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### **Recommendations on how to determine earnings for use in forecasts**

#### **I. Introduction**

When outside parties such as investors and financial analysts forecast the future earnings of companies, the forecasts are generally based on published information from prior period financial statements. The data used to prepare the forecasts must be carefully analysed, so as to identify, in particular, any exceptional items. After intensive discussions, the working party came to the view that it would be appropriate to eliminate all non-recurring items from the actual data. Only then should work on the forecast begin. To facilitate this analysis, it would be very helpful to have a comprehensive schedule of non-recurring items. However, such a list is not currently available. Therefore, the working party initially addressed this task, before dealing with the rest of the procedures for forecasting results.

The recommendation of the working party, to eliminate all non-recurring items from the initial data when forecasting future earnings, is a development which is consistent with the recommendations on the determination of adjusted earnings per share in accordance with DVFA/SG.<sup>1</sup> Whereas in the latter case, the aim is to obtain a benchmark that is as objective as possible to measure the current results of operations of the company, the deliberations about earnings forecasts aim to establish the most appropriate starting point for the assessment of the future results of individual companies. To determine a current figure for earnings per share, the adjustment may be limited to a schedule of material exceptional items<sup>2</sup>, as forecasting earnings is not the priority here, and therefore, for those exceptional items for which no adjustment is made<sup>3</sup>, the presumption suffices that they will recur in future in a similar order of magnitude. The aim of the working party is to improve the ability to forecast future earnings.

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<sup>1</sup> Edited by Busse von Colbe/Becker/Berndt/Geiger/Haase/Schellmoser/Seeberg/v. Wysocki: Earnings per share in accordance with DVFA/SG, 3rd edition, Stuttgart 2000

<sup>2</sup> Busse von Colbe et al, section 41 ff.

<sup>3</sup> Busse von Colbe et al, section 61 ff.

## **II. Starting point**

### **1. IASB / FASB convergence project**

From the point of view of investors and financial analysts, the decision of the EU to require all group financial statements of quoted companies to be prepared in accordance with IAS / IFRS with effect from 2005 will significantly improve the meaningfulness, reliability and comparability of those financial statements. The convergence with companies which comply with US GAAP will become greater as a result of the convergence project between IASB and FASB. The figures for group earnings and earnings per share will then present a true and comparable picture of the results of the group for the reporting period.

However, these figures alone do not provide evidence about the causes of the net profit or loss which are relevant to forecasts of earnings. This requires more extensive analyses using additional information from the annual financial statements (balance sheet, profit and loss account, notes to the financial statements), segment reporting, the cash flow statement, the statement of changes in equity and the management report. Such analyses are the prerequisite for forecasts of future earnings trends by investors and financial analysts. Here, exceptional items included in the earnings of the previous reporting period assume particular importance, as it is most probable that they will not recur at all or not recur to the same extent in the period covered by the forecast.

It has become much easier in recent years to prepare analyses of financial statements as a result of the publication of additional information, both mandatory and voluntary, particularly in the Notes to the financial statements. Nevertheless, the information required for a suitable analysis of results and a reasonable forecast of earnings is still not standardised and may sometimes be incomplete or so well-concealed that identifying exceptional items may require a disproportionate amount of time, so that estimating may be the only way of quantifying these amounts separately.

Financial statements prepared in accordance with IAS / IFRS and US GAAP take account in different ways of the requirements for the analysis of earnings and the ability to forecast results.

### **2. US GAAP financial statements**

According to US GAAP, the management of the company must include in the annual or Group financial statements an analysis of the principal changes from the previous year and of the main exceptional items (Management discussion and analysis). Moreover, the management must provide information not only on the earnings per share (as reported earnings), but also the impact on earnings per share of changes in accounting methods, discontinued business operations and extraordinary events, as well as the remaining balance of operating earnings per share. This means that some of the main exceptional items are identified in terms of value, while others continue to be included in the figure for operating earnings. This situation has led to the management of many companies providing information about additional exceptional items based on their own judgement or making the adjustments they deem appropriate to operating earnings. These pro-forma earnings are specific to each company and are frequently determined in different ways in different years.

Therefore, they have been discredited and are not permitted by the US Securities and Exchange Commission (SEC). On the other hand, it is recognised that it is imperative to separate out exceptional items in order to evaluate financial statements and forecast future earnings.

