



European Financial Reporting Advisory Group ■



Pro-active Accounting Activities in Europe

■ PAAinE

A photograph of two men in business suits walking across a large, glowing map of Europe. The map is superimposed on a blurred background of a modern office interior with large windows and a desk.

## DISCUSSION PAPER 2

### THE PERFORMANCE REPORTING DEBATE

**What ( if anything ) is wrong with  
the good old income statement?**

November 2006

*This paper has been prepared jointly by the staff of the Spanish standard-setter, the Instituto de Contabilidad y Auditoría de Cuentas (or ICAC), and the staff of EFRAG as part of Europe's PAAinE initiative. It has been approved and issued by ICAC and EFRAG. The paper (in near-final form) was considered at the quarterly meeting between EFRAG and representatives of the European National Standard-Setters (ENSS) on 11 October 2006, and the representatives of the ENSS confirmed that they were content for the paper to be issued to stimulate debate. The paper has been posted on the ICAC and EFRAG websites and the intention is that it will also be posted on other ENSS websites. A limited number of copies of the paper will also be available in a printed form.*

*Paragraph 1.15 invites comment on the discussion in the paper in order to help the authors in the next stage of the project. Such comments should be sent by email to [commentletter@efrag.org](mailto:commentletter@efrag.org) or by post to EFRAG, 13-14 Avenue des Arts, 1210 Brussels, Belgium, so as to arrive no later than 31 March 2007. All comments received will be placed on the public record unless confidentiality is requested.*

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### **About the PAAinE**

EFRAG and the European National Standard Setters have agreed to pool some of their resources and work together more closely so that Europe as a whole can participate more effectively in the global accounting debate. It was agreed that this initiative should in the beginning concentrate on long-term pro-active work. The objective of the initiative is to stimulate debate on important items on the IASB agenda at an early stage in the standard-setting process before the IASB formally issues its proposals. The initiative has the joint ambitions of representing a European point of view and exercising greater influence on the standard-setting process. This initiative is known as the 'Proactive Accounting Activities in Europe' (or PAAinE) initiative.

Several projects have commenced under the PAAinE initiative, and this paper is the result of the PAAinE project that relates to the joint IASB/FASB project on Financial Statement Presentation.

Work carried out under the PAAinE initiative can take a number of different forms and the full objectives of the initiative are:

- to stimulate, carry out and manage pro-active development activities designed to encourage the debate in Europe on accounting matters and to enhance the quality of the pro-active input to the IASB;
- to co-ordinate and resource monitoring work of IASB and FASB projects; and
- to try to ensure, as far as is practicable, that the messages Europe gives the IASB are consistent.

A further description of the PAAinE initiative is available on the EFRAG website ([www.efrag.org](http://www.efrag.org)).

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## **1 Introduction**

### *Reasons for this project*

- 1.1 The current formats for reporting performance of an entity (as prescribed by IAS 1 *Presentation of Financial Statements*) were initially developed when the assets employed were mainly inventory, machinery and buildings and the operating activity mainly manufacturing or retailing. As entities have started to acquire more diverse assets and liabilities, carry out more complex operating and financing activities, and use more complex corporate structures, so the reporting model has had to be adapted to try to cope with the issues that these developments have created.

For that reason, and also because of the ever increasing intricacy of the environment and conditions in which entities operate and the growth and increasing maturity of the financial markets, accounting has evolved dramatically over the last couple of decades and become more sophisticated and complex. Accounting for share based payments and the introduction of the mixed attribute accounting model with a significant number of assets and liabilities measured at fair values are only two examples of this.

- 1.2 However, to date there have been only incremental changes to the performance reporting model. Although further incremental changes could no doubt be made, some market participants are now arguing that there is a need for fundamental changes to the model. For example, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are currently carrying out a joint project<sup>1</sup> addressing, amongst other things, how best to report and present information about financial performance. It currently seems likely that the Boards may propose some radical changes to the existing model.

The prospect of making fundamental changes to the performance reporting model is already proving highly controversial, because many believe that, although the existing model is not flawless (so there is room for improvement), the need for fundamental change has been neither demonstrated nor clearly articulated.

It is clear that many European participants in the debate have very strong views about performance reporting. Therefore, to encourage an early, comprehensive and fully informed debate within Europe on the subject—and therefore enhance Europe's contribution to the global debate—the European national standard-setters and EFRAG have decided to undertake their own work on the subject through the PAAinE initiative.

### *Objectives of this paper*

- 1.3 The intention is that this project will result in two papers. This first paper attempts to set the scene for the debate. It seeks to do that by:
- (a) identifying the perceived weaknesses of the existing performance reporting model as alleged by those who believe that it is in need of fundamental change; (see section 3)

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<sup>1</sup> The joint IASB/FASB project is now called 'Financial Statement Presentation', although prior to March 2006 it was called 'Performance Reporting'.

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- (b) articulating the basic position of those who believe that no fundamental changes to the current performance reporting model are necessary. The objective of this part of the paper is to express that position in the context of the qualities of the current reporting model rather than in the context of the allegations described in section 3. The validity of the arguments for and against fundamental change will be part of the scope of a later paper; (see section 4)
- (c) to analyse the alleged weaknesses identified in order to identify the specific issues that need to be discussed in more detail to determine what (if any) changes to the current reporting model should be considered. Some of those issues will be debated in the second paper of this project; (see sections 4 and 7) and
- (d) to describe other perceived weaknesses in the current reporting model that, it is alleged, prevent the usefulness of the information presented about financial performance being maximised. These weaknesses are identified separately from those referred to in (a) above because there seems to be a widely held view that they could be dealt with by refining the existing performance reporting model, rather than making fundamental change. (see sections 5 - 7)

The prospect of making fundamental changes to the existing performance reporting model is potentially highly controversial partly because the subject of reporting entity performance is one which many market participants are deeply interested in and about which many have strong views. However, another reason is that to date those participating in the debate seem to have a tendency to express their views in ways that take little account of, and make little effort to respond to, the views of the 'other side'. This paper will therefore attempt to take into account the opposing views. However, it will not reach any conclusions about those views—that is for the second paper.

