

AMF recommendation 2010-12 Financial statements 2010

Reference texts: Article 223-1 of the AMF General Regulation

Turbulence on the financial markets and economic uncertainty give particular weight to the financial information published by listed companies. Performance indicators, whether linked to a company's income or financial position (cash flows, and net debt *inter alia*) are closely examined by users.

In view of this, the AMF staff has carried out a transversal review of the performance indicators used in income statements by a sample of seventy industrial and commercial companies listed in Paris and a study on the information provided in the notes to their financial statements by the sixty largest issuers listed on the Paris stock exchange on earnings per share.

These studies have been supplemented by conclusions drawn as a result of inspection of the 2009 accounts as to the provision of information regarding operating segments and cash position.

The AMF's recommendations for the 2010 year-end therefore focus mainly on the presentation of both performance and financial statements.

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1. Presentation of performance and financial statements

Given the importance attached to the presentation of performance, particularly in a difficult economic context, the AMF staff has carried out a transversal review of the financial indicators used in income statements by a sample of seventy industrial and commercial companies listed in Paris¹ and a study on the information provided in the notes to their financial statements by the sixty largest issuers listed on the Paris stock exchange on earnings per share.

These two studies have brought to light the following areas for improvement:

1.1. IAS 1 - Presentation of income statements

In its recommendations regarding the financial statements for 2009, the AMF drew attention to the presentation of an intermediate line within the statement of profit or loss showing “net operating income”. Such an indicator aims at providing a clearer picture of income and expenses generated by operating activities in accordance with IAS 1 – Presentation of Financial Statements paragraph 85². In particular the AMF reminded issuers that all the operating income and expenses (including goodwill impairment losses) are to be included within the income statement, referring to paragraph 56 of the Basis for Conclusions to IAS 1³, as the net operating income is not defined in the standard.

Observation of practices tends to show that improvements in terms of justification of items excluded from the profit on ordinary activities (“résultat opérationnel courant” or ROC) are desirable, as well as for other performance indicators that are sometimes added to the income statement.

1.1.1. Profit on ordinary activities

The French National Accounting Council (CNC) recommendation 2009-R.03 proposes the use of an subtotal for profit on ordinary activities because the predictive value of this indicator is useful to readers of the financial statements. The CNC underlines that this subtotal must help facilitate understanding of the company's performance and that:

- the items that are excluded from the profit on ordinary activities must be unusual, abnormal and infrequent, as cited in paragraph 28 of the Framework (“*For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed*”);
- other operating income and expenses line items shall only be entered where a major event in the period may distort investors' understanding of the company's performance. As such, events of this kind are very limited in number and of material amounts;
- in accordance with IAS 1.97⁴ these items shall be disclosed in detail (amounts and nature) in the notes and shall be presented separately in the statement of income when they are material (IAS 1.85).

¹ 33 CAC 40 index companies, 8 Next 20 companies, 16 Mid 100 companies and 13 Small 90 companies.

² IAS 1.85: “*An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance.*”

³ IAS 1.BC 56: “*The Board recognises that an entity may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating'. In the Board's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.*”

⁴ IAS 1.97: “*When items of income or expense are material, an entity shall disclose their nature and amount separately.*”



The CNC recommendation goes on to give examples of items to which this may apply (capital gains or losses realised on disposal of assets, impairment, restructuring expenses, provisions relating to litigation).

In the framework of our study we noted that some issuers do not or no longer refer to the CNC recommendation. Nevertheless, a profit on ordinary activities is often presented.

The study also showed that almost a fifth of issuers classified amortisation (intangible amortisable assets arising from customer relations for example) arising from the impact of business combinations below profit on ordinary activities. In our view, these items are contributing to the predictability of future earnings, therefore we do not consider their classification below a subtotal such as “profit on ordinary activities” to be in accordance with paragraphs QC6 to QC 10⁵ of the conceptual framework.

The AMF therefore draws the attention of issuers to the criteria which should be used when defining performance indicators⁶ and underlines the fact that since these items shall respect the offsetting criteria in IAS 1.32⁷, they shall be presented on separate lines of the income statement.

Recommendation

When the concept used corresponds to that presented in the CNC recommendation, the AMF invites issuers to refer to the CNC recommendation in the notes to the financial statements and to ensure that the criteria stated by the CNC are respected.

When an issuer chooses to present a subtotal above the line “operating profit” but without referring to the CNC recommendation, the AMF recommends that the subtotal be defined.

We also deem it advisable that, in accordance with the recommendations from the AMF and CESR⁸ dated September and October 2005, they explain why this indicator has been used.

In addition, the AMF encourages companies to be consistent over time in the definition and the use of indicators presented.

The impact of accounting changes must also be explained. This is notably the case when it comes to acquisition costs, which, in accordance with the revised IFRS 3, are no longer accounted for within goodwill but as expenses.

