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EFFAS Position Paper on ESEF

August 06, 2018

The attached document on ESEF was prepared by EFFAS board for discussion with the European Commission and ESMA at a meeting held in Brussels in June 2018. EFFAS through its standing Commission on Financial Reporting (FRC) would like to take this opportunity to remark the following:

1). - The introduction of an electronic format for financial reporting is helpful for users. EFFAS- FRC however does not share the European Directive statement that the introduction will be ‘very beneficial, since it would make reporting easier and facilitate accessibility, analysis and comparability of annual financial reporting’. Accessibility is expected to be improved and the rest of the benefits will remain to be seen. Electronic reporting does not necessarily implies an easier analysis and better comparability.

2). - EFFAS believes that digitalization of accounting metrics will not implicitly lead to a “better communication”. In fact, the primary financial statements might continue to convey differences between IFRS reporting issuers due to the insufficient definition of key performance concepts such as operating profit or net debt. These differences broaden when comparing with issuers reporting under US GAAP or Japanese GAAP.

3). - EFFAS believes that ESEF availability could produce better tools for scoring. However scoring/data analysis is a starting point for users. ESMA should guarantee that the chosen ESEF format, iXBRL will improve scoring quality to facilitate capital markets to channel and allocate more efficiently financial resources to companies in Europe. In this regard, EFFAS is eager to work with stakeholders -rating agencies, academics, issuers and regulators- to assure that iXBRL provides adequate and reliable financial information as required by analysts and investors.

4).- The ESEF project, the work on taxonomy and the extension of reporting outside the primary financial statements should incorporate a qualified representation of users which was not the case in the first phase of the project. EFFAS is willing to participate in this project which in our view relates to the implementation of the “better communication” project currently under discussion by IASB and supported by ESMA.

In concluding, EFFAS would like to stress that ESMA should firstly work on providing quality data guidelines on financial information reporting on items such as APMs and IFRS relevant disclosures. The risk of jeopardizing the quality of data provided to users should be basically eliminated. Thereafter, ESMA should work and focus on ESEF.

EFFAS will be honoured to collaborate and work with ESMA and issuers to improve the quality of financial information provided through iXBRL.

If you would like to further discuss the views expressed in this letter, please do not hesitate to contact us.

Javier de Frutos, Chairman & Jacques de Greling, Vice-Chair
On behalf of EFFAS
Commission on Financial Reporting

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 22-member organizations representing more than 16,000 investment professionals. The Commission on Financial Accounting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint. FAC members are Javier de Frutos (Chairman, IEAF-Spain), Jacques de Greling (Vice-Chairman- SFAF, France), Rolf Rundfelt (SFF, Sweden), Friedrich Spandl (ÖVFA, Austria), Henning Strom (NFF, Norway), Serge Pattyn (BVFA/ABAF, Belgium) and Luca D' Onofrio (AIAF, Italy).

European Securities and Markets Authority

PANEL ON ESEF

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EXECUTIVE SUMMARY:

CAN ESEF HELP TO TRANSFORM SCORING FROM AN ART INTO A SCIENCE?

DISCLAIMER: THIS PRESENTATION IS OUR PERSONAL OPINION

(1) **Financial analysis is not scoring:** limited scope for input cost reduction because the focus is on projections (ie making growth profitable)

(2) **ESEF & XBRL could become useful tools:** huge interest for using “big data” to improve benchmarking & scoring

(3) **But value of BIG DATA is driven by TAXONOMY:** AI and other cobot cannot make non standard adjustments

(4) **ESMA must enlarge “back testing’” to the use of big data:** back testing will open the “black box” and improve feed back from users

(5) **Stronger input from users through a “financial lab”?** Europe must build more efficient methodologies to industrialize the scoring process

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1. BIG DATA & COST REDUCTION?

Scoring is not the stronger focus for investment professionals (ie portfolio managers and analyst)

- **Added value focus more on reliability in projections based on they own financial models**
  - Estimated time spend to crunch data: between 5% and 10% of the typical work load
  - Work load more intense at inception of the coverage: due diligence on metrics is a first building block toward proprietary model
- **Big data usage based on historical metrics is key for passive asset management, quants and investment bankers**
  - Analyst employed for such purpose spend more than 2/3 of their time in number crunching
  - M&A modelling to brainstorm on "what if" scenarii)

XBRL and ESEF is a progress to outsource "maintenance work" for comparison purposes (BENCHMARKING)

- Some company (usually large one) already provides their accounts (primary statement and segments) in excel format which are easier to plug into financial model
- Competition between the major data providers should include their capacity to apply standard restatement in order to filter the information (avoid short term "noise")

FINANCIAL ANALYSIS WILL REMAIN MORE AN ART (IE RATING IS NOT SCORING)

