THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

30 March 2007

Our ref: ICAEW Rep 20/07

Your ref:

EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

By email: *commentletter@efrag.org*

Dear Sir

THE PERFORMANCE REPORTING DEBATE

The Institute of Chartered Accountants in England and Wales is pleased to respond to Discussion Paper 2 *The Performance Reporting Debate - What (if anything) is wrong with the good old income statement?*, published on behalf of Pro-active Accounting Activities in Europe ('PAAinE') by the European Financial Reporting Advisory Group ('EFRAG') and the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), in November 2006.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours faithfully

Desmond Wright

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 20/07

THE PERFORMANCE REPORTING DEBATE

Memorandum of comment submitted in March 2007 by the Institute of Chartered Accountants in England and Wales in response to Discussion Paper 2 *The Performance Reporting Debate - What (if anything) is wrong with the good old income statement?*, published on behalf of Pro-active Accounting Activities in Europe ('PAAinE') by the European Financial Reporting Advisory Group ('EFRAG') and the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), in November 2006.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on Discussion Paper 2 *The Performance Reporting Debate - What (if anything) is wrong with the good old income statement?*, published on behalf of Pro-active Accounting Activities in Europe ('PAAinE') by the European Financial Reporting Advisory Group ('EFRAG') and the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), in November 2006.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the UK Department of Trade & Industry (DTI) through the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR ISSUES

Welcome for the paper

4. We welcome the paper as contributing to a conceptual debate on the important topic of reporting performance through the income statement. There is much concern amongst preparers and users about changes the IASB might in future introduce in relation to performance reporting, particularly amongst those who believe that the current situation has not been shown to be fundamentally flawed, and is anyway fluid as a result of incremental changes in IFRS. By contrast, others take the view that there are many helpful improvements that could be made, so this paper is useful in setting out the questions to be considered.

5. We commend the Group for its even-handed and neutral approach in setting out the issues. In ICAEW REP 12/07, our response to Discussion Paper 1 *Elements of the Framework Debate: The Conceptual Framework: Starting from the Right Place?,* we set out our general comments on the work of PAAinE. These comments are also relevant to this response.

Scope

Value of a 'clean sheet' approach

6. We understand why the Group adopted a 'clean sheet of paper' approach to developing the paper, so as to develop the Group's own thinking in a neutral environment. However, we suggest that there may be disadvantages in this approach going forward, given one of the stated intentions of the paper, which is to influence the IASB's debate on an existing agenda project.

(a) As the IASB is due to publish a Discussion Paper (DP) by the end of the second quarter of 2007, EFRAG will need to expedite the final paper in order to hope to influence the debate at the IASB.

(b) The paper does not deal with the amendments to IAS 1 already proposed by the IASB in Phase A of the project, nor the current developments under Phase B, which have already been discussed with the relevant Joint International Group to the IASB and FASB.

7. Moreover, this subject has been under discussion in various fora for some considerable time and there is a substantial amount of literature that covers some of the ground covered in this PAAinE paper. In developing the second paper, therefore, we suggest the Group should:

(a) refer back to previous literature that has already addressed these issues, so that if any areas need to be reopened it can be done on the basis of building on previous work, rather than through a lengthier process of duplicating original thought;

(b) take account of and address the IASB's proposals, in order to maximise the potential for influencing the IASB's thinking.

Objectives

8. We are not clear at this stage what the second PAAinE paper on this subject will comprise. We believe that it will need to be broader in ambition and scope than the first paper, by specifically addressing the IASB's current proposals and, inter alia:

- arriving at a robust and principled definition of performance and performance measurement. This is something that neither the IASB nor FASB literature has managed to do, so we accept that it will be difficult for the Group to achieve. However, even seeking to arrive at and appropriate indicators for how performance should be defined and measured, and setting out the arguments for and against including specific items in the income statement, will contribute considerably to the current debate (see paragraphs 16 et seq below);

- leading on from this, articulating the categories, headings and sub-totals required, the principle(s) that should be applied to determine where gains and losses are shown and the relationship of the performance statement(s) to the other primary statements.

9. We suggest that it would be helpful to the Group to consider precisely what it is hoping to achieve by publishing the second paper. We suggest that there are two major objectives:

- *European consensus* While it would clearly be helpful to have a European consensus when deciding what messages should be given to the IASB, we do not think such a consensus is achievable in the IASB's available time-frame, given the controversial nature of the project and the wide variety of views held by participants in the debate. However, we believe the second paper (as well as the first) should point to at least some areas of possible agreement.

