the French (57%) or German respondents (where views are equally divided 50/50).

Figure 10 How would you qualify segment reporting with respect to your needs?

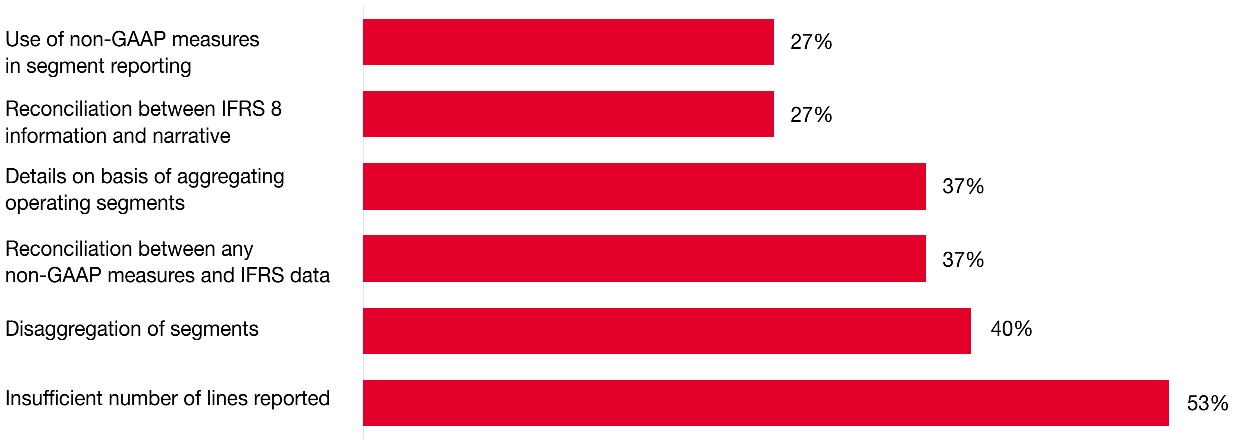


> *"Segment reporting does not allow comparison between companies."*

> *"The results of the post implementation review of IFRS 8 should be closely looked at."*

As segment reporting constitutes important information for analysts, those answering it is inadequate not surprisingly believe it should be a priority for the IASB (with a rank of 3.6 in a scale where 4 is very high priority).

Figure 11 In which areas do segmental disclosures fall short of your needs?



In addition to the areas of improvement listed in figure 12, some analysts have also raised the following issues :

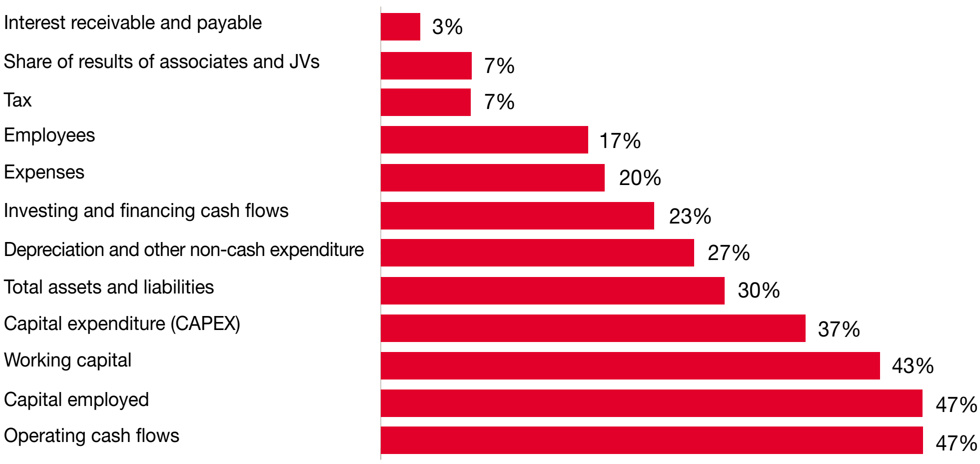
- the lack of divisional (segmental) balance sheets,
- the fact that too much is left in corporate centres, often with the netting of significant gains and losses.

"Reconciliations of non-GAAP figures with accounting figures at the segment level would be very useful."

"It is difficult to understand what is going through the Corporate segment and what the impact on the underlying business might be."