- 1.4 The discussion in sections 3 to 6 of this paper is then summarised by listing (in section 7) the issues that need to be discussed further in order to determine the future direction of performance reporting. The second paper will debate those specific issues, which are essentially issues of disaggregation, grouping and subtotalling of performance information.

Currently items of income and expense<sup>2</sup> are divided into two categories, some being included in net income (ie within the income statement) and some being reported outside the income statement. (This paper refers to this as 'the net income notion.')

The implication is that items included in the income statement possess attributes that allow them to 'capture' and report an entity's performance that other items are alleged not to have. This therefore places an emphasis on the net income subtotal. Whether such emphasis on a net income notion is meaningful and should be retained is at the heart of the performance reporting debate and this is one of the questions that will be considered in the second paper.

- 1.5 It is important to highlight here once again that it is not the objective of this first paper to evaluate the various arguments that are advanced in favour of or against fundamental change; that will be the objective of the second paper. Nor should it be assumed that, simply because this paper sets out and explains in some detail the views of proponents and opponents of fundamental change, those views are

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<sup>2</sup> The terminology used in this paper is explained in paragraphs 1.10 – 1.14

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necessarily shared by the authors of this paper or the organisations issuing it. In fact, the views are the opinions of a variety of market participants and have been collected from a number of sources (including internal and external papers written by standard-setters, academic research and meetings with users and preparers).

#### *What this paper does and does not cover*

- 1.6 This paper focuses exclusively on the presentation of items of income and expense (as defined in paragraph 1.11 below) in the primary financial statement(s)—the income statement and other statement(s) of income and expense (terms that are defined in paragraphs 1.12 and 1.13). The paper does not address the cash flow statement, the balance sheet or the statement of changes in equity.
- 1.7 This paper does not address recognition or measurement. It is taken as a given that transactions and events are recognised and measured in accordance with the accounting standards that are in force at the time of writing this paper (November 2006).
- 1.8 Furthermore, when describing the alleged pros and cons of the current reporting model, this paper bases its analysis on financial reporting as defined by the version of IAS 1 that is in force at time of writing this paper (ie no consideration is given to the amendments proposed in the exposure draft the IASB issued in March 2006, *Amendments to IAS 1 Presentation of Financial Statements: A Revised Presentation*).

#### *Specialised industry considerations and specialised SME type considerations*

- 1.9 Currently, the performance reporting model adopted varies to some extent depending on the type of activities the entity undertakes. For example, the items in the income statement of an insurer are presented in a different way from the items in the income statement of a bank, which are in turn presented in a different way from the items in the income statement of a manufacturing company. The approach taken in developing this paper was to analyse and discuss initially matters that are applicable to a wide spectrum of industries without focusing specifically on specialised industries or considering the implications for smaller, non-listed entities. That analysis and discussion were then reconsidered to see if there were any issues that needed to be taken into account to enable specialised industry and SME matters to be addressed, so that ultimately this paper would apply to all entities in scope of IFRSs. At the level at which this paper is written, no such specialised matters were identified.

Similarly, the paper's discussion is intended to apply to both separate and consolidated financial statements.

As a result, the authors believe that the issues raised in this paper apply to all entities and to all financial statements within the scope of IFRSs.

#### *Terminology used in this paper*

- 1.10 The terms set out below are used in this paper with the meanings also set out below. Those meanings are in all cases consistent with the way the terms are defined by the accounting standards in place at the time of writing this paper.
- 1.11 *Income and expense*—all changes in net assets during the period excluding those that result from transactions with owners in their capacity as owners (such as the

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injection of additional equity capital or the payment of dividends to equity holders). Specifically, “income is increases in economic benefits during the accounting period in the form of inflow or enhancement of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Expenses are decreases in economic benefits during the accounting period in the form of outflow or depletion of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.”<sup>3</sup>

- 1.12 *Income statement*—a primary financial statement in a model based on the principle that not all items of income and expense are presented in one statement. The income statement includes, amongst other things, operating income and excludes certain items that are presented in the statement of other income and expense or the statement of changes in equity. The bottom line of the income statement shows net income.
- 1.13 *Statement(s) of income and expense*—a generalised term used to describe the statement (or all the statements) that report all current period items of income and expense.<sup>4</sup> In the context of the existing reporting model, this includes statement(s) other than income statement where some of the current period items of income and expense are reported (such as the statement of changes in equity or statement of recognised income and expense).
- 1.14 *Recycling*—a way of presenting results of certain events that is a consequence of using two different sets of recognition criteria to report items of income and expense. When two sets of recognition criteria are used, the effect is that items of income and expense are reported initially in one statement of income and expense (or part thereof) and then, in a subsequent period when the second set of criteria is met, in another statement of income and expense (or another part thereof). For example, increases and decreases in the values of available for sale securities are recognised outside the income statement initially and then, when the instruments are sold (or in certain other limited circumstances), they are recycled to (and recognised in) the income statement.

*Invitation to comment*

- 1.15 We welcome constituents’ views on the matters raised in the paper. Such comments are useful for two reasons. First of all, they may highlight a weakness or omission in the paper’s analysis that could have an impact on the approach adopted in the second paper of this project. Secondly, they will help us to better understand the issues and arguments being considered in that part of the project. For those reasons we would greatly appreciate it if the responses sent to us were as detailed as possible and included arguments in support of the positions expressed.

It would be particularly useful to us in developing the second paper if constituents could comment on some or all of the questions 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

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<sup>3</sup> The IASB’s *Framework for the Preparation and Presentation of Financial Statements*.(henceforth ‘IASB Framework’), paragraph 70.

<sup>4</sup> For the purposes of this paper, the cumulative effects of retrospective application of changes in accounting policies and in corrections of errors are not items of current period income and expense.



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

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

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- Holding gains and losses vs. non-holding gains and losses.
- 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?
- 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?
- 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?

## **2 Setting the scene**

2.1 Before we start considering the allegations made about the existing reporting model, we need first to deal with three issues that, though often mentioned in the debate, are actually not central to the debate because they neither demonstrate the advantages of the current reporting model nor illustrate its weaknesses.

