EFRAG
European Financial Reporting Advisory Group

PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE (PAAinE)

PERFORMANCE REPORTING

A EUROPEAN DISCUSSION PAPER

COMMENT LETTER DEADLINE 30 SEPTEMBER 2009

This paper has been prepared jointly by the staff of the Spanish standard-setter (Instituto de Contabilidad y Auditoría de Cuentas (ICAC)) and the staff of EFRAG as part of Europe's PAAinE initiative.

The paper is being issued by

- *ICAC,*
- *EFRAG,*
- *the Danish standard-setter (Foreningen af Statsautoriserede Revisorer (FSR)),*
- *the French standard-setter (Conseil National de la Comptabilité (CNC)),*
- *the German standard-setter (Deutsches Rechnungslegungs Standards Committee e.V. (DRSC)),*
- *the Italian standard-setter (Organismo Italiano di Contabilità (OIC)),*
- *the Polish standard-setter (Komitet Standardów Rachunkowoś (KSR)),*
- *the Swedish standard-setter (Rådet för finansiell rapportering (FSR), and*
- *the UK standard-setter (Accounting Standards Board (ASB)).*

The views in the better reflect the preliminary views of ICAC and EFRAG. The other bodies issuing the paper, while encouraging debate on the matters discussed in the paper, do not express any opinion on those matters at this stage.

Copies of the paper are available from the websites of those bodies issuing the paper. A limited number of copies of the paper will also be made available in printed form.

Paragraphs 1.20 – 1.25 invite comment on the discussion in the paper. Such comments should be sent by email to commentletter@efrag.org or by post to EFRAG, 35 Square de Meeûs, 1000 Brussels, Belgium, so as to arrive no later than 30 September 2009. All comments received will be placed on the public record unless confidentiality is requested.

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 proactive 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).

SUMMARY OF CONTENTS

TABLE OF CONTENTS

continued

APPENDICES

1 INTRODUCTION

Objective of this PAAinE project

1.1 When users pick up a set of financial statements, they are primarily interested in what the statements tell them about financial performance. As such, the primary objective of all accounting standards and all standard-setting effort is to maximise the usefulness of the performance reporting aspects of the financial statements.

1.2 This has implications for which items are recognised in the primary financial statements and for the amounts at which they are measured. It also has implications for the way recognised items—in particular, income and expenses, gains and losses[1]—are displayed (or presented) in those financial statements. Indeed, the focus on earnings by preparers and users of financial statements means that the way income and expenses are presented is central to the overall debate on performance reporting and the structure of financial statements.[2]

1.3 The way in which income and expenses are presented has stayed largely unchanged over the years, despite the use of measurement bases other than cost, the increasingly complex operating and financing activities that entities undertake, and changes in the user environment. With all these changes, it is important to ask ourselves whether the reasons why we do things the way we do continue to exist and whether there are better ways to do those things.

1.4 With that in mind, since 2001 the International Accounting Standards Board (IASB) has been conducting a project—Financial Statement Presentation—looking at the way all the “primary” financial statements are presented.[3] This project started out as a project focusing on reporting performance and the main motivation remains to improve how items are presented in the statement(s) of income and expense.

1.5 The IASB/FASB project is being carried out in phases, with the first phase resulting in an amendment to IAS 1 *Presentation of Financial Statements* in September 2007 and the second phase resulting in an IASB/FASB Discussion Paper *Preliminary Views on Financial Statement Presentation* (issued in October 2008). That discussion paper contains proposals on, inter alia, how items in the statement(s) of income and expense should be disaggregated, but does not specifically address the related questions of:

- whether the net income line should be retained and, if it should, what should be the basis determining whether something is within or outside net income, and

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1 Henceforth simply “income and expenses”. These terms are used in the way defined in the IASB *Framework for the Preparation and Presentation of Financial Statements.*

2 This is not to deny that the statement of financial position, statement of cash flows and notes also provide important information about performance.

3 This project is now carried out in conjunction with the US Financial Accounting Standards Board (FASB).

- recycling between different categories of income and expenses.

