Accounting Standards Board

Aldwych House, 71-91 Aldwych, London WC2B 4HN
Telephone: 020 7492 2300 Fax: 020 7492 2301
www.frc.org.uk/asb

Stig Enevoldsen
Chairman
EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

30 March 2007

Dear Stig

PAAinE Discussion Paper – "The Performance Reporting Debate- What if anything is wrong with the good old income statement"

This letter sets out the ASB's comments on the PAAinE discussion paper "The Performance Reporting Debate- What if anything is wrong with the good old income statement". The ASB welcomes the discussion paper and believes that it is a worthwhile contribution to the overall debate. However, we think that it could have usefully made reference to the UK's Financial Reporting Standard (FRS) 3 'Reporting Financial Performance', which is also relevant to the performance reporting debate.

The appendix sets out our responses to the questions in the discussion paper. This covering letter highlights the main points that the ASB wishes to raise:

- We do not believe that it is possible to distil the performance of a complex organisation into a single measure
- "Net income" in its current form is a meaningful and necessary notion solely from the point of view of serving as a reference point for companies and users in the preparation of information for financial markets;
- Users should be encouraged not to think of a single "bottom line" as providing all information on the entity's performance;
- In order to achieve convergence with IFRS some recycling is now permitted within UK standards; however, the ASB continues to believe that recycling should conceptually have no place in financial statements; and
- The ASB believes the current IFRS provisions concerning netting are appropriate.

We hope these comments are helpful. We are happy to provide further explanations and clarification if required. If you would like any further information on the comments made above then please contact Simon Billingsley on 020 7492 2428, David Loweth on 020 7492 2420 or myself on 020 7492 2434.

Yours sincerely

Ian Mackintosh
Chairman
DDI: 020 7492 2434
Email: i.mackintosh@frc-asb.org.uk

Appendix

PAAinE Discussion Paper 2: Responses to Questions raised in the Invitation to Comment

A *Is there a need to have a key line in the statement 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?*

It is not possible to distil the performance of a complex organisation into a single measure. Undue significance therefore should not be placed on any one such measure which may purport to achieve this aim. To assess the performance of a reporting entity during a period all contents of its activities must be considered.

However, it would be naïve to believe that commentators on financial performance will not highlight single measures when reviewing financial performance. A well presented statement of financial performance would enable any earnings figures quoted by entities in their market communications to be reconciled back to the underlying statement of income and expense. The purpose of "key lines" in the statement of income and expense e.g. operating income, net income, etc is to provide a reconciliation point for earnings figures provided by the management of the entity.

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?*

One definition of income or profit is that the overall profit or income for a period is equal to the change in recorded net assets after excluding those transactions attributable to owners. This amount will reflect all the revenues, expenses gains and losses for the period and may be referred to as total recognised gains and losses or comprehensive income and therefore will constitute "entity performance". It is difficult to envisage what elements of entity performance are excluded to arrive at management performance. It is preferable to focus on the components of financial performance such as operating profit. Within entity performance there will be other measures of profit that will need to be considered as well as they relate to differing components of financial performance. These components are discussed in F below.

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?*

"Net income" in its current form is a meaningful and necessary notion solely from the point of view of serving as a reference point for companies and users in the preparation of information for financial markets. It also provides a reconciliation point for Company defined non GAAP measures of earnings.

Items required by standards or other authority to be charged directly to equity should form the basis of items not charged to net income.

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?*

Users should be encouraged not to think of a single “bottom line “as providing all information on the entity’s performance. The financial performance of a reporting entity is made up of components that exhibit different characteristics in terms of, for example nature, function and relative continuity or recurrence. All these items are relevant to an assessment of financial performance and therefore need to be reported in the statement of financial performance. This assessment will carry greater weight than a line featuring at the bottom of a net income statement.

Information needs to be presented in a way that focuses attention on the components of financial performance. If this is achieved then whether there is one or more than one statement of financial performance is not of fundamental importance.

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

In order to achieve convergence with IFRS some recycling is now permitted within UK standards; however, for the reasons outlined below the ASB continues to believe that recycling should conceptually have no place in financial statements.