2.2 The first issue concerns whether different presentations really make a difference. Some argue that there is no need to consider making changes to the presentation of financial performance because sophisticated analysts will come to the same conclusions regardless of the form in which financial information is presented. In their view much energy is wasted by management in designing, and by standard setters in prohibiting, forms of presentation that the good analyst will unpick anyway. Informed investors will search for information they require regardless of where it is located and will know how to analyse and interpret financial data regardless of the way it is reported. As such, the usefulness of financial information to market participants does not depend on the way that information is presented.

However logical this might sound, experience shows that it *does* matter how and where the information is presented. In fact, this is implicitly accepted by for example those arguing over whether there should be one statement of income and expense, and those arguing whether the net income notion should be retained. Research also suggests that presentation matters. Hence a debate about presentation *is* necessary.

2.3 Secondly, some argue that a fundamental change needs to be made simply to bring performance reporting into line with the current IASB Framework—because the Framework does not differentiate between different types of income and expense nor does it contain any sort of net income notion. However, such an argument treats consistency with the Framework as an end in itself when in fact, although adherence to the Framework is essential, the Framework can and should be changed if the concepts are proven to be inadequate. Ultimately, the only relevant tests of a proposed change are whether the financial statements would be

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more useful as a result and whether the change is practically implementable, not whether they would be more consistent with the existing Framework. Sometimes the debates over proposed changes lose sight of this important fact and it is essential that we keep it in mind throughout our debate.

- 2.4 Finally, reference is sometimes made to ‘accounting scandals’ as evidence of the need to change accounting standards or existing practice, and some call for the accounting standards to be established in such a manner that would prevent abuse. This argument is also sometimes used to criticise the existence of two statements of income and expense on the grounds that the current split between the income statement and the second statement of income and expense encourages entities to manipulate published performance information.

However, it is not appropriate to allow concerns about accounting abuse to drive the standard setting process. Instead, standard setting should concentrate on identifying the right principles and finding ways of implementing them in a robust way. If this is done, there is no need to give any additional specific consideration to the potential for abuse.

### **3 What the current reporting model is and what its alleged fundamental flaws are**

#### *The current reporting model*

- 3.1 If one had to summarise the essence of the current performance reporting model it could be done by stating that it focuses on and largely revolves around a net income notion. As the IASB's current Framework explains, “information about performance is primarily provided in an income statement”,<sup>5</sup> the bottom line of which under IAS 1 is profit or loss.

As it currently stands, not all items that comprise income and expense are eligible for recognition in the income statement when they arise, although some of them subsequently become eligible. In other words, two different sets of recognition criteria are in use. Recycling is used to move those items recognised outside net income when the first set of criteria is met into net income when the second set is met.

Thus we have a system where income and expense are recorded in one of the two statements, with the main focus placed on the first statement as it is the income statement that is or at least is meant to be the main source of the information about entity performance.

#### *Alleged fundamental flaws*

- 3.2 Currently the following items that represent current<sup>6</sup> period income and expense have to or can be presented outside the income statement (net of current and deferred tax):
- Gains and losses arising from translating the financial statements of a foreign operation. IAS 21 *The Effect of Changes in Foreign Exchange Rates*

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<sup>5</sup> IASB Framework, paragraph 19.

<sup>6</sup> As already mentioned, for the purposes of this paper the correction of errors and the cumulative effects of changes in accounting policies are not items of current period income and expense. This is consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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explains that “these exchange differences are not recognised in profit or loss because [they] have little or no direct effect on the present and future cash flows from operations”.<sup>7</sup>

- Gains and losses on re-measuring available-for-sale financial assets. The rationale for this is not explicitly explained in the basis for conclusion of the relevant standard.<sup>8</sup> It appears that the reason for such accounting is that, although the re-measurement of available-for-sale assets to fair value is required, these assets might be held by entities for extended periods of time and recognition in the income statement of potentially significant changes in value that might reverse in subsequent periods would not reflect the underlying nature of the entity’s performance or the way in which it is managed.
- The effective portion of gains and losses on hedging instruments in a cash flow hedge. The reason why IFRS requires these gains and losses not to be recognised in the income statement as soon as they arise is because it is thought to be more representationally faithful to defer their recognition in net income until they can be matched with the gains and losses on the hedged item.
- Changes in the revaluation surplus of property, plant and equipment. Again, the reasoning is not specified by the IASB but exclusion from the income statement was probably because initially these were the only revaluations permitted and it was thought appropriate to keep ‘holding gains’ separate from other gains and losses, particularly bearing in mind the potential size and volatility of the numbers that would otherwise be recognised in the income statement without any assurance of or proximity to realisation.<sup>9</sup>
- Actuarial gains and losses on defined benefit pension plans. Paragraphs BC48C(c) and BC48E of IAS 19 *Employee Benefits* states the rationale for this is that “whether or not the volatility resulting from immediate recognition [in the income statement] reflects economic events of the period, it is too great to be acceptable in the financial statements. It could overwhelm the profit and loss ... of other business operations. ... The IASB accepts that requiring actuarial gains and losses to be recognised in full in profit or loss in the period in which they occur is not appropriate at this time because the IASB has yet to develop fully the appropriate presentation of profit or loss and other items of recognised income and expense.”

Some claim that there is no consistent reason or reasons for excluding these items from the income statement and that is a serious weakness in the existing model. It is, however, probably overstating things at the current time to say there is no consistent reason. Certainly practice in this area has developed in a somewhat ad hoc fashion, but that does not necessarily mean that a consistent rationale cannot be developed—even if that might mean changing the list of items that are excluded. Therefore, it might be more accurate to describe this concern in the following terms: **no consistent and credible principle or principles has to date been articulated as to which items of income and expense are shown where.**

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<sup>7</sup> IAS 21, paragraph 41

<sup>8</sup> IAS 39 *Financial Instruments: Recognition and Measurement*,

<sup>9</sup> The concept of realisation and of ‘a realised profits’ 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.