- *Influencing the IASB* The first paper does not move the debate forward (and, indeed, was not intended to). It is essential for the second paper to take account of current reporting and the IASB's proposals as the basis for practical recommendations as to the way forward.

10. We believe strongly that the Group needs to accelerate the timetable for a second paper, particularly in relation to the need to influence the IASB. Certainly, delaying publication of any further material until the end of 2007 would be too late.

Principles

11. We agree with the proposition in the paper that *'no consistent and credible principle or principles has to date been articulated as to which items of income and expense are shown where'* (section 3.2). Furthermore, not only are there no consistent principles applied throughout the standards, but the Bases for Conclusions accompanying the standards are generally inadequate for providing conceptual explanations that might elucidate more general principles.

12. The implication of this is that no principle or set of principles could support the current situation. In other words, if a principled approach to the income statement should be developed - and we consistently ask the IASB for principles-based standards - it will necessarily require changes in current standards and reporting requirements.

13. It may be that acceptable governing principles cannot ultimately be established. However, we believe that it is important at this stage of the IASB's process to develop in the second paper a robust and conceptually sound basis for reporting performance. Using such principles it will be possible to identify flaws in current IFRS in their impact on performance reporting and point to how these flaws should be rectified, and so present a viable alternative to the current framework. We believe that presenting a suite of principles and concomitant changes to IFRS is the best way to ensure a focused and fruitful debate with and within the IASB and the Joint International Group.

14. Once the principles have been articulated, it will be necessary also demonstrate how they should be applied, in order to ensure that there is agreement on what they mean. It may also be that exceptions to the principles are unavoidable. Exceptions should be acknowledged, along with proposals for dealing with them.

15. It will also be necessary to articulate why certain items need to be shown separately, why that should be in a single statement (or not) and how recycling (if permitted at all) should be dealt with in the case of more than one statement (or between different parts of the same statement).

Performance

16. It is difficult to see how any debate about the income statement can be conducted without a robust and accepted definition of performance. Seeking to achieve this should be a priority concern for the Group as it is something that neither the IASB nor the FASB has managed to articulate. The articulation of such a definition should in turn lead to a more consistent approach to the main issues to be determined (how gains and losses should be categorised and so on).

17. In the absence of an articulated definition of performance, the IASB implicitly views financial performance as the change in measured values between balance

sheet dates. This change is quantified by aggregating the balances that result from the application of accounting standards, rather than attempting a more decision-useful measure of how the business has performed. Deriving performance from measurement bases is arguably approaching this aspect of financial reporting from the wrong angle: establishing the best measurement bases depends on deciding what is meant by performance and how it should be presented.

18. We note that the other primary statements, the balance sheet and cash flow statement, are not considered in the paper. While we understand the attempt to limit the scope of the paper to the income statement, we do not believe that performance can realistically be captured without consideration of assets and liabilities, cash flows and other information (such as supporting notes and narrative reports). Performance needs to be considered holistically before appropriate decisions can be made about what needs to be presented in a dedicated statement (or statements).

19. It is therefore clear that performance cannot be taken to be a residual - ie, the difference between two balance sheets. It is possible that there will be balance sheet changes that do not belong in the income statement. However, at present we do not have a set of principles for identifying such changes. We suggest that exploring this issue would be a valuable contribution for the Group to make in its second paper. Considering the income and the balance sheet approaches together when considering the performance of an entity, and focusing on what should be reported in the income statement or in different measures of income, will also provide a basis for considering balance sheet reporting.

20. It is worth bearing in mind that, as well as all the primary financial statements being considered together, it will also be helpful to consider distinctions about what should appear in a primary statement and what may more helpfully be reported in the notes to the statements or in narrative reports. This will allow different views of performance to be given in the notes, allowing more flexibility there than deemed acceptable in the primary statements.

Management view

21. Paragraph 4.3 states that *'It is not clear why what is appropriate for managing the business would not be appropriate for external reporting.'* We agree with this to some extent, in that performance as reported outside the business to shareholders must not be allowed to diverge too far from performance as applied in managing the business. However, it is fair to say that management view does not generally form the basis for external reporting (with exceptions - as proposed, for example, in relation to segmental reporting). Adopting a more management orientated view of performance would therefore be likely to result in significant changes to the current external reporting model.