Lastly, the AMF considers that the new relevance criteria with respect to information presented as set by the September 2010 conceptual framework, must, as well as the IAS 1 provisions recalled in the CNC recommendation, serve as the basis for defining the lines and subtotals presented within the income statement. Thus, in accordance with paragraph QC7 of the conceptual framework, all items with a predictive value should contribute to a subtotal such as “profit on ordinary activities”. Conversely, unusual, infrequent items could be excluded from such a subtotal if they are material.

⁵ Conceptual framework QC6: “Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.”

Conceptual framework QC7: “Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.”

Conceptual framework QC8: “Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.”

Conceptual framework QC9: “Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations.”

Conceptual framework QC10: “The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.”

⁶ Conceptual framework QC 7: “Financial information is capable of making a difference in decisions if it has a predictive value, confirmatory value or both”

⁷ IAS 1.32 “An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS”

⁸ CESR Recommendation on alternative performance measures

1.1.2. Other subtotals before profit on ordinary activities

In its study, the AMF noted that several issuers also used other subtotals above and before the profit on ordinary activities line (in particular subtotals such as gross margin – or “Excédent Brut d'Exploitation” EBE - and profit on ordinary activities before amortisation expense). IAS 1.85 states: “*An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance.*” In application of paragraph 85, we consider it important for the issuers concerned to ensure the relevance and usefulness of these intermediate indicators.

Recommendation

We also consider it useful to define the contents of subtotals presented on the face of the income statement and explain their importance in terms of evaluation of performance. Such an explanation could include how such components are used internally by the principal operating decision-maker and be reinforced by the fact that these indicators are presented as segment information.

2. IAS 33 – Earnings per Share

IAS 33 – *Earnings per Share* states that an entity must present in the income statement the basic earnings per share⁹ (corresponding to the net income attributable to ordinary equity holders of the parent entity) and the diluted earnings per share (calculated by adjusting the income attributable to ordinary equity holders¹⁰ of the parent entity as well as the weighted average number of shares outstanding¹¹, for the effects of all dilutive potential ordinary shares).

The study carried out on a sample of seventy listed companies shows that, although not a great deal of information is requested in the notes, there is room for improvement in terms of the disclosure of this information.

2.1. Disclosure

IAS 33.70 requests disclosure of the following:

- the amounts used as the numerators (in calculating the earnings per share and diluted earnings per share) and a reconciliation of those amounts to net profit or loss for the earnings per share and the diluted earnings per share (IAS 33.70 (a)): this information was disclosed by almost all issuers we looked at;
- the weighted average number of ordinary shares used as the denominator and a reconciliation of these denominators (before dilution and after dilution) including the effect of each class of instruments that affects earnings per share and the diluted earnings per share (IAS 33.70 (b)): almost a quarter of the issuers we looked at do not disclose a reconciliation of the effects of all these dilutive instruments (bonus shares, stock-options, convertible bonds and so on). The standard states clearly that the effect of each class of instrument must be disclosed;
- information on instruments that are antidilutive for the period presented but that could potentially dilute basic earnings per share in the future¹² (IAS 33.70 (c)): this information is only disclosed by a third of the issuers in our sample.

⁹ IAS 33.10: “*Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.*”

¹⁰ IAS 33.33: the earnings is adjusted by “*any dividends or other items related to dilutive potential ordinary shares*”, “*any interest recognised in the period related to dilutive potential ordinary shares*” and “*any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.*”

¹¹ IAS 33.36: the number of ordinary shares “*plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.*”

¹² For example, an equity option whose exercise price is 100 although the quoted price is 50 at closing.

Recommendation

The AMF considers that this information is important for the evaluation of performance and strongly encourages issuers to disclose it: by disclosing the number of shares potentially concerned and linking this to information on share-based payment plans. The issuers concerned could usefully build on good practice such as:

- “In 2009, owing to the annual average price of the share of X Euros, the share subscription plan 200Y is antidilutive for tranches A, B and C. The same goes for the amended stock option plan (tranches A, B and C of the plan)”. The exercise price for each tranche being disclosed in the note describing the share subscription plans;

- “Given the decrease in the average price during fiscal year 2009, the antidilutive instruments are all stock option plans outlined in note Y as well as convertible bonds outlined in Note Z”.

- a description of ordinary share transactions that occurred after the reporting period and that would have changed significantly the number of ordinary shares in the calculation of the earnings per share and diluted earnings per share (IAS 33.70 (d)): in the sample of the issuers we looked at, only one company seems to have found itself in this position.

Recommendation

When this situation does come about, we consider this to be important information for investors.

2.2. Adjusted earnings per share

Moreover, in the course of this study, the AMF noted that in addition to net earnings per share and diluted net earnings per share, some issuers disclose adjusted earnings per share (calculated from adjusted net earnings) on the face of the income statement.