### **3. IAS / IFRS financial statements**

The International Accounting Standards / International Financial Reporting Standards do not currently pay much attention to earnings analyses and forecasts. The rules on disclosure in the profit and loss account are relatively flexible. Information must, however, be provided about important effects and transactions, such as the effect on net profit or loss of changes in accounting policies, discontinued operations and extraordinary items. This must be disclosed separately in the profit and loss account or shown in the Notes to the financial statements. There is, however, no separate disclosure in earnings per share. Moreover, management is not required to make any analytical comments on the financial statements. It is anticipated that the performance reporting project currently being discussed will generate some improvements which will be helpful for analysis. It is expected that there will be a requirement for separate disclosure in the profit and loss account of the effect on net profit or loss of remeasurements of other components of net profit or loss. As a result, at least some of the non-recurring items would be disclosed, which will acquire greater importance given the increasing volatility of certain balance sheet items which must be reported at their fair value. Those exceptional items which are based on business transactions which occur infrequently, would not however be affected by this. It is possible that a contribution to this discussion may be made by a project being carried out by the German Accounting Standards Committee (DRSC). This is concerned with the information to be provided in the management report and will also deal with the reporting of exceptional items.

### **4. Consequences**

Given the current situation, investors and financial analysts often have no alternative but to prepare their own analyses based on the all the published financial statement information and to quantify the main non-recurring items themselves or to use the pro forma earnings analyses prepared by the company's management as the basis of their own evaluations.

### **III. Determining the net profit or loss to be used in forecasts**

Appropriate forecasts of the earnings of companies must be prepared on the basis of figures which exclude all material exceptional items. This process does greater justice to those economic uncertainties and significant fluctuations prevailing at the time than if unadjusted initial values were used. It is described in the sections below.

## **1. Non-recurring items**

The identification of non-recurring items in the International Accounting Standards is based on the following existing or proposed disclosure, i.e. the effect on net profit or loss for the period of

- changes in accounting policies
- discontinued operations
- extraordinary items
- changes in carrying amounts and
- other non-recurring items.

In passing, it is worth mentioning that the use of forecast earnings in order to estimate future stock exchange prices and the preparation of corporate valuations require an additional evaluation of the cash effects of non-recurring items. Here, the following four categories are possible:

- Income and expenses which are recorded prior to the relevant receipts or payments being made (e. g. provisions or claims for damages)
- Income and expenses which are recorded after the relevant receipts or payments have been made (e.g. amortisation and depreciation, prepaid expenses and deferred charges and deferred income)
- Income and expenses which are recorded at the same time as the relevant receipts or payments have been made (e. g. salary costs and sales revenue in the retail trade)
- Income and expenses not involving the movement of funds (e. g. income and expenses arising from changes in accounting policies).

### **a) Changes in accounting policies**

Income and expenses arising from changes in accounting policies must be clearly and separately disclosed to comply with either IAS or US GAAP. This information must therefore be provided in clearly quantified form.

### **b) Discontinued operations**

The same principles apply to income and expenses arising from discontinued operations as to those arising from changes in accounting policies. In this case as well, there are relatively clear rules and the items must be disclosed separately. Included here too are companies removed from the consolidation even though the investment has not been sold, e.g. due to the loss of a controlling interest other than as a result of a sale.

### **c) Extraordinary items**

Income and expenses arising from extraordinary items are relatively infrequent due to the narrow definitions of such items under IAS and US GAAP. The abolition of the

separate disclosure of these items is therefore under discussion. This would of course be a disadvantage for earnings forecasts, which would need to record these items with other non-recurring items.

#### **d) Changes in carrying amounts**

Gains / losses on mergers: Where such gains or losses do not arise from changes in valuations, they should be included in Other non-recurring items (section III.1.e).

Exceptional goodwill impairment losses: As it is probable that the IASB will adopt the new US GAAP rules, it is expected that the scheduled amortisation of goodwill will no longer be permitted.

Exceptional impairment losses on other fixed assets or current assets: These exclude the depreciation of low-value fixed assets and general provisions for bad and doubtful debts. These are deemed to be recurring items included in earnings.

Reversals of impairment losses when there is an indication that an impairment loss recognised for an asset in prior years may no longer exist.

Profits arising on the recovery of debts and other assets previously written down.

Unrealised gains / losses from restating financial assets, liabilities and hedging transactions at fair value.