1.6 It is expected however that those issues will be addressed in due course, probably in a later phase of the project. Because of the fundamental nature of the issues, it is very important that European views on them are developed. Even more importantly, we think the issues need to be thoroughly debated within Europe so that the European views are well thought through and effectively articulated. That is the purpose of this PAAinE project. It therefore seeks to address what are some of the most important issues in accounting, and it seeks to do that in a way that will help to enhance Europe's contribution to the forthcoming global debate on the subject.

1.7 The approach adopted in this PAAinE project has been to identify the main arguments for and against the existing performance reporting model; analyse those arguments to identify the key underlying issues; and then investigate, discuss and invite comment on those key underlying issues. An initial discussion paper was issued in November 2006 (*What (if anything) is wrong with the good old Income Statement?*) and this second paper starts where that paper finished.

The first PAAinE paper on Performance Reporting

1.8 The first discussion paper sought to:

(a) identify the perceived weaknesses of the existing performance reporting model as alleged by those who believe that it is in need of fundamental change;

(b) articulate the basic position of those who believe that no fundamental changes to the current performance reporting model are necessary;

(c) describe other perceived weaknesses in the current reporting model that, it is alleged, prevent the usefulness of the information presented about performance being maximised; and

(d) analyse the alleged weaknesses identified in the context of the arguments against change 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.

1.9 The paper concluded that the key issues that needed to be addressed in the performance reporting debate were as follows.

(a) What is 'performance'?

(i) What are the attributes of 'performance' in the context of financial reporting of an entity? Are there different types of performance and, if so, what are the types? What do they encapsulate and how can/should they be differentiated?

(ii) How do companies describe their performance now? What measures do they use?

(iii) How do users analyse performance? How much do they adjust the raw accounting data as well as the performance measures put forward by management?

(b) Is there a need to have key lines in the statement(s) of income and expense? If so, what is its (or their) purpose and what should it (or they) represent?

(c) 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? In other words, should the bottom line be a key line?

(d) Is recycling needed?

(e) Which disaggregation system (or systems) have both merit and are capable of being implemented?

1.10 These issues are of course to some degree related. For example, the disaggregation system or systems used will need to be designed around the key lines that are thought to be necessary. For example, if the answer to question (b) is that a key line is needed to show the aggregate of the income and expense items thought likely to have a bearing on the entity's expected future cash flows, then an essential attribute of the disaggregation model chosen under (e) should be that it distinguishes between items of income and expense thought likely to have a bearing on the entity's expected future cash flows and other items of income and expense.

This second PAAinE paper on Performance Reporting

1.11 The purpose of this second PAAinE discussion paper on Reporting Performance is to explore the key issues identified in the first paper.

(a) The paper starts (in Chapter 2) by briefly summarising the existing performance reporting model.

(b) The paper notes that it is sometimes argued that net income encapsulates performance. Such an argument implies that there is agreement as to what 'performance' does or should represent. Chapter 3 asks whether such agreement exists; in other words, what is performance? It does this by:

(i) considering how the term is commonly used;

(ii) considering how companies and others report performance; and

(iii) considering how users analyse performance and what academic research says about the value-relevance of performance measures.

(c) Chapter 4 considers the necessity and importance of key line(s) and bottom line(s). In particular it asks whether key lines are needed and, if they are, what they are needed for. This leads into a discussion about the attributes key lines need to exhibit. Chapter 4 also asks whether the bottom line of a performance statement needs to be a key line, and that leads into a discussion about the number of statements of income and expense that might be needed. Finally, the chapter discusses the relationship between the debate about key lines and the extent to which recycling (of items of income and expense) might be necessary.

(d) Chapter 4 concludes in effect that the key issue underlying all these other debates—for example, about net income and recycling—is disaggregation: which disaggregation model or models should be used in presenting income and expenses. Chapter 5 considers some models for disaggregating income and expenses and some of the issues that would arise in relation to the different approaches.

(e) Brief concluding comments are given in Chapter 6.