22. It is also true to say that there are dangers in applying the management view model too widely. Consistency would be sacrificed. Moreover, management may, for example, ignore certain recognised gains and losses for internal reporting purposes, but may not necessarily be correct to do so: it is not always the case that management's view will be correct in this regard from an external reporting viewpoint. For example, management may justifiably exclude items that they consider are uncontrollable, but these can still be vitally important elements of performance for the reporting entity and reflect earlier management decisions that in fact were controllable.

23. It is also worth noting that the more prescriptive the reporting framework becomes, the less information value is obtainable from management's own decisions and explanations about how various items are treated in the financial statements. It is essential that accounting standards achieve a balance between prescription and flexibility.

24. Managers often hold that fair values are of little use in running the business. However, for managers and external users of the financial statements alike, valuation may often provide useful information, although it may not always be appropriate for inclusion the balance sheet. The best answer is likely to be a combination of fair value and historical cost but different elements of performance (depending on how it is defined) may be demonstrated or described by each.

Realisation

25. As already noted, the IASB has never articulated a consistent principle for determining what should be recognised in the income statement and what should not. It does not employ, for example, a concept of realisation for this purpose. Net income is the result of what is required to be recognised by those standards current at any particular point in time, including what is recycled into it (which again is not determined on a consistent basis). This does not mean that net income has remained static: net income changes with almost every new standard where new gains and losses are recorded or gains and losses are measured in a new way.

26. The key question is whether it is justifiable, in principle, for any gains and losses to be excluded from net income. We welcome the paper's articulation of how gains and losses might be classified and we believe that it would be helpful to try to separate this issue from the less important issue of whether the gains and losses, once categorised, should be shown one statement or two (or more). The question needs to be taken out of the legal arena of realised and distributable reserves in the European legal context and dealt with conceptually in order to have the best chance of influencing the IASB.

27. A discussion of reporting of income in Europe is, not surprisingly, affected by the historical legal context of capital maintenance for creditor protection under European law, because the law links the issue directly to what is reported in company accounts. However, for the international project, the concept of realised and unrealised gains and losses needs to be separated from the legal context in which it tends to be considered in Europe. As stated in the footnote on page 13, *'The concept of realisation is widely used in the debate on reporting performance, however the clear distinction of realised items from unrealised needs to be further explored and defined'*. The Group may find it helpful to articulate what should be considered realised and unrealised, in order to try and determine the extent to which this distinction can be considered relevant outside of a purely legal context, and to what extent it could then be seen as relevant in reporting income.

28. Taking one strict view, net income could be taken to include only realised amounts (however defined), with everything else recycled (although in principle we oppose recycling, as set out in paragraph 39 below). This could be seen as a legitimate approach where only realised amounts can be distributed to shareholders, and is therefore the information in which they are interested.

29. However, accounting in individual entities has taken different routes in different jurisdictions, so that in some countries realisation drives the accounting, but in others the distinction between realised and unrealised amounts is seen mainly as a legal construct for the protection of creditors. In the UK, for example, and generally under IFRS, realised profit does not equate with income statement profit. Moreover, UK companies rarely actually disclose the amount of their realised or distributable reserves. Arguably, such information is not of such great relevance to shareholders (otherwise more companies might disclose it), who are more interested in measures of performance that reflect on the ability of the company to generate cash flows rather than legal constraints on distributions at any particular time (particularly as there are often legal routes to freeing up cash for shareholders even where distributable reserves are not immediately available).

30. Moreover, notions of realisation are arbitrary. For example, some fair value gains on financial instruments are treated as realised in the UK, based on the type of instrument and the market it is traded in. It is not clear that all European countries would adopt the same approach even for the purposes of the legal distinction.

31. What is clear is that, even in the absence of revaluation amounts, the concept of realisation does not remove accounting uncertainties. For example, it does not resolve problems in relation to uncompleted contracts, unsettled foreign exchange gains or gains on untraded financial instruments. In short, we do not believe that realisation provides a basis for defining performance in the income statement. If the Group believes differently, it should articulate the principles involved and demonstrate how it resolves income statement uncertainties.

Flexibility across different entities

32. Broadly speaking we have up until now had a regulated reporting model in Europe in which much of the accounting requirements are driven by statute. This is not necessarily a bad thing, as it provides a framework for comparability between companies. However, it needs to be acknowledged that companies are not usually fully comparable. And furthermore, in the context of the capital markets, much of the information provided by companies is non-statutory, with attendant problems of less audit scrutiny and therefore notionally less reliability. This points to a potential need for the reconciliation of statutory and non-statutory information.

SPECIFIC QUESTIONS

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?