Gains and losses from changes in pension plans, pension curtailments and settlements (see III.1.e – Pension plan costs).

Income from the release of provisions, provisions for bad and doubtful debts and other assets and differences on the liabilities side.

The effects on net profit or loss arising from adjustments to deferred tax as a result of changes in tax rates and from adjustments to deferred tax provisions not previously set up or subsequently reversed.

#### **e) Other non-recurring items**

##### **aa) Sales**

Only company-specific gains arising from exceptional prejudice to others can be deemed to be non-recurring items, for example gains arising from a strike at a competitor's. Other non-recurring items do not include fluctuations which are typical of the industry.

##### **bb) Income from subsidies**

Income from subsidies is treated as non-recurring if it does not correspond to expenditure incurred during the accounting period.

##### **cc) Profit or loss on the disposal of fixed assets**

Significant amounts are deemed to be non-recurring.

**dd) Investment income**

This is generally treated as a recurring component of earnings. In special circumstances, it may be possible to justify exceptions to this rule, such as in the case of income from the distribution of reserves and the associated tax effects.

**ee) Costs associated with the acquisition of companies**

Such costs are deemed to be non-recurring to the extent that they are not capitalised as incidental acquisition costs.

**ff) Costs arising from product defects**

Significant recalls of products (e.g. pharmaceuticals) or of major production runs (e.g. motor-cars of a particular type from a particular year) are deemed to be non-recurring items where it can be assumed that, due to their size, these are relatively one-off events.

**gg) Costs arising from litigation, claims and strikes**

Income and expenses arising from insurance claims and litigation, as well as from uninsured losses, are non-recurring items. The same applies to the costs of industrial disputes.

**hh) Pension plan costs**

Non-recurring items are those items which have an effect on earnings which arise from subsequent changes but do not relate to amendments to the valuation (see section III.1.d). These include additional contributions to one or more of the plan assets where these are not deducted from the plan liabilities and corresponding repayments. This applies principally to defined contribution plans and/or pension funds.

**ii) Costs of earnings-related employee remuneration including share option schemes**

These are only treated as non-recurring items if they are not generally accounted for through the profit and loss statement.

**jj) Redundancy schemes**

The costs of redundancy schemes, mass lay-offs and extensive early retirement schemes are deemed to be non-recurring items.

**kk) Other rationalisation and restructuring costs for continuing operations**

The costs remaining after eliminating impairment losses (see section III.1.d) and pension plan costs (see above) are generally deemed to be recurring items. Occasionally, there are exceptions to this, which might arise, for example, from the premature termination of delivery and service contracts in the case of major plant closures and similar types of event.

Any positive impact on earnings in the post-restructuring periods is generally deemed to be sustainable and should therefore not be treated as a special item.

## **ll) Maintenance costs, start-ups and improvements**

Only in a small number of exceptional cases is it possible to justify the inclusion of such items as non-recurring items, such as, for example, start-up and improvement costs which have not been capitalised and companies which have set up provisions in accordance with the German Commercial Code (HGB) for deferred (i.e. future) maintenance.

## **mm) Company anniversaries**

Company anniversary costs are treated as non-recurring items.

## **nn) Advertising costs**

These are generally deemed to be recurring items. Under certain circumstances, where advertising costs have changed substantially in comparison with prior years, the opposite treatment might be justified.

## **oo) Marketing costs**

It may be possible to justify the disclosure as non-recurring items of significant changes as a result of the company opening up new markets.

## **pp) Distribution costs**

It may be possible to justify the disclosure as a special item of a significant change in distribution costs due to a major reorganisation of distribution systems.

## **qq) Research and development costs**

Where research and development costs have changed substantially in comparison with prior years, treatment as a special item may be justified. Costs arising from acquired in-process R&D must be treated as non-recurring items to comply with US GAAP.

## **rr) Costs of raising capital**

Non-recurring items may be justified in the case of substantial issue costs for bonds, unaccrued and considerable amounts of pre-maturity compensation. The same applies if flotation costs and the costs of raising capital are charged to the profit and loss account, an accounting treatment which is not permitted by either IAS / IFRS or US GAAP.

## **ss) Taxes**

The effect of tax arrears and tax rebates on earnings is of a non-recurring character.