1.12 It should be noted that this paper is intended to be a discussion paper. It seeks primarily therefore to raise issues for thought and discussion, rather than to reach conclusions. Having said that, in the early part of the paper the discussion identifies some observable facts about performance and about key lines, and the paper does not shy away from highlighting those facts.

1.13 On a more general note, in order to have a rounded discussion the authors have included in this paper views that are neither theirs nor the views of any of the organisations that have issued or approved the paper. Rather, they are the views of a variety of market participants and other commentators that have been collated from a number of sources, including internal and external papers written by standard-setters, academic research and meetings with users and preparers.

Scope of the paper

1.14 This paper focuses exclusively on the presentation of items of income and expenses in the primary financial statement(s), namely the income statement[4] and other statement(s) of income and expense[5]. Therefore, it does not address the statement of cash flows, the statement of financial position or the statement of changes in equity. Nor does it address the interaction between the statements. Those are important performance reporting issues, but the authors nevertheless

4 For the purpose of this paper, the income statement is a primary 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. The bottom line of the income statement shows net income.

5 In this document, 'statement or statements of income and expense' is a generalised term used to describe the statement (or all the statements) that report all current period items of income and expense. In the context of the existing reporting model, this includes statement(s) other than the income statement where some of the current period items of income and expense are reported i.e. the statement of recognised income and expense.

believe the issues addressed in this paper can be discussed largely in isolation from them.

1.15 This paper refers in its analysis to the version of IAS 1 that is applicable at the time of writing (i.e. the amended version of IAS 1 published in September 2007 and still extant in December 2008).

1.16 This paper does not primarily address recognition or measurement matters; it has been assumed that transactions and events will be recognised and measured in accordance with the accounting standards that are applicable at the time of writing. Nevertheless, the discussion on recycling (see Chapter 4) and the consideration of different disaggregation models (see Chapter 5) involves some consideration of possible changes in recognition and measurement.

1.17 As noted in the first discussion paper, currently the format and structure of the performance statement(s) provided varies, at least 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 very different way from the items in the income statement of a bank, which are in turn presented in a very different way from the items in the income statement of a manufacturing company. The approach taken in developing this paper has been to address matters that are applicable to a wide spectrum of industries without focusing on specialised industries. It follows that, before being able to operationalise any of the approaches discussed, further consideration may need to be given to industry-specific issues and also to conglomerates reporting on very different businesses within one group.

1.18 Similarly, no special consideration has been given in this paper of the differences that might arise because of the size or accountability of the entities involved.

1.19 The authors believe that the paper does, however, address matters that will usually be of equal relevance to both separate and consolidated financial statements.

Invitation to comment

1.20 Although we welcome constituents' views on any aspect of the paper, we would particularly welcome views on the questions asked at the end of each chapter. Those questions are as follows:

Chapter 2

1.21 As already mentioned, Chapter 2 summarises the existing performance reporting model as prescribed in current accounting standards—including how net income is segregated from other items of income and expense—and how those standards have developed.

Question 1: Do you think there is anything else in the development of existing standards (apart from that discussed in chapter 2) that should be taken into account when considering the way forward for performance reporting?

Chapter 3

1.22 Chapter 3 considers whether there is agreement as to what 'performance' does or should represent.

Question 2: Do you agree with the observation in this chapter that, at the level at which standards are written, there is no generally agreed notion of what represents 'performance' and that in fact performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers? If you do not, please explain your reasoning.

Chapter 4

1.23 In Chapter 4 we consider the necessity and importance of key line(s) and bottom line(s), the number of statements of income and expense that might be needed and the extent of recycling of items of income and expense between categories of statements that might be necessary.

Question 3: Do you agree that key lines are still useful, though only because of their value as a basis for communication to the market and as a starting point for analysis and comparison? If you do not, please explain your reasoning.

Question 4: Do you agree that, in order to fulfil this function, it is important that there are clear principles that underpin what is included and excluded from the key line(s) (in order to make their content understandable) and those principles need to be such that the content of a key line is standardised to a fair degree (in order to ensure the necessary comparability).