IFRS 8 Segment Reporting currently requires that revenue and a measure of operating profit be disclosed for each segment. As shown in figure 12, analysts who believe the number of required indicators is inadequate have expressed the wish for the following additional line items, in a descending order of importance: operating cash flows, operating capital employed, working capital, capital expenditures, total assets and liabilities, depreciation and other non-cash expenditure.

Figure 12 Which of the suggested additional line items would you like most to be disclosed at a segmental level?



"It would be really useful to have operating cash flows by segment, with a reconciliation to operating profit showing movements in working capital."

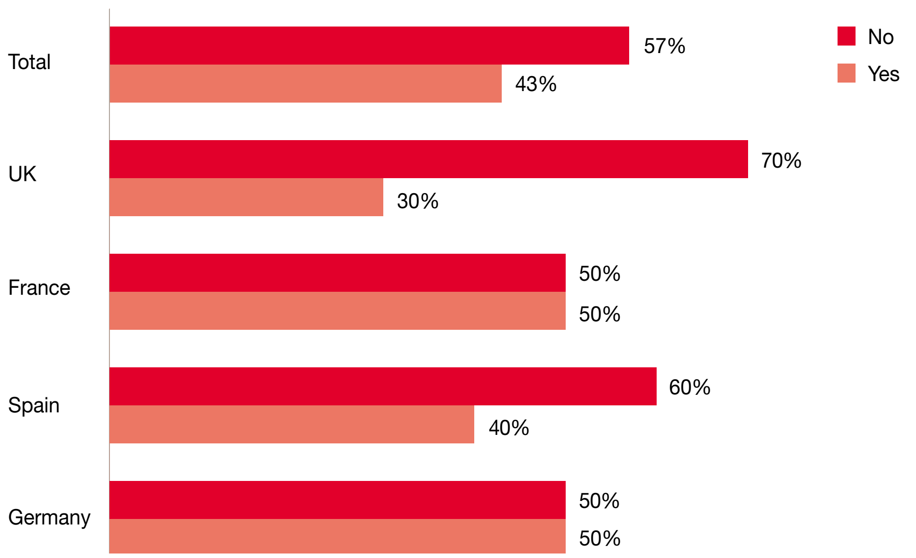
Statement of other comprehensive income

A majority of survey respondents (57%) do not think that the statement of Other Comprehensive Income (OCI) is clear enough (see figure 13).

They don't always understand what goes in or out and what gets recycled.

> *"General principles of what goes in OCI and on what should be recycled, are needed."*

Figure 13 Do you believe that the statement of Other Comprehensive Income is clear enough?



Cash flow statement

Throughout our analysis, we have highlighted that the majority of investments professionals surveyed have concerns about the cash flow statement. They believe there is a real need for a greater level of granularity. The cash flow statement could also be improved by better thought out disclosures.

> *"Investment community generally likes the indirect method in the cash flow statement."*

Disclosure notes

Dissatisfaction with reported information in the notes remains.

70% of respondents consider the ratio relevance-materiality-and-volume of disclosures is not set correctly (see figure 14). They think the IASB should give a high priority to improving the relevance of information. There is a double dilemma:

- too much information is given but some useful information is left out,
- the notes are not relevant enough.

"Too much boilerplate and not enough focus on what analysts and investors really want to know."

"Currently, there is too much non relevant information in the notes. I need more relevance!"