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2. ESEF IS A TOOL BUT ITS VALUE IS LINKED TO THE QUALITY OF THE DATA

- TODAY: existing providers are not using consistent methodologies: reliability of benchmarking based on non adjusted metrics is uncertain
- TOMORROW? a global data base could provide a cheap, relevant and reliable source of data for working on investment themes and give ability to asset managers to define instantly key factor exposure: this is a attractive tool to select return drivers or to update risk sensitivity

ESMA, the FRC and the SEC should WORK TOGETHER to improve the ability to share big data

- The initial focus by ESMA on Primary Financial Statement for listed issuers based on IFRS taxonomy is a first step
- Digitalization does not require building a global platform but the need is to normalize TAXONOMY because big data based on non adjusted metrics will be detrimental for the value of European issuers and their access to the global markets

BIG DATA will improve stability in financial markets only when benchmarking between US and European listed companies will become more efficient & reliable

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3. VALUE OF BIG DATA IS DRIVEN BY TAXONOMY

TODAY: usage of XBRL or iXBRL is mostly done in Europe for compulsory reporting

1. Computation of taxes or social charges (company individual account reporting as in UK or as the SBR system in the NL)

2. Prudential use in the European banking system (reporting to ECB Finrep and Corep)

<u>In both cases, taxonomy is clearly determined by the responsible Authority: no need to adjust information</u>

TOMORROW: digitalization of the scoring process for listed company is jeopardized by the fact that accounting standards are still a "black box"

- <u>Divergence between IFRS and US GAAP</u>: IFRS 16 as a business case
- <u>IFRS is currently not prescriptive enough</u> and generate many differences in format for P&L
  not enough details in IAS 1 Balance Sheet (industry specific presentation) or CFS (option left on interest and tax in operating CF or not).

ESEF requires more convergence to be sure that accounting data can be used as facts: **SCORING MUST BECOME A SCIENCE TO OPEN THE BLACK BOX**

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4. BACK TESTING TO MAKE SCORING “CLEAR AND SIMPLE”

<u>The conceptual framework applied by IASB should be tailored on the metrics used by users</u> (ie equity and credit analysis, regulator & management) to structure data and Primary Financial Statement :

1. **Inclusion of segment data:** understanding trend in marginal return for capital employed by business unit is the key issue to assess if growth is profitable
2. **Ability to “clean” cash flow and to adjust debt:** key to make stress testing
3. **Incorporation of parent company data** and main non consolidated affiliates: what are the costs to upstream cash flow to pay back debt and distribute dividends?
4. **More convergent industry standard as a way to regulate non gaap?** Non Structured data and MD&A : PDF is fine for the time being, ESMA could envisage field test and impact study to judge the cost/benefits

Bigger use of BACK TESTING is urgently needed to make scoring “CLEAR AND SIMPLE”

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5. A FINANCIAL LAB COULD ACT AS A THINK TANK TO IMPROVE CONCEPTUAL FRAMEWORK

(1) ESMA sharing big data though easy and cheap one point of access (as Edgar) will be efficient if users switch to more sophisticated financial models which could be shared as "templates" to industrialize scoring

(2) The LAB could work with association of users to improve taxonomy holding & monitoring (urgent need to improve accounting standards)

(3) The LAB could act as a "go between" with academics on the definition of key metrics to score financial performance from the accounts (EBITdA(R), FCF, Net Financial debt, etc)

(4) The promotors of iXBRL and XBRL should make the POC that ESEF will work on investment processes

(5) Impact study before moving to second step, after primary Financial Statements

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IFRS 16 AS A BUSINESS CASE

NOT SIMPLE

IASB

- Convergence in international standards is more perceived as a "nice to have" with the affirmation of a conceptual framework divergent with US GAAP?
- "Fair" value is focused on making balance sheet more transparent but at the risk of making the income and the cash flow statement more complex?

Equity and credit analysts

- Methodologies are focused on discounted cash flow
  - **Rating agencies:** stress testing to assess expected loss over 10 years
  - **Equity analysts:** discounted cash flow ie replacement value is more relevant to benchmark companies with different capital structures

Issuers and regulator

- Europe urgently needs to speed up profitable growth
  - Trust in accounting standard is key for financial stability
  - Balance sheet management can distort enterprise value (ie capital employed are impacted by accounting standards)

NOT CLEAR

- **What is the consistency in the ways to adjust pensions, leasing and ARO?**
- **Where is the border between operational debt and financial debt? Covenants are just a mess**
- **More focus on free cash flow than EVA creates versatile business model (ie asset light balance sheet)**

- The conceptual framework must be global and improve the ability to fund more efficiently profitable growth in Europe

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