Question 5: This chapter discusses the need for standard setters to balance the competing demands of comparability and flexibility, in order to give users fairly consistent starting points for analysis, while allowing management to present income and expenses in a manner that reflects the particular circumstances of the entity. Has the range of approaches to flexibility and comparability given in the chapter been appropriately described? What do you believe would offer the best approach in practice?

Question 6: This chapter finds no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Do you agree that it is not important for the "bottom line" of statement(s) of income and expense to be a key line? If you do not, please explain your reasoning.

Question 7: In chapter 4, the paper observes that there is no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Assuming that is correct, do you agree that it follows that the number of performance statements provided is not particularly important either. And thus that the one or two performance statements debate is a non-issue; the real issues relate to the key lines. Do you agree with this analysis and conclusion? If you do not, please explain your reasoning.

Question 8: Do you agree that recycling is mainly an issue if a realised/unrealised split is the main disaggregation criterion for the statement(s) of income and expense, that therefore recycling is really a secondary issue and that the main issue is which disaggregation model should be used? If you do not, please explain your reasoning.

Chapter 5

1.24 Chapter 5 considers some models for disaggregating income and expenses and some of the issues that would arise in relation to those approaches.

Question 9: Would the issue of recycling on its own affect your decision as to the best approach to disaggregation? Please explain your reasoning.

Question 10: Do you have any comments on the basic models of disaggregation presented in this chapter? Are there any other broad types of model that would have been worth exploring?

Question 11: Is the discussion of the advantages and disadvantages of each disaggregation model fair and complete? If not, how could it be improved?

Question 12: Which of the models of disaggregation—or combinations of models—do you favour and why do you believe it meets the needs of users better than the alternatives?

1.25 Comments are requested by 30 September 2009, and should be sent to one or other of the addresses set out in the inside front cover of this paper.

2 THE EXISTING PERFORMANCE REPORTING MODEL

As when tackling any difficult issue in financial reporting, it is useful to remind oneself how standards have evolved to their present condition and what debate has already taken place on the subject.

2.1 Before considering the main issues in this paper, it is worth reiterating briefly some of the material covered in the first discussion paper, particularly on the current situation as to how items of income and expense are reported under IFRS, how this situation was reached and what are the consequential problems and issues.

2.2 The application of the recognition and measurement requirements in existing IFRS gives rise to various assets and liabilities being identified and recognised in the statement of financial position. According to the IASB Framework, income and expenses are defined by reference to changes in assets and liabilities, with the result that total income less total expenses for a period will be equal to the total change in net assets over the period excluding transactions with owners. This "all-inclusive" total income less total expenses figure is often referred to as "comprehensive income", although the IASB also uses the term "all (or total) non-owner changes in equity".[6]

2.3 "Net income" is not defined by IFRS, but is a term used under US GAAP (and other national GAAPs). It is intended to be a reference to the bottom line of the existing income statement, but the IASB tends to refer to net income as 'profit or loss'.

2.4 In the past, "net income" represented all recognised income and expenses as required by accounting standards or generally accepted accounting practice; in other words, net income and comprehensive income were the same.[7] However, as business complexity has increased and the economic environment has become more sophisticated, accounting standards have moved away from an entirely historical cost, transaction-driven approach. As up-to-date values (hereafter referred to as current values) were introduced (sometimes on an optional basis as in the case of property, plant and equipment revaluations), the standard-setter had to consider what to do with the resulting recognised income and expenses. At different times, when dealing with different items, the standard-setter decided to keep some of the income and expenses arising outside net income (in what is commonly referred to as 'Other Comprehensive Income' or OCI)[8]. In some cases those items of income and expense are subsequently recognised in net income, usually after a realisation event. This is commonly known as 'recycling' (although IFRS refers to it as 'reclassifying').

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6 IAS 1 *Presentation of Financial Statements*, BC49-BC54.

7 In some jurisdictions, it also equated to realised and hence distributable profit, which still exists as the European legal basis for capital maintenance to protect creditors.