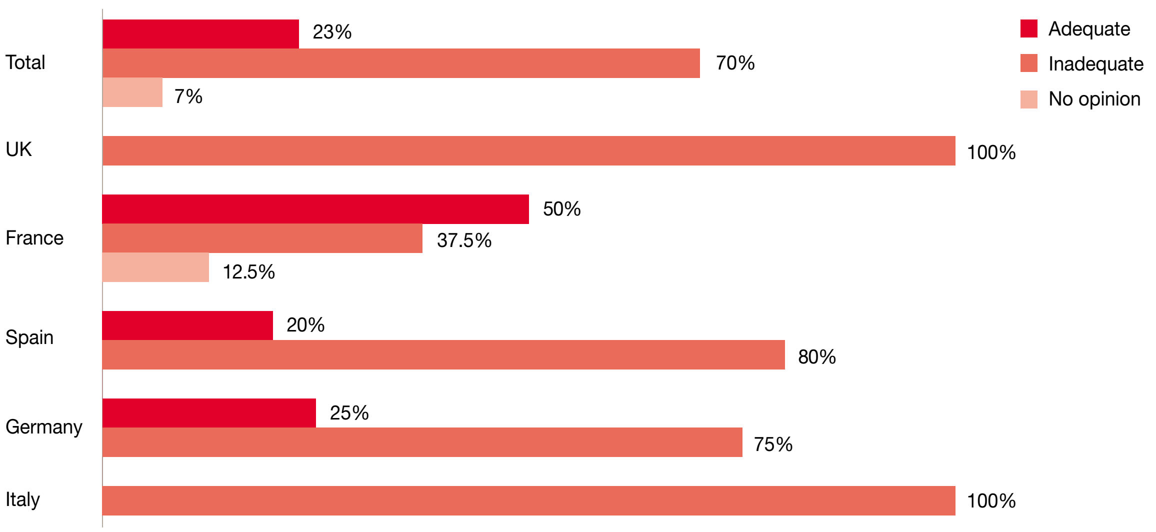
Participants share largely similar views on the description of accounting policies in the notes: boilerplate and irrelevant.

"I find accounting policy sections really depressing."

Overall, most investors consider that the IASB should focus on the relevance and materiality of disclosures.

"Quality of notes varies. My main concern is around notes like financial instruments and deferred tax."

Figure 14 Is the ratio Relevance/Materiality/Volume of disclosures adequate or inadequate?

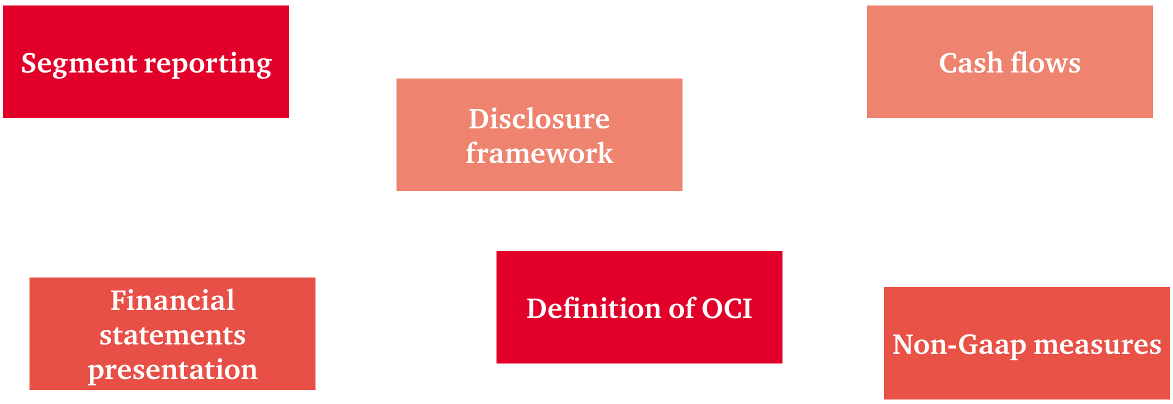


Top priorities the IASB should focus on

Asked to name the top three priorities the IASB should focus on, the investment professionals have mixed views.

However, the most popular item is segment reporting, followed by non-GAAP measures and a disclosure framework (see figure 15).

Figure 15 In your opinion, what should be the IASB's top priorities?



Timing of financial information

The majority of participants have no concern with the timely release of financial information. However, they wish that the time gap between the preliminary announcements and the annual report's publication would be reduced.

> ***"No issues with timing of preliminary announcements but it would be useful to reduce the time gap with the publication of the annual report."***

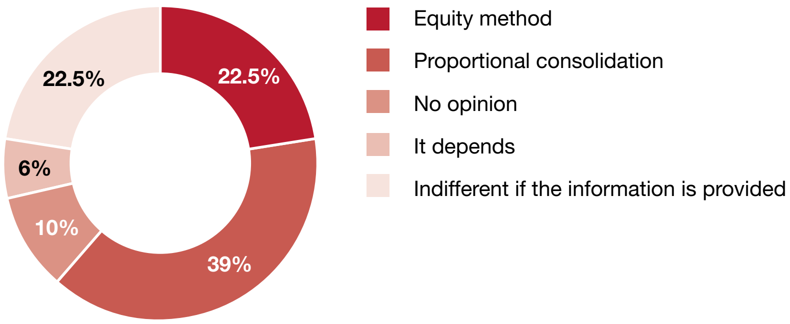
4

Joint ventures

The IASB has recently removed the option to use proportional consolidation in the accounting for joint ventures (IFRS 11 published in May 2011 with effect from 2013). Thus, we asked investment professionals which method of accounting for joint ventures they prefer.

