RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS TO PAAinE DISCUSSION PAPER 2: THE PERFORMANCE REPORTING DEBATE

Introduction

We are pleased to have the opportunity to comment on the PAAinE Discussion Paper. As well as being accounts preparers UK insurers are major portfolio investors accounting for some 20% of the securities quoted on the London Stock Exchange. Clear and logical reporting of performance is a fundamental requirement of financial statements. The management of firms will want to ensure that their performance is properly communicated. Performance is also one of the main criteria for investors in making decisions on capital allocation.

We note that the purpose of the Discussion Paper is to set the scene for the debate. A further paper will evaluate the arguments for and against any change to the current performance reporting regime. We also note that the paper does not address the particular circumstances of specialised industries such as insurance.

Before responding to the specific questions raised in the paper, we would like to draw attention to what we regard as some confusion in the current terminology in use referred to in paragraphs 1.11 to 1.13. The *income statement* includes expenses. The inclusion of expenses is implied in the existing references to *profit and loss account.* A better terminology therefore might be *statement of net income* or *income and expense statement.*

Another confusion is that the *income statement* excludes certain item of income and expense that fall within the definition of *income and expense.*

A solution to this problem might be to dispense with a separate income statement and concentrate instead on the statement of income and expense. This statement would then need to be redesigned to ensure that:

- It covers those key measure of performance that are important to preparers and/or users of financial statements;
- It is made clear how the components of the statement are reflected in the balance sheet, for example either as profit or loss as determined in accordance with legal and accounting requirements, or movements in equity.

Comments on the specific questions raised

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 communications and can be used as a* *starting point for further analysis? If so, what should this (or these) key lines(s) represent?*

For the purposes of comparability between firms within and across industries, it would be desirable to have a single headline measure of performance that can be used by investors for comparison with benchmarks and the derivation of various investment metrics. The focus of debate will then be what that measure should be.

A credible approach would be to take the bottom line of the statement of income and expense as that measure. This might be acceptable provided other relevant measures required by users are also included in the statement (see question B below). Many industries also have their own specific key performance indicators not all of which will be financial but in general these are covered outside the performance statement in for example separate management reports.

This solution also reduces questions over whether certain items should be included in the income statement or the statement of income and expenses to second order problems.

Investors main concern will be to gauge the quality of earnings and how this impacts on management. For example the revenue figure will give an indication of the skill of management in developing products and in selling and distributing those products while expenditure will reflect to some extent managements' ability to keep costs under control. Other ingredients of performance will reflect the firm's skill in capital management. On the other hand an increase in investment values may arise because management has been particularly astute in selecting investments or because of rising stock markets.

Accounts users must have sufficient information to make their own judgements. In this regard, whether particular profits or gains are reflected in the profit and loss account or in equity, is largely a matter of accounting convention, subject to change as accounting thought develops, but not necessarily of any great relevance to accounts users.

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 have already alluded in the answer to question A that there are certain active and passive components of performance in terms of management input. We believe however that the performance statement should incorporate sub-totals that reflect other aspects of performance that accounts users will want to see. EBITDA has become a popular measure especially for capital intensive firms with significant amounts of debt. Operating profit is also an important measure, although in need of some standardisation in terms of its definition. European life insurers would also like profit based on the European Embedded Values methodology to figure prominently in the income statement.

It should not be lost sight of however that the performance statement is only one element of the financial statements and that other useful and relevant information can be found in the cash flow statement and the notes to the accounts.

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 could be presented in a line on the statement of income and expense. Its value is limited however in the absence of any stable consensus on how it should be derived. In particular, there is still a conceptual debate over whether some items contribute to net income or should be treated as changes in equity.

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?*

It will be for individual users to decide which line is most relevant to their needs based on their individual criteria. However, if there is to be a main point of comparison, the bottom line would seem to be a strong contender as it reflects the total balance sheet movement (excluding transactions with owners as owners) whereas other measures are just a subset of this. We do not see why it would ever be necessary to have more than one performance statement provided that it includes those measures that investors find helpful and those measures reflect the business model and the way it is managed.