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Some think that it is not possible to develop a consistent rationale and, in the absence of such a rationale, it is not appropriate to differentiate between items. They argue that the net income notion should therefore be abandoned and there should be a single statement. They further argue that, in order to build a full picture regarding the past and future financial performance of an entity, it is essential that all transactions and events that change net assets (other than transactions with owners) must be recognised in a single statement (the statement of changes in net assets available to common shareholders), not merely those that have traditionally been considered to be components of performance. They also argue that, if there is to be an exception to this, it needs to be a principled exception.

Others, while accepting that a consistent, well articulated and credible rationale as to which items of income and expense are shown where needs to be articulated, believe that it is possible to develop such a rationale.

3.3 The adoption of a two statement approach—with recognition of the effects of income and expenses in the balance sheet not always being synonymous with their recognition in the income statement—is the primary reason why recycling has developed. Recycling enables items of income and expense recognised in an earlier period outside of the income statement to be recognised in the income statement in a later period.<sup>10</sup> Thus, it enables different recognition criteria to be applied to the income statement from those applied to the balance sheet. However, although those additional criteria are in most cases loosely based around realisation, as can be seen from the following summary of the IFRS requirements in relation to recycling, there are inconsistencies in principle and in detail.

- Gains and losses arising from translating the financial statements of a foreign operation are recycled to the income statement only if and when that foreign operation is sold or otherwise disposed of.<sup>11</sup>
- Gains and losses on re-measuring available-for-sale financial assets are recycled. “A gain or loss on an available-for-sale financial asset shall be recognised [outside the income statement] ..., except for impairment losses ... and foreign exchange gains and losses ..., until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised [outside the income statement] shall be recognised in profit or loss.”<sup>12</sup>
- The effective portion of gains and losses on hedging instruments in a cash flow hedge is recycled to the income statement in subsequent periods so as to match the gains and losses on the items being hedged although, if the entity expects that all or some of a loss recognised directly in equity will not be recovered in one or more future periods, it should immediately recycle to the income statement the amount that is not expected to be recovered.<sup>13</sup>
- Changes in the property, plant and equipment revaluation surplus are not recycled. Instead, paragraph 41 of IAS 16 *Property, Plant and Equipment*

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<sup>10</sup> It can also be used to present gains and losses recognised in one part of the income statement in an earlier period in a different part of the same statement in a later period.

<sup>11</sup> IAS 21, paragraph 48

<sup>12</sup> IAS 39, paragraph 55 (b)

<sup>13</sup> IAS 39, paragraph 97

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states that “the revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised”.

- Actuarial gains and losses on defined benefit pension plans (recorded outside the income statement in accordance with IAS 19, paragraph 93A) are not recycled. The IASB decided on this treatment “because of the pragmatic inability to identify a suitable basis and [because such a decision] does not prejudice the wider debate that will take place in the project of reporting comprehensive income”.<sup>14</sup>

Some critics of recycling look at the summary above and argue that there is no consistent conceptual rationale for the recycling requirements that exist currently and that it follows from that that recycling should be abandoned. However, while the inconsistencies noted above are acknowledged, it would be more accurate to argue that **a consistent, well articulated and credible principle has not to date been developed for deciding which items should be recycled when between the statements**. Some would say it is not possible to develop a consistent and credible recycling principle; others would disagree.

Some argue that inconsistencies in recycling principles are not the main issue. In their view, the main issue is whether recycling techniques should be applied at all. They argue that, as all changes in net assets reflect the performance of an entity, such changes should be reported once—as and when they occur. Recycling results in them being reported twice. However, recycling is merely a tool that is used to ensure that items of income and expense are recognised in a manner that is consistent with the reporting principles adopted; in other words, if we have a reporting model that adopts one set of recognition criteria for the balance sheet and another for the income statement, there will usually be a need for recycling. Thus, the debate about whether recycling is needed and useful is not a separate debate; its outcome will be a consequence of the conclusions reached about the net income notion and the need for two sets of recognition criteria.

It should be noted that, notwithstanding the conclusions as to whether net income has merits, recycling can also be employed simply to accommodate a second presentation criterion. For example, items of income and expense can be disclosed according to their nature (for example, revenues, salary costs, depreciation, etc.) with further segregation of realised<sup>15</sup> items from unrealised. This aspect of recycling will be considered when discussing the disaggregation principles.

- 3.4 Finally, some criticise the existing **two statement approach** because it **creates a risk that one statement will be given a lower profile than the other and, as a result, important information will be overlooked**. Some argue that—even if it is accepted that presentation matters (see paragraph 2.2 of this paper)—whether information is given in one statement of income and expense or, say, two is not important. Others, however, believe this not to be the case and assert that in practice users and preparers attach different levels of significance to income and expenses reported in different statements simply because they are reported in different statements. In particular, given that the logic and principles for taking income and expenses to different statements are not currently well articulated,

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<sup>14</sup> IAS 19, Basis for Conclusions paragraph 48R

<sup>15</sup> 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.

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many appear to assume that the information in the second statement is not as relevant as the information in the first statement and as a result tend to downgrade the second statement and the information reported in it.

No empirical evidence appears to be available concerning the degree of relevance attached to each of the statements of income and expense as a whole. However, research studies seem to confirm that the same items are treated differently by users depending on whether they are presented in the income statement or in the statement of changes in owners' equity. For example, D. Eric Hirst and Patrick E. Hopkins<sup>16</sup> studied whether the two types of comprehensive income presentation (in the income statement and in statement of changes in owners' equity) affect the judgment of buy-side equity analysts when they estimate the stock price of a company that upwardly manages<sup>17</sup> its net income through its available-for-sale marketable security portfolio. In other words, does the analysts' valuation of such companies differ depending on whether gains on available-for-sale marketable securities are shown in the first statement or the second? Hirst and Hopkins concluded that it did.<sup>18</sup>

Similarly, Laureen A. Maines and Linda S McDaniel<sup>19</sup> carried out a study to try to determine if non-professional investors' judgement is influenced by whether items of other comprehensive income and expense are presented in the income statement rather than the statement of changes in equity. They concluded that the "format affects how non-professional investors weight comprehensive income information ... [but] not whether they acquire this information or how they evaluate it".