On this subject, IAS 33.73¹³ and 73A¹⁴ state that if the company discloses in addition to basic and diluted earnings per share, earnings per share determined by an adjustment other than that imposed by IAS 33, “the basic and diluted amounts per share relating to such a component shall be [...] presented in the notes”.

Recommendation

Disclosure of adjusted income¹⁵ or adjusted earnings per share on the face of the income statement is therefore not in accordance with the Standard. Moreover, the number of shares used as the numerator must be the same as used for the determination of basic and diluted earnings.

¹³ IAS 33.73: “If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of comprehensive income other than the one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard. Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. If a component of the statement of comprehensive income is used that is not reported as a line item in the statement of comprehensive income, a reconciliation shall be provided between the component used and a line item that is reported in the statement of comprehensive income.”

¹⁴ IAS 33.73A: “Paragraph 73 applies also to an entity that discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the separate income statement (as described in paragraph 81 of IAS 1 (as revised in 2007)), other than one required by this Standard.”

¹⁵ For example items that are judged to be non-monetary by the issuer (goodwill impairment, intangible amortisation expense linked to business combinations, taxes and so on)

In addition, the AMF recalls that the Standard requires (Para. 66¹⁶) disclosure in the income statement the basic and diluted earnings per share and, when applicable, the basic and diluted earnings per share for profit or loss from continuing operations. IAS 33.68¹⁷ states, that in the case of discontinued operations, the basic and diluted amounts per share for the discontinued operation shall be disclosed either in the statement of comprehensive income or in the notes.

3. IFRS 8 – Segment information

IFRS 8 – *Operating segments* requires separate reporting of information about each operating segment or group of operating segments that exceed certain thresholds. Paragraph 5 defines an operating segment as “a component of an entity:

- (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
- (b) whose operating results are regularly reviewed by the entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- (c) for which discrete financial information is available.”

As application of this Standard is mandatory in annual financial statements for periods beginning on or after 1 January 2009, the AMF staff carried out a transversal study of the application of this Standard by the sixty largest issuers listed in Paris. This study gave particular focus to the treatment of operating segments.

This analysis revealed certain areas for improvement as regards disclosures about operating segments.

3.1. Aggregation of operating segments into reportable segments

Paragraph 12¹⁸ states that several operating segments may be aggregated into a single operating segment to be presented in the notes if their economic characteristics are similar in terms of the nature of the products and services, the nature of the production processes, the type or class of customer, the methods used to distribute their products and, if applicable, the nature of the regulatory environment.

On reading the information in the notes, it is often impossible to know if an issuer has aggregated operating segments or not, this in spite of the fact that IFRS 8.22 (a)¹⁹ requires the disclosure of factors used to identify the entity’s reportable segments. In the sample studied, we noted that some groups only present one or two operating segments, which, in view of the size of the groups studied, implies that aggregation has necessarily been carried out.

¹⁶ IAS 33. 66: “An entity shall present in the statement of comprehensive income basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period. An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.”

¹⁷ IAS 33.68: “An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of comprehensive income or in the notes”

¹⁸ IFRS 8.12: “Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects: (a) the nature of the products and services; (b) the nature of the production processes; (c) the type or class of customer for their products and services; (d) the methods used to distribute their products or provide their services; and (e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.”

¹⁹ IFRS 8.22 a: “An entity shall disclose the following general information: (a) factors used to identify the entity’s reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated)”

Recommendation

The AMF therefore encourages issuers who have carried out aggregation of significant segments to detail in the notes the operating segments involved. We remind issuers that during controls performed by the auditors or the market regulators, documentation and justification of these aggregations may be required from them.

3.2. Entity-wide disclosures

Paragraphs 31 to 34 of IFRS 8 require that, whatever the operating segments retained, information relating to products and services, geographical areas and major customers be disclosed.

The AMF found that the information on revenues by products and services (IFRS 8.32²⁰) and that on geographical areas (IFRS 8.33 (a)²¹) is presented by almost all issuers in the sample group.

However, when it comes to the information required by IFRS 8.34²² on the degree of dependence on major customers, very few issuers disclose this information or state that no customer exceeds the threshold of 10 percent or more of the entity's revenues (information given in a little less than a quarter of the cases analysed).

Recommendation

Given the current economic situation and increased market anxiety with respect to counterparty risk, the information required by Paragraph 34 sheds some important light not only on risks at year-end but also those that may impact on future operations (in particular if past operations show too great a dependence on a reduced number of clients). It is therefore particularly important that this information be disclosed.

3.3. Allocation of items to operating segments

We observed some cases in which issuers had not allocated certain items to operating segments that seem, at first sight, eligible to an allocation to operating segments (goodwill impairment losses, restructuring expenses).