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

Much of the confusion on recycling results from the accounting presentation and in particular the current two-statement approach. In reality there is no double counting of gains. Unrealised gains are recognised as they arise either in the income statement or the statement of income and expense. The whole of any gain arising on realisation by reference to original cost is then recognised but this is offset by elimination of the unrealised gains previously recognised. The problem is that this reversal of previously recognised unrealised gains is often lost in the overall movement in such unrealised gains over the accounting period.

A better presentation might be to present realised gains and the reversal of the related unrealised gains together with a separate line for the movement in unrealised gains on assets held at the balance sheet date. This would enable accounts users to see the overall gain or loss arising on an asset over the whole period of ownership and the amount arising in the accounting period of disposal.

A potential difficulty with this approach however is that currently the income statement is seen as something separate and distinct from the other items included in the statement of income and expenses. As a result, the inclusion of realised gains in the income statement is viewed in isolation from any reversal of unrealised gains recognised outside the income statement and this is regarded as recycling (i.e. the gains appear once in the statement of income and expenses but outside the income statement and later they appear again in the income statement). Proper disclosure of the reversal of previously recognised unrealised gains however should correct this misleading impression.

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?*

We think all the disaggregation criteria merit further consideration. Some of them however may give rise to definitional issues, problems of subjectivity, and might be difficult to implement in practice. In particular, there might be difficulties in distinguishing between certain and uncertain events, sustainable and non-sustainable results and controllable and uncontrollable variables. Attempting to do so might be misleading and engender false confidence, for example if items listed as certain subsequently turn out to be uncertain.

The distinction between cash flows and accruals is already recognised in financial statements.

The distinction between re-measurement and before remeasurement is important. In an insurance context for example it could reflect the impact on claims provisions of changes in assumptions and/or methodology.

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 agree with the requirements of paragraph 33 of IAS 1 that assets and liabilities, and income and expenses should be reported separately except where offsetting better reflects the nature of the transaction or other event.

We do not wholly agree with IAS 1 in its definition of off-setting. For example, accounts users might prefer separate disclosure of any allowance for bad debts or stock obsolescence. Rather than just being a measurement adjustment, this may be important data in judging management performance.

In some circumstances, there may be a case for linked presentation where appropriate; that is for the presentation together of assets and liabilities that are related, for example a loan and the assets that it is secured against.

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?*

There are a number of non-GAAP measures made by entities. EBITDA is perhaps the most referred to. These are intended to provide accounts users with information that they find helpful but which is not mandated by legal or accounting requirements. It might be desirable to incorporate some of these into the GAAP model but this would require some standardisation in the way these measures are determined.

In relation to life insurance business, we would like to see greater recognition of the European Embedded Values Methodology. Ideally this should supplant the existing accounting presentation rather than being incorporated into it. The justification for this methodology is that it is more relevant as a measure of performance because it gives an indication of profitability of contracts that are long term in nature over the whole period of the contract rather than the snapshot of performance in a discrete period provided by the current GAAP presentation.

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?*

Prior to the introduction the EU Regulation on the use of IFRS, the precise formats set out in the European accounting directives applied to the generality companies, although banks and insurers had their own industry specific accounting formats. These formats still apply to firms that are not require and do not choose to adopt IFRS. There is some merit in a prescriptive approach as it aids comparability. However, there are also some dangers. Firstly, the prescribed presentation should not prohibit alternative ways of presenting certain items or the addition of extra lines if this is more helpful to accounts users. Secondly, it should not constrain developments in accounting methodologies that more accurately reflect performance simply because there is no line, box or sub-total in the prescribed format for new items resulting from the application of the superior methodology.

As the Discussion Paper recognises, some specialised industries such as insurance and banking will require a format that more closely reflects their business model.

We are also concerned that any prescribed format should not require too much information to be shown in the performance statement itself. In particular any requirement to include items by type as well as function on the face of the performance statement could make them over-complex and thereby detract from the usefulness of the performance statements. Consideration will therefore need to be given to presenting any additional disclosure requirements in the notes to the accounts.

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