8 The statements in which OCI items are reported are referred to as "the statement of total recognised gains and losses" (STRGL) in the UK and statement of "other comprehensive income" (OCI) in the US.

2.5 The general approach under existing IFRS is that all items of income and expense recognised in a period are included in net income unless a Standard or Interpretation requires otherwise, i.e. entities may not include any other items in OCI as a matter of choice or accounting policy, nor may they include OCI items within net income. The items that Standards and Interpretations currently require to be excluded from net income/profit or loss are:

- gains and losses arising from translating the financial statements of foreign operations;
- gains and losses on re-measuring available-for-sale (AFS) financial assets;
- the effective portion of gains and losses on hedging instruments in a cash flow hedge;
- the effective portion of gains or losses on hedging instruments of a net investment in a foreign operation;
- revaluation of property, plant and equipment (and, where possible,[9] intangible assets);
- actuarial gains and losses on defined benefit pension obligations, when the reporting entity applies the option to include such gains and losses in OCI;
- deferred tax effects on all items recorded in OCI.

Of those items, actuarial gains and losses and revaluation gains and losses on property, plant and equipment are not recycled to net income/profit or loss.[10]

2.6 The reasoning behind presenting each of these items of income and expense outside net income is not always articulated in the relevant accounting standard; and, where it is, the reasons given are not consistent. (Some of the impetus behind such decisions may have arisen from a reluctance to include in net income unrealised gains or losses, measurement uncertainties, volatility, items that are large enough to dwarf the rest of the figures or a combination of these factors.) Also, while there has been some discussion about what is currently excluded from net income, there has been little on items currently in net income that perhaps ought be included in OCI. For example, some argue that goodwill impairment charges ought not to be in net income.

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9 IAS 38 requires that an active market exist in order to be able to apply the revaluation model for intangible assets.

10 Recycling will be further discussed in Chapter 5.

2.7 Another concern that some have raised is that both net income and other comprehensive income are aggregations of non-homogeneous items from all sorts of viewpoints: operating, financing and other non-operating items; taxes; historical cost and current value income and expenses. There is no properly-articulated underlying rationale for the disaggregation within those categories.

Question 1: Do you think there is anything else in the development of existing standards (apart from that discussed in chapter 2) that should be taken into account when considering the way forward for performance reporting?

3 WHAT IS PERFORMANCE?

It is often said that the existing income statement and net income notion does a pretty good job of reporting performance. That implies that there is general agreement as to what 'performance' represents. But does that general agreement exist? To answer that question, we look in this chapter at how the term 'performance' is used currently, what companies report when they report performance, and whether users focus on particular performance numbers.

Introduction

3.1 Accounting information is provided to help users to understand, inter alia, the entity's current performance and in so doing to make assessments about future performance. Without understanding what performance might encompass—including the possible breadth of views of what performance means—accounting standard setters cannot determine what information their standards should require or how that information should be organised. More particularly, as explained in the first discussion paper, managements often argue that the current presentation formats reflect appropriately the economic performance of their entities. This would seem to imply that there is a common understanding of what is meant by 'performance'. It follows that it is important to understand what the attributes of performance are in the context of financial reporting; whether there are different types of performance; and how these should be encapsulated and perhaps differentiated, need to be explored. Put simply, what is 'performance'?

3.2 Of course, in a general sense there is widespread agreement as to what performance means; it is about how an entity has progressed during the period. Has it generated profits and if so, are those profits of a satisfactory level? And perhaps at what cost to the entity's position (risk profile, liquidity and financial adaptability etc) have those profits been generated? However, a more detailed understanding of what is meant by performance is needed to develop accounting standards on the subject.

3.3 In this chapter, the authors look at the evidence of how the term is used and how performance is reported and analysed in order to determine if there is a common understanding of what is meant by 'performance'.

How is the term 'performance' used in practice?

3.4 Even if one puts aside notions such as environmental and social performance, it is clear that, when people talk about performance, they can be talking about a range of notions, including economic performance, operating performance, and management performance amongst others. There are also various aspects to performance to consider, including sustainable performance (or perhaps performance before non-recurring items), core activity performance, performance before amortisation (such as EBITDA), and gross profit performance; the list is endless.