As figure 16 demonstrates, close to 40% of participants prefer the proportional consolidation method and only 22.5% choose the equity method.

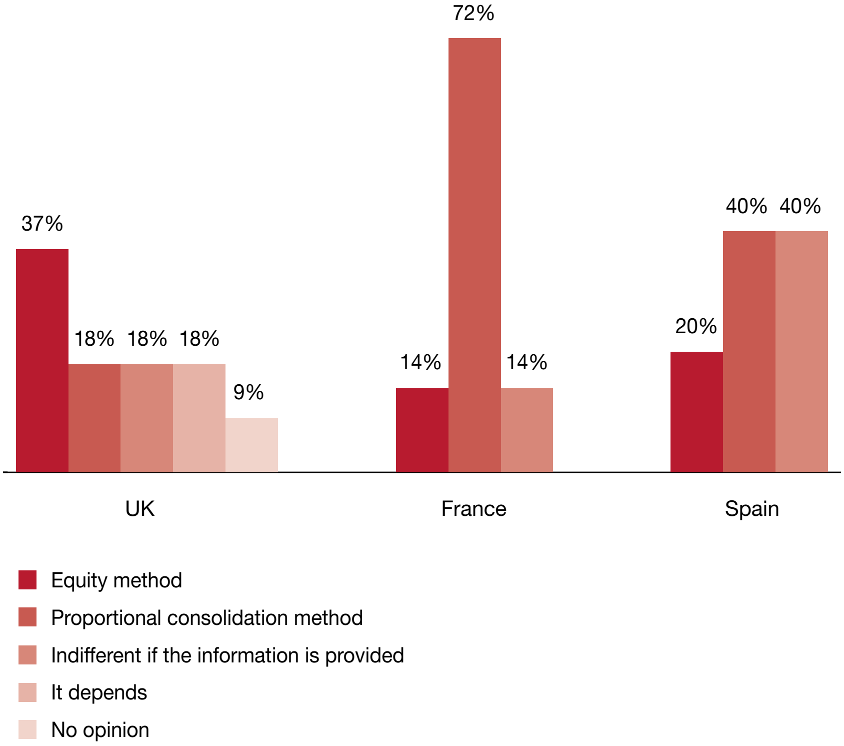
Figure 16 Which method of accounting for joint ventures do you prefer?



> ***"Proportional consolidation method gives more direct information: no need to restate."***

However, we noted strong regional differences among respondents. The vast majority (over 72%) of those interviewed in France have a stronger preference for the proportional consolidation method. This result could be expected as the proportional consolidation method is the one used under French GAAP. In the UK, only 18% prefer this option. Most of the UK respondents (36%) selected the equity method. Regardless of territory, nearly 23% of investors are indifferent if the information they need is provided in the notes (see figure 17).

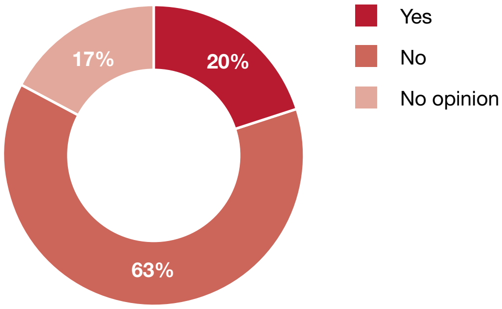
Figure 17 Which method of accounting for joint ventures preferred in UK, France and Spain?



Asked if requiring the equity method for all joint ventures would impact their analysis, 63% of investment community don't think so (see figure 18).

However, half of those interviewed in France are worried they will not have the proper information and thus think their analysis will be impacted.

Figure 18 Will requiring equity accounting for all joint ventures adversely impact your analysis for companies?