When an entity allocates assets and liabilities acquired in a business combination to its various operating segments, it is to be expected that the goodwill also be allocated to various different segments. In that capacity, it is advisable to recall that Paragraph 129²³ of IAS 36 provides for an indication of impairment losses and reversals of impairment losses recognised in the reporting period for each reportable segment. The standards setter would seem to look for consistency between items allocated to Cash Generating Units forming the operating segments and information disclosed for reportable segments. Nevertheless, such consistency is not expressly required.

²⁰ IFRS 8. 32: "An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed. The amounts of revenues reported shall be based on the financial information used to produce the entity's financial statements."

²¹ IFRS 8.33 (a): "revenues from external customers (i) attributed to the entity's country of domicile and (ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. An entity shall disclose the basis for attributing revenues from external customers to individual countries."

²² IFRS 8.34: "If revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues."

²³ IAS 36,129: "An entity that reports segment information in accordance with IFRS 8 shall disclose the following for each reportable segment: (a) the amount of impairment losses recognised in profit or loss and in other comprehensive income during the period. (b) the amount of reversals of impairment losses recognised in profit or loss and in other comprehensive income during the period."

**Recommendation**

The AMF considers that consistency between allocation to Cash Generating Units and that to reportable operating segments often helps better understand the financial statements.

Nevertheless, various cases can be observed:

- the position may be temporary (for example when an acquisition is made at the end of the reporting period and allocation has not yet been completed at closing). In this case, it is useful, when amounts at stake are material, for the entity to mention the temporary nature of the allocation;
- when the allocation corresponds to a reporting choice made in the reporting to the CODM, we consider that is useful to detail in the notes those items subject to a different allocation with respect to Cash Generating Units and to reportable segments.

4. Accounting methods and concepts**4.1 IAS 1 - The concept of materiality**

As it did in 2007 and 2008, the AMF reminds issuers that, in accordance with the concept of materiality referred to in IAS1.29-31, specific disclosure provisions need not apply to information that is not material.

Recommendation

In view of regular complaints about the excessive length of financial statement notes, the AMF urges issuers, once again this year, to focus on the relevance of disclosures rather than their volume.

The AMF has identified several practices illustrating that this principle is not always applied:

- the notes describe accounting treatments for three types of hedging transactions (net investment hedge, cash flow hedge and fair value hedge) in spite of the fact that the issuer has not put into place any net investment hedge;
- one issuer devotes twice as much space to the description of impairments of accounts receivable carried out on a collective basis than those on an individual basis. Yet according to the information supplied by this issuer, the collective impairments are recurrently not material (they represent a lower amount and are not material in terms of the groups operating income);
- one issuer describes methods for accounting and impairing intangible assets with an indefinite live but has no such intangible assets in its statement of financial position.

4.2 IAS 1 – Reference to the accounting framework used

Following publication by IOSCO of a recommendation on the transparency of accounting frameworks used (published in February 2008 and entitled "*Statement on Providing Investors with Appropriate and Complete Information on Accounting Frameworks Used to Prepare Financial Statements*"), the AMF published a news release in February 2008 entitled "The AMF invites issuers to follow the International Organization of Securities Commissions recommendation on the transparency of accounting frameworks used". In this news release, the AMF recalled that with the convergence of accounting standards round the world, investors may assume that financial statements of companies are comparable, while in fact they are prepared in accordance with relatively different accounting frameworks. This may be the case when national or regional frameworks are founded on International Financial Reporting Standards (IFRS) issued by the IASB without necessarily corresponding exactly to them.

On the basis of the IOSCO recommendations, the AMF requested in particular that the following items appear in the notes:

- A clear and unambiguous statement of the reporting framework on which the accounting policies are based, which for European companies constitutes the IFRS as adopted by the European Union;
- A clear statement that the financial statements have been drawn up in accordance with the IASB's IFRS, if this is the case (this means for example that the issuer will not have used the IAS 39 carve-out);
- An explanation of the differences between the framework used and the IASB's IFRS, if this is the case (if the issuer has used the carve-out for example or if they are affected by standards or interpretations applicable according to the IASB but not yet adopted by the European Union) and an explicit indication of this and a description of the differences between the concepts used and the IFRS.

Following a review of the notes on the accounting methods used by the sixty largest companies listed in Paris, it appears that a significant proportion of this sample (20 companies out of 60) only refer to the IFRS as adopted by the European Union and do not refer to the IFRS as adopted by the IASB.

Recommendation

Whilst recognising the importance of focusing the information presented on items essential for the user, we consider that it is advisable:

- **either to indicate clearly that the framework used is in accordance with the IFRS published by the IASB;**
- **or to explain succinctly the differences between the framework used and the standards adopted by the IASB the application of which is mandatory²⁴ to the reporting period.**

²⁴ As opposed to the standards the anticipated application of which is possible.