In accordance with UK law and accounting standards, certain gains and losses have to be taken to the statement of realised gains and losses rather than being credited or charged to the profit and loss account. The ASB believes that in principle such gains and losses are reported once and for all when they occur, in the statement of recognised gains and losses, and are not recycled in a later period. The rationale for this principle is that a gain or loss should be reported in the period in which it occurs in order to provide a complete picture of the economic impact of events of that period and not in any other. A further benefit of this approach is to introduce consistency between the various parts of the financial statements. If for example gains on revaluation are recycled, the profit or loss on sale of a revalued property is based, not at the amount at which it is carried in the balance sheet, but on its original cost. Yet the purpose of including a revalued amount in the balance sheet is to provide more up to date information on the entity’s assets. It is inconsistent with this purpose to calculate a gain or loss on sale by reference to an amount that has not been used in the financial statements –sometimes for many years- and which in consequence may result in a gain being reported on a transaction that actually results in a loss compared with the more up to date balance sheet value.

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 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*

As stated above, financial analysts and other users of financial statements are primarily interested in information concerning historical financial performance in order to form expectations concerning future cash flows. When forming these expectations the following disaggregation criteria have merit and are capable of being implemented. The Board's understanding of the definitions of the terms are provided

- Disaggregation by function

Analyses by area within the business e.g. cost of sales, administration expenses and distribution costs

- Disaggregation by nature

Analyses by type of costs incurred e.g. staff costs, advertising, and marketing.

- Recurring vs. non recurring

Recurring costs have a high possibility of recurring in the future whilst non-recurring costs occur infrequently.

- Sustainable vs. non sustainable

Sustainable is where an activity is seen to be continuing into the future whilst non sustainable is a discontinued activity.

- Core vs. non core

Core activities are the principal activities of the business whilst non core activities are more peripheral activities.

- Operating vs. non operating

Operating activities are the principal trading activities of the business.

- Operating vs. finance vs. other

A separation of the activities across the principal headings of operating, finance and other.

The following disaggregation criteria, whilst capable of being implemented, is, we believe, information that is more relevant for use within the entity rather than by external users:

- Fixed vs. variable

  Fixed costs do not vary with the activity of the business whilst variable costs do.
- Controllable vs. uncontrollable

  Controllable costs are costs that can be varied by management action whilst uncontrollable costs are outside the control of management.

The following disaggregation criteria would require the exercise of considerable judgement and would therefore be difficult to implement:

- Certain vs. uncertain

  A disaggregation of costs and income based on the likely probability of the costs or income arising.
- Based on actual transactions vs. others

  A disaggregation based on separation between actual costs and revenues earned and accounting entries e.g. depreciation, impairment etc.
- Cash flows vs. accruals

  A disaggregation of earnings between actual cash flows and accruals in order to attempt to increase predictive ability.
- Re-measurement vs. before re-measurement

  Where the value of an asset is adjusted the corresponding entry to income and expense results in a re measurement.
- Holding gains and losses vs. non holding gains and losses

  Gains or losses arising from re-measuring assets that are held throughout the period are holding gains or losses. Non holding gains or losses arise on the realisation of an asset
- Realised vs. unrealised

  Realised is when an item has been converted to cash or near cash form.

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?*

Gains and losses are generally not offset in presenting information on financial performance. However gains and losses can be offset if they relate to the same event or circumstance and disclosing the gross component is not likely to be useful for an assessment of future results or the effects of past transactions and events. If a profit is made on the disposal of a fixed asset then that profit is usually best shown as a gain rather than by showing the sales proceeds as a gain separately from the depreciated cost of the asset. The Board believes the current IFRS provisions are appropriate.

***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.*

As stated in the report the nature of these adjustments is to help users understand what is happening to the underlying business by taking out the impact of volatility and adjusting for non recurring items. Common items adjusted for are impairment charges, restructuring costs exceptional items and fair value re measurements. The Board does not believe that these non GAAP measures should be incorporated into IFRS as these measures are generally specific to entities. The requirement should continue to be that non GAAP measures are reconciled to the financial performance statement.

***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 IAS1 appropriate or should more precise formats be prescribed? If the latter what are the specific areas that should be more stringently prescribed?*

The Board believes that the level of standardisation in the current IAS1 is appropriate. Any greater prescription would reduce the ability of the management to set out their perspectives on performance.