LONDON SOCIETY OF CHARTERED ACCOUNTANTS

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Mr Thomas Oversberg

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Dear Mr Oversberg

The Performance Reporting Debate: What (if anything) is wrong with the good old income statement?

With a membership of in excess of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales (ICAEW). London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to bodies such as yourselves.

Our responses to the specific questions raised in the Discussion Paper are set out below:

A Is there a need to have a key line in the statement(s) of income and expense that succinctly summarises entity performance, acts as a headline number in corporate communication and can be used as a starting point for further analysis? If so, what should this (or these) key line(s) represent?

We do not believe that there is a need to have a key line in the statement(s) of income and expense that acts as a headline number in corporate communication.

Different users of the financial statements will have different needs and will therefore naturally focus on different aspects of performance, consequently we do not believe that there is a need for one key line summarising performance. Instead we believe there is a need for a more formal framework setting out a number of prescribed headings, such that users can make comparisons between companies on a consistent basis. For example, there should be consistency in what is included in headings such as operating profit and net income.

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We acknowledge however that some users will wish to focus on performance indicators such as earnings per share, and we suggest therefore that where such indicators are presented, the framework should set out how they are to be calculated.

B What are the attributes of 'performance' in the context of financial reporting of an entity? Are there different types of performance (for example, management performance, entity performance) and if so, what are the types? What do they encapsulate and how can/should they be differentiated?

We believe that management is responsible for the performance of an entity as a whole, and that it is therefore inappropriate to distinguish between say management performance and entity performance. Even exogenous events such as natural disasters can be addressed by management, for instance through insurance. We believe that the management commentary section of a company's annual report is the more appropriate place for management to discuss aspects of performance which it believes to be outside their control.

We do believe however that a distinction can be made between items in terms of the degree of predictive value which they possess in relation to future trends in business performance, and we believe that the structure of the income statement (or potentially a statement of comprehensive income) should be presented in such a way as to make that distinction clear. For example, changes in the value of assets and liabilities that are stated at fair value usually have less predictive value because of the inherent unpredictability of the markets involved. A particular example would be actuarial gains and losses relating to movements in a pension scheme deficit. We would therefore advocate presenting movements on such items in a separate part of the performance statement(s).

C Is 'net income' (in its current form or a variation thereof) a meaningful and necessary notion? If so, what should it represent and how are items included in net income to be differentiated from other items of income and expense?

We believe that 'net income' is a useful notion for some businesses, particularly those of a traditional manufacturing nature. We do not believe that it is a useful concept for all entities however; we would point out that for some businesses, changes in the value of particular assets may be equally important to understanding the performance of the entity yet these may not be reflected in the income statement.

We therefore believe that a single statement of comprehensive income should be presented, and that this should draw a distinction between items by grouping together items with greater and lesser degrees of predictive value. It may well be that the concept of net income could be retained to describe the segment of the single statement of comprehensive income that encompasses those items of income and expense that possess greater predictive qualities. Where headings such as net income are presented, we believe that there should be common definitions underpinning them (see our response to question A above).

D Does the bottom line of a statement of income and expense bear more weight and significance than other lines of the statement simply by virtue of being at the bottom? Consequently, how many statements of income and expense should there be and why?

We do not believe that the bottom line of a statement of income and expense has inherently more weight than any other line. This does not mean that users will not naturally tend to focus on the bottom line however. As mentioned in our response to question C above, we believe that a single statement of comprehensive income should be presented and that within this it will be useful to draw a distinction between elements of performance with greater and lesser degrees of predictive value. By making these presentational changes, we believe that this will alleviate the tendency for users to focus solely on the bottom line.

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

No we do not believe that recycling is needed.

We find it unacceptable in principle that the same item of income should be recognised twice within the financial statements. We do however recognise that there is a need to make an exception for cash flow hedging in order for that concept to work in practice. We would emphasise that this is the only matter for which we believe the recycling concept to be appropriate.

F Which of the following disaggregation criteria both have merit and are capable of being implemented? How would you define the terms used in those criteria and what are the pros and cons of using the criteria for disaggregation purposes? (NB. Please specify your own criteria if the criteria you believe to be necessary are not listed below.)

- **Disaggregation by function;**
- **Disaggregation by nature;**
- **Fixed vs. variable;**
- **Recurring vs. non-recurring;**
- **Certain vs. uncertain;**
- **Realised vs. unrealised;**
- **Core vs. non-core;**
- **Operating vs. non-operating;**
- **Sustainable vs. non-sustainable;**
- **Operating vs. financing vs. other;**
- **Controllable vs. uncontrollable;**
- **Based on actual transactions vs. other;**
- **Cash flow vs. accruals;**
- **Re-measurement vs. before re-measurement;**
- **Holding gains and losses vs. non-holding gains and losses.**

We would comment as follows:

Firstly, we believe that a structure for the income statement or a statement of comprehensive income (our preferred option) should be developed based on function. Thus it would make a distinction between operating costs and financing costs with clear definitions for headings such as operating profit and net income.

Secondly, we do not believe that it is appropriate to make a distinction between controllable and uncontrollable events, as we believe that all elements of performance are the responsibility of management. As mentioned above, we believe that the appropriate place for management to discuss events which it believes to be outside its control is in the management commentary section of the annual report.

Thirdly we believe that the income statement or statement of comprehensive income should be structured in such a way as to draw a distinction between those items of performance with greater degrees of predictive value and those with lesser predictive value. In making this distinction, we believe that one of the main factors to consider will be whether an item of income or expense arises from a change in the fair value of an underlying asset or liability; the inherent volatility associated with recognition of items at fair value diminishes the predictive nature of the financial statements and merits separate presentation.

G Are the current IFRS provisions in relation to the netting of items of income and expense appropriate? What (if any) are the specific areas where the current requirements allow information essential for analysis to be concealed or, alternatively, do not permit netting where it would result in more useful information?

We believe that the current IFRS provisions on netting are broadly appropriate and well understood. As a result, we do not see any need to change them.

H What is the underlying nature of the adjustments made by entities when reporting non-GAAP measures in their communications with the markets?

What are the adjustments seeking to achieve? Please provide specific examples illustrating this. Should any of these non-GAAP measures be incorporated into the IFRS financial reporting model? If that would be desirable, is it feasible and how should it be done?

Many entities in the UK seek to present an ‘Adjusted Earnings Before Interest and Depreciation’ (Adjusted EBID) figure, doing so because they wish to draw attention away from volatile figures which they do not believe to be controllable by management.

We believe that there is a case for such measures to be brought within the IFRS framework if only to ensure consistency across companies presenting such information.

Should non-GAAP measures continue to be presented , we believe that steps should be taken to ensure that undue prominence is not given to such measures relative to those which are prescribed by IFRS.

Furthermore, we believe that attention should be given towards developing guidelines over the practice of presenting information in boxes (‘boxed presentation’) on the face of the income statement to ensure that presenting items in this way is not open to abuse.

I In determining the optimum degree of standardisation of the reporting formats, what is the right balance between comparability and flexibility? In other words, is the level of standardisation in the current IAS 1 appropriate or should more precise formats be prescribed? If the latter, what are the specific areas that should be more stringently prescribed?

We believe that the current level of standardisation in IAS 1 is broadly appropriate, but that additional material needs to be developed to address the use of headings within IFRS financial statements. As mentioned above, we believe that the reporting formats should be defined in terms of headings for total items, specifically operating profit and (where presented) net income. In drawing up these definitions, we recommend that a framework is drawn up which sets out core principles to be followed in terms of what companies should be trying to achieve.

Yours sincerely

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