Although it could be argued that this research supports the view that the first statement is viewed as being more important than the second, there are other interpretations because it is not clear, for example, whether and to what extent it is really possible to isolate the effect of having two statements from the effect of the particular approach adopted in classifying items between the two statements.

- 3.5 So, to summarise, the current reporting model is based around a net income notion and it uses recycling techniques to recognise items of income and expense that have previously been recognised outside net income within net income at the appropriate time. Some believe that there is no consistent, well-articulated and credible rationale underpinning the model—no such rationale has been developed to date and, in their view, no such rationale is capable of being developed. As such, in their view the current net income reporting model should be abandoned in favour of a model that is based on a consistent, well-articulated rationale, and would almost certainly involve a single comprehensive statement of income and expenses. Until that happens, important information will continue to be overlooked simply because it has not been deemed to be part of net income.

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<sup>16</sup> "Comprehensive Income Disclosures and Analysts' Valuation Judgments", February 1998

<sup>17</sup> Where companies recognised previous periods' holding gains on its available-for-sale securities by selling a portion of its marketable portfolio in the current year and repurchasing securities of equal value

<sup>18</sup> They concluded that, in the presence of upward earnings management, presentation of comprehensive income in the statement of changes in owners' equity caused analysts' valuation judgments to fall between the valuation judgment observed when there is not comprehensive income presentation and when comprehensive income is presented in the income statement. They however found that comprehensive income presentation has no effect on analysts' stock price judgment in the absence of earnings management

<sup>19</sup> "Effects of Comprehensive Income Characteristics on Non professional Investors' Judgements: The Role of Financial Statement Presentation Format", December 1999.

## **4 What the current reporting model is thought to do well**

- 4.1 Assessing the validity of the views explained in section 3 (and summarised in paragraph 3.5) is outside the scope of this paper—it will be dealt with in the next paper. However, one has to acknowledge that the existing model is a product of the long journey that accounting has undertaken and some strongly believe that it is no accident that things are the way they are—they are that way for a reason. Additionally, while accepting that there is always room for improvement, many do not believe a case has been made for fundamental change. These views are elaborated on further below.
- 4.2 **The present income statement measures effectively the entity's degree of success in fulfilling its primary socio-economic function.** The primary socio-economic function of an entity is to provide for the material needs of society by producing goods and services in the most economically efficient manner. Some, as noted above, argue that, in order to fully assess how successful an entity has been in fulfilling this function, one needs to look at all the changes between the opening and closing net asset positions that arose as a result of transactions other than transactions with owners. Others believe that users focus on the underlying business activities that capture events and transactions closest to cash flows, and that does not necessarily equate to an analysis of the changes between the opening and closing balance sheets. In their opinion, the present income statement measures effectively the entity's degree of success in fulfilling its primary socio-economic function by showing the value of its output compared with the economic resources consumed in producing it at the value spent to acquire them. In doing so it simultaneously supports stewardship by displaying, amongst other things, the return secured for shareholders on the amounts actually invested.
- 4.3 **The current income statement is a widely used tool for managing business and, therefore, is an important part of the internal reporting system. Any substantial changes to it will lead to divergence between internal and external reporting, which is undesirable.** The current income statement has been found over time to be a valuable instrument internally for planning and managing the financial activities and performance of an entity and appears to reflect properly the way management sees the business. Furthermore, the current income statement links in well with modern EVA-based techniques<sup>20</sup> (both focus on sustainable income and cash flow generation) and thus with the process of shareholder value creation.

Incremental changes to the external reporting model tend to be incorporated into internal reporting model, because either they reflect the manner in which business operates or they are not of such significance that they require big changes to the way the reporting entity is managed. However, some believe that the fundamental changes currently being discussed are of a different nature and that as a result internal reporting could not be aligned to accommodate them. The adoption of a performance reporting presentation for external reporting that is significantly different from the approach used internally would raise a number of important questions and concerns.

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<sup>20</sup> EVA (Economic Value Added) is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in enterprise. EVA is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk.



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- As it currently stands, the current presentation formats seem to be widely considered by management to reflect appropriately the economic performance<sup>21</sup> of their entities for internal purposes. It is not clear why what is appropriate for managing the business would not be appropriate for external reporting. If managements exclude some items of income and expense from their internal performance evaluation reporting (or, at the very least, downgrade the importance of some items), it will be because the items of income and expense merit that treatment. It is essential therefore that a common understanding of the term 'performance' is achieved in order to help prevent the divergence of external and internal reporting.
- A divergence between internal and external information could potentially lead to significant negative effects such as a reduction in the quality and reliability of the external information, gaps in understanding between preparers and users and increased complexity in financial reporting. These factors need to be carefully considered in assessing the appropriateness of the suggested fundamental changes. And, if changes leading to such divergence are nevertheless pursued, it is essential that such negative effects are offset by demonstrable benefits.

4.4 **There is little evidence of dissatisfaction with or demand for fundamental change in the performance reporting model.** Financial reporting is essentially a means of communicating financial information between the primary parties concerned, namely the preparers and the users. Any changes to financial reporting ought therefore to derive from the unmet needs of those parties. The great majority of users have not made preparers aware of any fundamental dissatisfaction with the current presentation of financial statements, which they appear to find acceptable as a basis for determining past, and forecasting future, sustainable earnings and cash flows after exclusion of non-recurring items—the basis for their decision-making.

Generally preparers respond to users' needs and requests by providing information that is in addition to that required by accounting standards. That is because it is in preparers' interest to ensure that users understand the entity and what has happened to it so that they can take their economic decisions on a well-informed basis. Such information—to be found in the Management Commentary and in the notes to the financial statements, in presentations to financial analysts and in similar sources—generally focuses on trends, the financial impacts of non- or infrequently recurring 'special' events (such as acquisitions, divestments and restructuring) and business developments (markets and competitive positions, margins, innovation and development pipelines, prospects for new products and services, and strategic options). An understanding of these items is clearly essential if users are to make reasonable forecasts of future free cash flows and long-term sustainable earnings of the entity. Such additional disclosure, however, does not necessarily indicate that there are shortfalls in the existing performance reporting model. Rather, this information complements the information on entity performance provided by the primary financial statements.

