AH/ASC-SUB/mb

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

By email: commentletter@efrag.org

30 March 2007

Dear Sir or Madam

EFRAG DISCUSSION PAPER 2: THE PERFORMANCE REPORTING DEBATE 'WHAT (IF ANYTHING) IS WRONG WITH THE GOOD OLD INCOME STATEMENT?'

The Institute's Accounting Standards Committee has considered the above discussion paper and I am pleased to set out its comments below.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

General comments

We welcome this discussion paper as a useful summary of the main issues relating to the key topic of performance reporting. However, we believe that the impact of the paper is in some cases weakened by using terminology in ways that are not widely recognised or understood. In future, we would urge EFRAG to use terminology in the way that it is understood in IASB literature so that commentators will interpret concepts in a consistent manner, thus leading to more useful responses to EFRAG documents.

Our responses on the specific issues to be debated are included below.

CA HOUSE • 21 HAYMARKET YARDS • EDINBURGH • EH12 5BH
PHONE: 0131 347 0100 • FAX: 0131 347 0110
E-MAIL: enquiries@icas.org.uk • WEB: www.icas.org.uk

DIRECT LINE: 0131 347 0225 • EMAIL: ahutchinson@icas.org.uk

EFRAG's specific issues to be debated

1. **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 have significant problems with using the phrase 'entity performance' in relation to financial statements. We believe that financial reporting does not and cannot be expected to measure or articulate the performance of an entity, and is still a long way from achieving this. Analysts will always undertake significant work in deconstructing the financial statements in order to determine entity performance, and would not expect to obtain this information directly from the financial statements. Therefore, we believe that it is not possible to summarise entity performance in one key line of the accounts, although we recognise that there is still a demand to have such a line. This line is demand-driven i.e. the market chooses which line they wish to focus on, and therefore cannot be dictated by standard-setters. A single line ultimately does become meaningful because it is used and relied upon. The financial statements should make clear the limitations of whichever line is chosen.

2. **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?**

   Please see our comments on 'performance' in response to question one. Performance is also assessed by users of the financial statements through supplementary information such as the directors' remuneration report. Users' needs are a key consideration in the development of performance reporting; therefore standard-setters should take these views into account to ensure consistent thinking between the two. Cost-benefit analysis is also a vital element in considering any new financial reporting requirements.

3. **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 for income and expense?**

   We are somewhat confused by this paper's definition of 'net income.' It is counter-productive to attempt to define this term in a way that is not widely recognised. The paper should only refer to terminology already used and defined within IASB literature.

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

   Please see our comments on the key lines in financial statements in response to question one.

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

The need for recycling depends on whether there is a single comprehensive income statement – if so, there is no requirement for recycling. One of the benefits of a comprehensive income statement is that users can draw out whichever figures they wish to focus on, therefore it is useful to a wider range of users. However, the practicalities are more problematic e.g. a multi-columnar statement is more difficult for non-accountants to understand. We would prefer an accounting structure which would mean that recycling is unnecessary since we are aware that recycling can be and is used for earnings management. However, we recognise that certain accounting structures e.g. available-for-sale financial instruments and cash flow hedging make recycling necessary.

6. Which disaggregation criteria have both 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 this disaggregation principle?

We do not believe that any conclusions on disaggregation criteria can be drawn by standard-setters. Disaggregation will in practice be decided on a company-by-company basis dependent on how they wish to present certain information. Disaggregating figures in the financial statements would be feasible in an on-line reporting system, but not in traditional paper-based financial statements. Figures may be disaggregated outside of the financial statements if the company thinks it is important.

7. 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 it is appropriate to net off like items in the financial statements where showing separate items could be misleading. It is not appropriate to net off different items.

8. 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? 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?

We are unclear as to the purpose of this question. It is surely self-evident that non-GAAP measures cannot be included within the IFRS financial reporting model. Nor do we believe it to be appropriate for the IFRS framework to be extended to control narrative sections of the annual report.

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9. 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 general 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?

The format of the income statement under IFRS is currently very free-form, which does not lend itself well towards achieving comparability and consistency. There is a case therefore for introducing clearer definitions into IFRS e.g. a definition of operating profit. UK company law sets a highly prescriptive format for financial statements – we believe that the optimal balance is somewhere between this and the current flexibility under IFRS. A total lack of standardisation clearly does not promote global consistency although we recognise that companies within a particular industry will attempt to report in a way that is comparable with others in the same industry. Prescription in financial reporting formats should only be to a degree whereby there is a set of overarching principles rather than detailed rules.

I hope our comments are useful to you. If you wish to discuss any of them, please do not hesitate to contact me.

Yours faithfully

AMY HUTCHINSON
Assistant Director, Accounting & Auditing
Secretary to the Accounting Standards Committee

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