## **f) Impact on corporate reporting**

The list of non-recurring items included in earnings is relatively extensive, as might be expected. The current rules for corporate accounting, whether IAS, US GAAP or the German Commercial Code (HGB), do not require the disclosure of all the non-recurring items listed above, even if they are material. It is, however, anticipated that new reporting requirements will emerge from the IFRS performance reporting project and the DRSC management report project. In an increasing number of listed companies, information about many of the listed items is already being reported on a voluntary basis, if it appears to be meaningful from the point of view of the

companies. In the context of the value reporting which companies are moving towards, this also complies with the wishes of investors and analysts.

The DVFA/SG working party sees the list of non-recurring items primarily as a forecasting aid for investors and analysts, which will then lead to questions to the companies themselves, if insufficient quantitative information is available about implied or reported non-recurring items.

## **2. Significance of different accounting policies**

The dissimilarities between the various accounting systems, IAS, US GAAP and the German Commercial Code (HGB), are a considerable obstacle when comparing the reported results of companies. The same is true when different accounting policies are applied within the same accounting system, such as different amortisation and depreciation policies and different methods for accounting for inventories and provisions. However, in forecasting the earnings of individual companies, the dissimilarities are not important, as there are no distortions, assuming a continuity in accounting methods and separate disclosure of non-recurring items. If a change in method is anticipated, it must be included in the forecast as a new exceptional item.

Differences in the accounting policies applied become important, however, if the purpose of the analysis is not merely to forecast earnings but to make comparisons between companies in order to evaluate officially quoted share prices or determine purchase prices. Significant variations in accounting policies might distort the comparisons between companies, unless the figures are properly restated or adjusted.

If a comparison is made between IAS / IFRS and US GAAP, it is clear that, as we stated at the outset, the differences in terms of the recording and measurement of balance sheet items are rapidly declining. Now that IAS will probably come into line with the new US GAAP rules on the treatment of goodwill arising on acquisition and no longer permit the amortisation of goodwill, there are only a few differences between the two sets of accounting standards which have potentially significant effects on earnings. Even these differences are likely to diminish still further in future as a result of the moves towards convergence by the IASB and the FASB. Currently, the differences between IAS /IFRS and US GAAP are as follows:

- In-process research and development is not recognised as an asset under US GAAP and should be recognised immediately as an expense.
- According to IFRS (ED 3), negative goodwill should in future initially be reduced by remeasuring the assets, with any remaining amount being taken immediately to income, whereas under US GAAP it reduces the assets acquired proportionately.
- According to IAS, the cost of internally-generated intangible assets should be capitalised given certain conditions. US GAAP requires this treatment only for certain clearly-defined assets such as sound or film rights and computer software.
- In the case of manufactured tangible fixed assets, the capitalisation of financing costs is optional under IAS. Under US GAAP, in certain situations (where there are qualifying assets), it is mandatory.

- If the reasons for recognising an impairment loss no longer exist, IAS currently requires that the loss is reversed. Under US GAAP, a reversal of the impairment loss is not permitted.
- In the case of inventories, US GAAP permits the use of any suitable accounting method. IAS restricts the methods to FIFO. Currently, LIFO is also still permitted.
- For financial assets and liabilities reported at fair value, the only current difference in the effect on earnings is in respect of available-for-sale financial instruments. There is the option under IAS to recognise unrealised gains on these assets, whereas US GAAP does not permit the recognition of unrealised gains.
- According to IFRS (ED2), share-based payments must in future be recognised in the profit and loss account. Under US GAAP, there is currently an option to do so.
- When accounting for provisions, US GAAP requires a slightly higher probability of the event occurring than IAS.

In respect of these differences, it should be noted that some items have already been deemed to be non-recurring items by the working party (see sections III.1.a to III.1.e) and adjustments should always be made for these items when preparing earnings forecasts. The remaining differences between the sets of standards are generally negligible. Adjustments should, however, be made to financial statements prepared according to the German Commercial Code (HGB) so that they comply with the main International Accounting Standards where necessary.

### **3. Taking account of non-recurring items when forecasting future earnings**

In practice, most earnings forecasts for companies listed on a stock exchange are prepared from financial analyses covering a period of 1 to 2 years. Special investigations and valuation calculations may also be based on longer forecasting periods, although these rarely exceed 5 years.

The forecast should begin by adjusting the reported earnings for the year under review (sometimes also for the quarter under review) for all material non-recurring items. This adjusted earnings figure is then used to forecast the adjusted operating result and the financial result, adjusted if necessary.