4.5 **No substantial body of evidence exists to prove that any of the fundamental changes that have been suggested would lead to information of a greater confirmatory or predictive value (ie greater relevance).** While some argue that the current reporting model is in need of fundamental change, so far it has not

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<sup>21</sup> The term 'performance' appears to mean different things to different people, so if it were to be used in further discussions or indeed a standard setting it would need to be defined.

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been demonstrated how the fundamental changes being suggested—abandoning the net income notion and reporting all items of income and expense immediately in a single statement of income and expense—would improve the quality of the predictions users make or would otherwise assist them in assessing past performance.

One would have thought that, if such changes are being suggested, the research performed by academics around the globe on the issue would be supportive. Yet, although substantial research has been performed, the results do not appear to be conclusive. For example, although D. Eric Hirst and Patrick E. Hopkins<sup>22</sup> found that the ability of analysts to estimate the share values is enhanced by the disaggregation of comprehensive income components, Dan Dhaliwal, K. R. Subramanyam and Robert Trezevant<sup>23</sup>—who investigated the association between stock returns and alternative performance measures—concluded that “comprehensive income is no more strongly associated with returns/market value or better predicts future cash flows/income than net income”.

- 4.6 In summary, some believe that the current net income/two statements reporting model works well and seems to capture the essence of an entity’s financial performance. There also seems to be little demand for fundamental change, and no substantial body of evidence showing that the fundamental changes being suggested will improve the usefulness of the information provided. It seems clear though that the changes would result in a divergence between internal and external reporting, which would represent a significant ‘cost’. It is essential that the debate takes proper account of the demonstrable improvements to financial reporting and the costs that would arise from the changes being suggested, and only if the benefits exceed costs should the changes be implemented.

## **5 What is alleged to be wrong with the way items are currently aggregated**

- 5.1 In sections 3 and 4 we have explained briefly why some believe the current performance reporting model should be abandoned, and why some others believe that such a fundamental change has not and cannot be justified. Although there is more we want to say about these views, we will do so later (in section 7) because first we want to mention another part of the performance reporting debate: the way in which items of income and expenses are disaggregated and grouped in the statement(s) of income and expense. A number of market participants on both sides of the debate about fundamental change have been suggesting that the way in which items are disaggregated, grouped together and totalled may not maximise the usefulness of the information being provided. This general concern can be broken down into a number of detailed concerns:

- Items with different predictability content are aggregated together;
- Some items of income and expense are presented on a netted basis when it would be better were they to be presented separately; and
- A different pattern of aggregation is adopted in each of the primary financial statements.

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<sup>22</sup> “Comprehensive Income Disclosures and Analysts’ Valuation Judgments”, February 1998

<sup>23</sup> “Is Comprehensive Income Superior to Net Income as a Measure of Firm Performance?”, 1999

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These matters are discussed in detail in the following paragraphs. There is also a further concern—that there is insufficient comparability between entities. This is discussed in section 6.

- 5.2 **Items with different predictability content are aggregated together.** “The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation.”<sup>24</sup> In order to facilitate the projection of future cash flows based on past performance, some argue the information should be disaggregated in a way that would allow differentiation of the reported amounts depending on the likelihood of them repeating and converting into cash flows in future periods (taking into account changes in the operating and business environment).

For that reason, some allege that there is a need for different disaggregation criteria to be used in the statement(s) of income and expense. The suggested criteria are aimed at providing information as to whether the items of income and expense are driven by output, time or another factors, the pattern of their recurrence in the future and sustainability. Such information is currently not usually explicitly available from a set of financial statements.

Some further suggest that a flaw of the current statement(s) of income and expense is that it does not disaggregate earnings into cash flows and accruals. As demonstrated in research by Mary E. Barth, Donald P. Cram and Karen K. Nelson, “each major accrual reflects different information about future cash flows, resulting in different weight in prediction. In contrast, aggregate earnings implicitly place the same weight on each earnings component, masking information relevant to predicting future cash flows. Disaggregating cash flows from aggregate accruals significantly increases predictive ability relative to aggregate earnings, but disaggregating accruals into its major components further significantly increases predictive ability.”<sup>25</sup>

Furthermore, currently IAS 1 allows an entity to present an analysis of expenses using classification based on either the nature of expenses (ie by type of resources consumed, such as labour, depreciation, purchased materials, transport costs, employee benefits and advertising costs) or their function within the entity (‘cost of sales’ method), whichever provides information that is reliable and more relevant. Entities classifying expenses by function are also required to disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefit expense. However, some users of statements based on a functional analysis argue that such an analysis results in items—for example, pension expense and depreciation—with different properties—for example, frequency of occurrence—being aggregated together, thus reducing the predictive value of the information. (Users also argue that it reduces comparability across companies and consistency within the statements of a single entity).

- 5.3 **Some items of income and expense are presented on a netted basis when it would be better were they to be presented separately.** Accounting standards currently permit the results of transactions that do not generate revenue but are incidental to the main revenue-generating activities to be presented, “when this

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<sup>24</sup> IASB Framework, paragraph 15

<sup>25</sup> “Accruals and the Prediction of Future Cash Flows”, January 2001

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presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction. For example:

- (a) gains and losses on the disposal of non-current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses; and
- (b) expenditure related to a provision that is recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and reimbursed under a contractual arrangements with a third party (for example, a supplier warranty agreement) may be netted against the related reimbursement.<sup>26</sup>

For investors to be able to understand the changes that have occurred in such instances and, consequently, the changes to their wealth, it is essential that they are able to analyse the individual forces at work that affect the company's performance. Some argue that a net presentation causes important information to be obscured or lost altogether thus making it impossible for the investors to analyse information at the appropriate level of detail.

Others disagree, arguing that the current IAS 1 requirements are adequate as they provide principles that ensure that information that is important in assessing entity performance, wealth and ability to generate future cash flows is not concealed through netting.