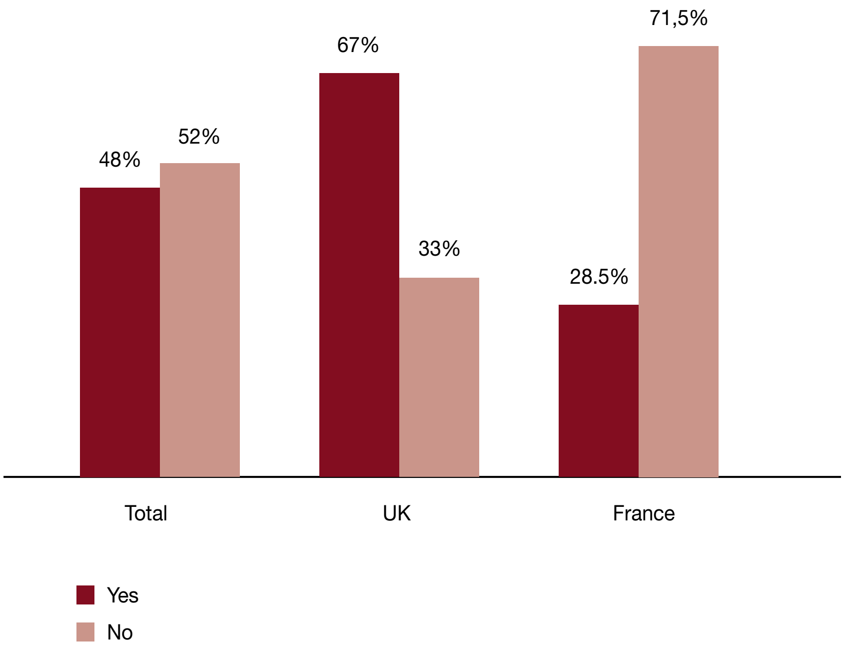
5

Fair value

We asked whether investment professionals have changed their mind on the usefulness of fair value measurement since the financial crisis began. There are mixed views in general and some regional differences (see figure 19).

During interviews, respondents told us that the fair value measurement was set up during market growth. No one had anticipated a financial crisis, which would shift the way that the world views the capital markets system. Where UK respondents' views have changed, this has been as a result of specific issues with certain types of fair value information, in particular business combination adjustments, own credit risk or level 3 valuations. French investors did not change their opinion as they have always disliked the use of fair value except for trading instruments.

Figure 19 Have your views on the usefulness of fair value measurement in financial statements changed during the current financial crisis?



"There is too weak an understanding of fair value in an inactive market."

Non financial assets and liabilities

A majority of respondents (60%) think that the use of fair value as a measurement basis in the balance sheet is inappropriate for non financial assets and liabilities, especially for acquisitions, brands and real estate.

Overall, they are concerned that fair value adds volatility in the financial statements. However, only 40% of UK investors consider it is inadequate.

"Fair value should not be applied to operating assets and liabilities."

"The case for extending fair value's use to other items is not proven."

Financial assets and liabilities

Most participating investors and analysts agree with a mixed measurement model, using the amortised cost model when the company intends to hold the instruments for the purpose of collecting cash flows and the fair value model for short term instruments.

"Fair value should be used only for derivatives and trading instruments."

This opinion confirms the trends noted in our last survey "What investment professionals say about financial instrument reporting", conducted in the first quarter of 2010 all over the world.*
The main findings were:

- *A majority of respondents favour a mixed measurement model, with fair value reporting for shorter lived instruments and amortised cost reporting for longer lived instruments;*
- *Respondents that favour the mixed measurement model think the information better reflects an entity's underlying business and economic reasons for holding an instrument;*
- *Fair value information for financial instruments is considered relevant and valuable by most respondents but is not necessarily the key consideration in their analysis of an entity;*
- *Respondents voice a consistent desire for improved disclosure of fair value information.*

(*) the survey is available on:
http://www.pwc.com/gx/en/corporate-reporting/investor-views/what-investment-professionals-say-about-financial-instrument-reporting.jhtml

Overall, a majority of those interviewed stress the importance of improving the disclosure of fair value, especially for level 3 valuations and illiquid financial assets.

Half of the respondents disagree that the own credit risk should be taken into account when measuring an entity's debt at fair value (see figure 20).

Most of those who agree think that the fair value movements due to own credit risk should be recorded in Other Comprehensive Income.

Figure 20 Do you agree that own credit risk should be taken into account when measuring entity's debt at fair value?