33. It is not necessary to have a 'key line' in the income statement to encapsulate entity performance. However, there should be sub-totals in the income statement with clearly understood meanings, such that users know what is and what is not included in the amounts. This will be an aid to consistency and comparability in reporting performance.

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?*

34. There are certainly different types of performance that are important in the context of financial reporting of an entity. For example, performance of assets vs performance of the business, operating performance vs financing performance, and management performance vs entity performance. Management should ultimately be judged on how the entity performs, so if people believe there is a difference between the two, this needs to be highlighted and explained. If the Group is inclining towards adopting a management view of performance, the second paper needs to articulate more fully what management performance really is. In our view, management performance should reflect what is within and outwith management's control. For example, in relation to pensions, management can control decisions about benefits and investment strategy; but it cannot control actuarial gains and losses, which therefore should arguably be treated differently. However, it is not clear that this view should appear in the primary statements. It may be better to apply this in the accompanying narrative reports.

35. Different measurement bases may be appropriate for the balance sheet and the income statement. The balance sheet amount will be the relevant information regarding an asset held as available for sale; however, an operating asset will be best presented at a performance-based value. The group could perhaps consider how measurement bases affect the way gains and losses are reported.

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?

36. Sub-totals that present articulated performance measures on a principled basis will be required. However, under current IFRS there are no principles for determining what should be included in such an amount. (See also paragraph 40 below in answer to Question F.)

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?

37. The 'bottom line' is more significant at the moment because it is taken to be earnings. However, if the bottom line is merely the difference between two balance sheets, then it is not itself a particularly useful or significant figure. There are behavioural issues here that could usefully be explored further by the Group. Would users be capable of distinguishing between a comprehensive gains and losses bottom line from other, well-articulated measures of performance within and outwith the income statement?

38. It is not really possible to state how many statements there should be, because the answer depends on developing and articulating the relevant principles. As a starting point it is difficult to see why gains and losses should be presented in more than one statement, unless they can be shown to be very different in principle. However, this may well be possible. Meanwhile, we suggest that it is sensible to put everything in one statement, which, in the absence of determining principles, at least avoids the possibility of putting a particular item in the wrong statement

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

39. We believe that recycling is confusing and that in principle gains and losses should be shown only once, although there may be items under current IFRS - such as measurement differences on hedging derivatives, which we do not believe are true gains and losses - that are required to be recycled. We accept, for example, that there is a difference between a revaluation and a sale of an asset. However, this difference may be dealt with sufficiently by helpful alignment of the income statement and the cash flow statement. This is an issue that needs to be explored further by the Group, perhaps focusing on asset types, and giving consideration to a second statement that deals only with recycled amounts. Detailed consideration would need to be given to how existing standards would need to be changed in order to align with any principle that is developed.

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.*

40. We are not convinced that listing possible disaggregation criteria in this way is necessarily the best approach. Much of the information listed is of potential value to users, even though not all of it would ideally be included in the income statement. We suggest that a more fruitful approach might be to limit the income statement to the presentation of recognised gains and losses disaggregated into operating vs. financing vs. other items, with other disclosures in the notes, the management commentary or separate statements such as the segmental report.

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?

41. Current IFRS assumes gross amounts, except where net amounts are explicitly required by a standard. We believe that this is generally appropriate, but we

would like the standard setter to develop a principle to guide it for requiring netting in specific circumstances.

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?

42. Companies frequently provide non-GAAP measures that exclude large and/or non-recurring items . However, there is no real consistency of approach in practice, although some specific non-GAAP measures are prevalent in certain industries. In our view, non-GAAP measures should be provided on whatever basis management judges to be the most appropriate in the circumstances, rather than according to prescribed criteria.

43. We would only expect the standard setter to set certain parameters surrounding disclosures and approaches to non-GAAP measures, for example that the criteria adopted should be stated and explained and that all non-GAAP measures shown should be reconciled to GAAP. We would also expect a standard setter to require restatement of comparative period non-GAAP measures if management changed its approach in any period. Other regulators might also specify that the information should be audited as to the underlying facts and to confirm that management has indeed presented the information according to the criteria it has laid down; however, the auditor would not be responsible for forming an opinion on the appropriateness of the non-GAAP measure(s).

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?

44. There is at present no principled basis for disaggregating information, so it is not possible to answer this question except in broad terms. In a principles-based standard we would not expect a great deal of prescriptive detail. As we set out in paragraph 40 above, we would look for a basic disaggregation in the formats into operating, financing and other items, in that order. Individual accounting standards then determine what falls into each category.

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