- 5.4 **A different pattern of aggregation is adopted in each of the primary financial statements.** Investors need to understand a company's process of wealth generation and the prospects for their investments. Some argue that this means that investors need to understand the basis on which the entity's assets and liabilities are measured, the uncertainties that affect those asset and liability measures, and the causes of changes to those measures. They further argue that this can best be achieved by, amongst other things, ensuring that each of the primary financial statements should adopt the same approach to disaggregation and subtotalling, using the same categories in each statement. This enables the relationships between items in the different primary financial statements to be made clearer. Currently this is not the case since, for example, the categories used in the cash flow statement are usually not in line with the items presented in the income statement so the statements do not follow a consistent structure or the same pattern of aggregation.

The IASB refers to this as presenting a 'cohesive' financial picture of an entity.

The need for a "cohesive financial picture" is something that can really be debated only in a wider context than this project, which is focused on the statement(s) of income and expense. However, some would argue that each primary financial statement has a different objective<sup>27</sup> and, because the optimum structure and

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<sup>26</sup> IAS 1, paragraph 34.

<sup>27</sup> For example, paragraphs 17 – 19 of the current IASB Framework state the following in relation to the objectives of the individual financial statements. "Information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. ... Information concerning changes in the financial position of an entity is useful in order to assess its investing, financing and operating activities during the reporting period. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement"

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categorisation of each statement might differ depending on that objective, the primary aim should be to get the right structure and categorisation for each statement so that each statement can meet its objective as effectively as possible. In their view, the degree of, need for and feasibility of cohesiveness should be discussed within that context.

## **6 What is thought to make comparability difficult**

6.1 Present IAS 1 requirements are often criticised as allowing too much flexibility. Some argue that, unless formats and various disaggregation criteria are mandated, comparability amongst entities is hindered. Others believe that business models can differ so much from one sector to the next that any standardisation beyond the existing requirements will be to the detriment of the users because it will prevent entities from portraying their performance in the optimal way. In this context, the following concerns in particular have been raised and they are described in more detail below.

- Non-GAAP measures are often used to highlight underlying performance; but there is little consistency in the approach to such measures;
- The variety of the presentation formats allowed impedes comparability; and
- Some terms are used with different meaning thus impeding understandability and comparability.

6.2 **Non-GAAP measures are often used to highlight underlying performance; but there is little consistency in the approach to such measures.** When communicating their results to users, rather than commenting on totals and subtotals of the formal financial statements, managements often focus on a variety of earnings presentations that are based on non-GAAP measures which have been designed to reflect the special characteristics of their company or the special features of the period under review. These non-GAAP measures are usually meant to help users understand what has happened to the underlying business, often by taking out the impact of volatility, adjusting for non recurring items and deducting or adding other items in order to arrive at 'underlying' results.

Sometimes the bases for these presentations are clearly explained, sometimes not, but in any event their very differences impede the task of comparing the results across a sector or sometimes even over successive periods of the same entity. Furthermore, these measures are usually not audited and may not exhibit the same qualitative characteristics expected of audited information.

On the other hand, the purpose of providing these non-GAAP measures is to help explain to the users, and make it easier for them to understand, the specifics of the entity and to elaborate on the results of the reporting period. Disclosure of such information appears to be an important tool in communication about entity performance and seems to be greatly appreciated by both the users and preparers.

6.3 **The variety of the allowed presentation formats impedes comparability.** IAS 1 stipulates only that the following six categories as a minimum should be presented on the face of the income statement:

- revenue;

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- finance costs;
- share of the profit or loss of associates and joint ventures accounting for using the equity method;
- tax expense;
- a single amount comprising the total of (i) the post-tax profit or loss of discontinued operation and (ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operations; and
- profit or loss.

As described in more detail in paragraph 5.2 above, IAS 1 allows entities to “present an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant”.<sup>28</sup>

Some argue that this allows such a wide range of presentation formats that it becomes very difficult to compare entities even in one industry.

On the other hand, some others believe that a ‘one size fits all’ solution is not appropriate. Presentation principles are indeed required but flexibility should be allowed in order to reflect appropriately the underlying nature of entity performance.

- 6.4 **Some terms are used with different meaning thus impeding understandability and comparability.** In addition to the fact that preparers are given significant freedom in choosing the presentation formats (including selecting and naming major subtitles), where entities do tend to use the same terms, those terms are not defined. For example, most entities use the term ‘operating’ when presenting their performance. However, there is not a single generally agreed definition of what precisely the term means. As a result, its meaning differs from entity to entity. This leads to a lack of comparability in the presentation of financial performance and makes it difficult for the users to interpret the information presented.

## **7 Specific issues to be debated**

- 7.1 So, there is much debate about the net income notion that underlies the existing performance reporting model, with some arguing that there is no consistent and credible rationale for it and some others arguing that the existing model works; it captures the essence of an entity’s financial performance. This debate has implications for the existing two statement model and also the way in which recycling is used currently. In addition, there are concerns about disaggregation, netting, and comparability. In order to properly assess the validity of these concerns, they are perhaps best restructured as a series of questions that the debate can focus on. The paragraphs that follow set out a structure that appears to be a logical starting point for the debate.
- 7.2 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

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<sup>28</sup> IAS 1, paragraph 88

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

Some believe that currently too much focus is placed on certain key performance indicators such as operating income, net income, EBIDTA, etc, thus understating the significance of individual components of income and expense. They argue that important and significant decisions are rarely made by rational market participants based on a single number. Instead a variety of financial and non financial data is used in analysis.

However, such key performance indicators are viewed by others as important figures on which a lot of analysis is based and initial attention is focused. They believe that it is important to have such key performance indicator(s) or key line(s) (ie line(s) possessing extra relevance compared to the other lines in the statement(s) of income and expense) to permit efficient communication and as a starting point for analysis.

These views should be debated further. If as a result, it is concluded that it is indeed important to have key line(s) that summarise and succinctly capture an entity's performance, the question then is what it is that this or these figure(s) should represent—total of income and expense, entity performance (if it is not the same) or something else?

- 7.3 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?

The term 'performance' is widely used in the debate about financial statements presentation but it appears to be used to mean different things. Some believe that an entity's performance can be faithfully represented only if the focus is on all the items making up the difference between the opening and closing balance sheets (in other words, all items of income and expense). Some others argue that only a subset of these items—perhaps those directly attributable to business activities that have proximity to cash flows—reflect entity performance.