When forecasting the financial result, the working party came to the view that the interest effects of the adjustments need not be taken into account. The interest effects of payment transactions, even when they are based on non-recurring items, are generally of a sustainable character and should therefore be deemed to be recurring items.

To determine total earnings before taxes, an estimate must also be made of the anticipated effects on earnings of non-recurring items in the period of the forecast, to the extent that this is possible. Then, the income tax charge should be deducted from the total earnings figure obtained in this way.

Due to the effects of future capital expenditure and financing, it is essential to supplement the earnings forecast with a balance sheet forecast.

## Example:

### Forecasting assumptions

Effects on earnings of the assumed non-recurring items on operating profit (EBIT). The figures in brackets show the payment effects where these occur at a different time for the calculation of financing costs:

Figures in EUR million, unless otherwise stated	n (actual)	n+1 (estimated)
(1) Provision for employee severance pay	-30	-
Provision for change in IT systems	-	-20
(2) Impairment losses	-50	-10
(3) Compensation paid for product defects	-15	-
(4) Claims for insurance recoveries	+10	(+10)
(5) Advance payments received for future profit on sale	(+30)	+30
(6) Gains on sales of businesses	+30	+10
<b>Total non-recurring items</b>	<b>-55</b>	<b>+10</b>

Tax charge/relief generally at a rate of 40%.

### Balance sheet information at 31 December

Equity excluding minority interests (500 million shares)	1,000	1,100
Minority interests	100	110
Interest-bearing loan capital and total provisions	1,500	1,300
- Cash and cash equivalents	-300	-300
Other loan capital	400	440
Total assets	3,000	2,950

### Profit and loss account information

Sales	4,000	4,160
EBIT	350	404
Adjusted for non recurring items	+55	-10
<b>Adjusted EBIT</b>	<b>405</b>	<b>394</b>
Financial result = Interest, net (interest rate = 6%)	-70	-65
Adjusted for non recurring items	-	-
<b>Adjusted financial result</b>	<b>-70</b>	<b>-65</b>
Earnings before tax	280	339
Adjusted for non recurring items	+55	-10
<b>Adjusted earnings before tax</b>	<b>335</b>	<b>329</b>
Taxes on income (40%)	-112	-136
On non recurring items	-22	+4
<b>Adjusted taxes on income</b>	<b>-134</b>	<b>-132</b>
Profit for the year	168	203
Non recurring	+33	-6
<b>Adjusted profit for the year</b>	<b>201</b>	<b>197</b>

<b>Minority interest</b>	<b>-10</b>	<b>-12</b>
(The example does not include any non recurring items)		
Net earnings	158	191
Non recurring	+33	-6
<b>Adjusted net earnings</b>	<b>191</b>	<b>185</b>
Earnings per share (in EUR)	0.316	0.382
<b>Adjusted earnings per share (in EUR)</b>	<b>0.382</b>	<b>0.370</b>

#### IV. Using forecast results

The evaluation of future earnings trends of listed companies is generally only a first step for financial analysts and institutional investors, which is followed, for example, by an assessment of the future value of the company in terms of market capitalisation and an evaluation of the future movements in the share price of the company being investigated. To make such judgements, many different types of macroeconomic information, such as peer group forecasts, are taken into consideration, and various valuation methods are used. An examination of these procedures is not within the remit of this paper. However, the working party with its recommendations would like to draw attention to the fact that the determination of an appropriate starting point is extremely important, not only for forecasting future earnings, but also for establishing the future value of a company, in order to avoid the multiplication of initial errors.

#### V. Summary and outlook

When outsiders such as investors and financial analysts forecast the future earnings of companies, the first step they must take is to conduct a thorough analysis of the initial data, the financial statement information published by the companies, so as to identify, in particular, any non-recurring items. The working party has attempted to devise some guidance on this subject and has prepared a list of non-recurring items which is as comprehensive as possible. It is conscious of the fact that some of this information in quantitative form may only be obtained from the companies if they are prepared to provide it on a voluntary basis. The willingness of companies to provide such information is likely to increase in future, not only as a result of the IASB performance reporting project and the DRSC management report project, but also as a result of an increase in the companies' own initiatives in the context of value reporting.

The working party recommends the complete elimination of all material non-recurring items from the initial data. At the same time, the adjusted forecast future earnings should be amended to include future non-recurring items where these can be estimated.

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