It appears important therefore to discuss the substance of 'performance' in order to try to achieve consistency of understanding and use of this term. It might be, for example, that differences in the meanings and characteristics attributed to the term are a result of there being more than one type of performance, for example management performance vs. entity performance. If this is the case, it would be necessary to understand the differences between the types of performance.

- 7.4 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?

As already mentioned, while some believe that the statement(s) of income and expense should be nothing more than an explanation of the journey between the opening and closing balance sheets, others argue that the statement(s) should focus on performance and not all items of income and expense represent performance of an entity. Some believe that net income is the appropriate measure of entity's performance, and that items of income and expense that are not part of net income are of a different nature.

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In this context, the question to be debated is whether there is a need for a notion of 'net income' (possibly refined) as a meaningful measure of an entity performance (resulting from company's 'core', 'value added' operations) either as a potential key line, bottom line or just a subtotal.

If it is concluded that it is important to differentiate in one way or another the 'net income' from other items of income and expense, it will be important to go on and discuss what the notion should represent and therefore, what are the possible criteria for differentiation between net income items and items that are not part of net income (for example, 'realisation', 'measurement', 'sustainability', 'management control', 'core vs. incremental activities', other).

- 7.5 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?

Clearly the final total in any statement of income and expense is an arithmetical total, but should it have some informational value as well? While some argue that it does not need to have any significant informational value, others believe it ought to be an important number in its own right. (Some of them then go on to argue that, if all items of income and expense were presented in a single statement, the bottom line of that statement would have little informational value.) So, should the bottom line figure bear extra importance just because it is at the bottom? And, if it should, what should it represent? Finally, if it has also been concluded that a key line is required, should that key line also be a bottom line? These are all issues that need to be discussed.

Having addressed the issues described above, it then becomes possible to resolve the debate about whether there should be a single statement of income and expense or two (or more). This should be debated in the context of the conclusions in the earlier parts of the discussion. So, for example, if a conclusion is reached that a 'net income' notion that excludes certain items of income and expense is a vital key line and needs to be presented as a bottom line, it follows that more than one statement of income and expense needs to be presented. At the other extreme, if it is concluded that all items of income and expense need to be displayed with equal prominence if entity performance is to be fully described, it follows that there should be one statement of income and expense. Of course, these are two potential but somewhat oversimplified extremes, and the debate needs to evaluate both these positions and those in between.

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

While the notion of recycling is currently not applied consistently nor is it necessarily well understood by all, it is nothing more than a mechanism that allows presentation together of items of income and expense based on criteria that are additional to the main presentation criteria (ie it is effectively an extra dimension and items can be recycled either between different statements or between different parts of a single statement). It follows that recycling might be a useful tool if properly rationalised and consistently applied in a way that is in line with the principles underlining the reporting model as a whole.

Therefore, depending on the conclusions reached on the issues set out above, we will need to consider whether recycling is needed to achieve the required presentation and (if it is needed) on what basis it should take place. For example,



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if it is concluded that net income should include only those items that have already been realised, then recycling would be necessary to ensure that items of income and expense that are recognised (outside of net income) before they are realised are recognised within net income when realisation takes place.

- 7.7 Which of the following 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?

The following list represents different disaggregation options that are suggested by some as being either appropriate or indeed essential in presenting income and expense. These are criteria that are meant to enable separation of items with different predictive value.

- 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; and
- Holding gains and losses vs. non-holding gains and losses.

In order to reach conclusions as to whether any of these criteria have merit and ultimately should be implemented, they need to be evaluated both in terms of the potential improvement in the usefulness of the information provided that will result and in terms of their feasibility.

It may be that items should be disaggregated using one criteria, and those disaggregated items further disaggregated using another. Therefore, the discussion needs to include an assessment of the potential hierarchy of these presentation formats and in that context the necessity and merits of recycling.

- 7.8 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

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requirements allow information essential for analysis to be concealed or, alternatively, do not permit netting where it would result in more useful information?

Opinions of the market participants as to the adequacy of the current principles in relation to netting of items of income and expense appear to differ. Therefore, existing IFRS requirements, the current practices adopted by the preparers and specifics of the areas that appear to present problems for analysis will all need to be considered in order to assess whether changes are needed to enable adequate analysis.

- 7.9 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?

Both the preparers and users believe that presentation of non-GAAP measures is very useful in corporate communication and financial analysis. Therefore, the overall debate on reporting financial performance could benefit from a clear understanding of the specifics of measures used and adjustments made by entities in communication with markets as it could provide useful lessons regarding the users' needs.

- 7.10 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?

While some argue that strict prescription of reporting formats would facilitate comparability, others believe that a 'one size fits all' solution is not appropriate because, although presentation principles *are* required, flexibility should be allowed in order to allow entities to reflect appropriately the underlying nature of their performance.

Thus, the issue of whether a greater standardisation of the reporting formats would be an improvement in the financial reporting should be considered by exploring where the right balance between comparability and flexibility lies.

## **8 Concluding remarks**

- 8.1 While opinions as to whether there is a need for a change of or to the current model of reporting financial performance differ significantly, no one claims that the current model is flawless. The issue is therefore not whether some change would be of a benefit but more as to how major these changes should be. And the substance of that debate is about the usefulness and meaningfulness of net income notion, the necessity for recycling and, consequentially, the pros and cons of one statement of income and expense compared to two or more such statements.
- 8.2 Given that some strongly believe that major changes are indeed required, one cannot simply ignore their views. The issues their views raise need to be debated appropriately before being either dismissed or accepted as a basis for a change. The authors of this paper believe that, by structuring the debate around the matters identified in the preceding section, the interests of all parties involved will

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be considered appropriately and the discussion will take place in an organised and structured manner.

- 8.3 Hence, a subset of the points for debate identified above will be used to form the basis of a second PAAinE discussion paper. That paper will aim to evaluate fully the issue involved from a European perspective, and thereby hopefully to make a valuable contribution to the global debate on this fundamentally important topic.

## **Acknowledgments**

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