3.5 As noted above, however, in the context of the hard financial information governed by accounting standards, establishing an agreed understanding of what performance means is vital in order for those accounting standards to require the most suitable reporting. Looking at two particular aspects—management vs. entity performance and financial vs. non-financial performance—may be revealing in this context.

Management performance vs. entity performance

3.6 In order for users to make informed and balanced investment decisions about an entity, they need to assess the quality and experience of the management team (i.e. management performance). To do this, it seems useful to be able to understand where management of an entity focuses its time and effort and where it has the power to change the performance of the entity through its decisions.

3.7 To some people, this is very different to 'entity performance', which they see as a more comprehensive notion that encompasses things that management might not have the power to change.

3.8 The difference between management performance and entity performance is probably more about the time horizon than anything else, because almost everything is within the control of management over the longer-term. (If management cannot control, say, whether prices go up or down, it is still usually able to control whether the entity has an exposure to price risk.) Furthermore, the time horizon that is decision-useful from a user's perspective seems likely in many cases to depend on the decision involved. That suggests that there could actually be a number of different notions of management performance, and that some of them might not be that different from what some would regard as entity performance.

Performance vs. financial performance

3.9 There is sometimes a debate as to whether the focus should be on financial performance or some wider notion of performance ('overall performance'). For example, some argue that, while there is quite reasonably a spotlight on reporting the financial numbers (i.e., the financial accounting measures of performance), other elements of performance may be equally or sometimes even more important. These other aspects (including growth in market share, consumer satisfaction, health and safety record, ability to recruit and retain good quality staff, management performance as well as wider social considerations such as environmental responsibility) may all be included by investors in their evaluation of entity performance.

3.10 However, all these aspects of performance will eventually feed through into financial performance; it is just that, because of the time lag for these aspects to be converted into financial performance in an accounting sense (as recognised items of income and expense), these other key financial and non-financial factors are not captured immediately in financial accounting performance. For example, orders received are not recorded as sales until the entity has earned the revenue through performing under the contract; but those assessing entity performance (and in particular likely future performance) may be interested in the strength of the order book. The importance users place in these non-financial factors is apparent from the frequent use of and reaction to such items by the market in relation to publicly-traded companies.

3.11 It follows that performance is not just about what appears in the financial statements, but is wider, taking into account other types of information which are often non-financial.

What do Standards and the Framework say about performance?

3.12 Narrowing the focus to the financial statements themselves, perhaps the first place to look for what the IASB's literature says performance is the current conceptual underpinning of accounting standards. Although the existing IASB Framework discusses performance briefly in the context of the income statement, it does not define the term. For example, paragraph 19 of the Framework states that "information about performance is primarily provided in an income statement." Paragraph 20 however notes that "an income statement provides an incomplete picture of performance unless it is used in conjunction with the statement of financial position and the statement of changes in financial position." Paragraph 69 tells us that ""profit is frequently used as a measure of performance .... ." But the Framework does not explain what performance actually is.

3.13 Similarly, the Framework defines income and expenses, paragraph 47 states that "the elements [of financial statements] directly related to the measurement of performance in the income statement are income and expenses", and paragraph 69 states that "the elements directly related to the measurement of profit are income and expenses"; but the Framework does not indicate whether some items of income and expenses are components of performance and some are not or whether some should be shown in the income statement and some reported elsewhere.

3.14 Paragraph 72 does, however, discuss disaggregation and different methods of presentation, stating that "Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making." It goes on to state:

> "For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another."

As this is described as just one example of how income and expenses might be presented, the Framework seems to contemplate other approaches to presentation.

3.15 The IASB has recently been putting more of a focus on the OCI items than hitherto. For example, the September 2007 revision to IAS 1 requires total comprehensive income to be presented prominently, rather than simply as one of the components of a reconciliation of opening and closing equity. The discussion paper *Preliminary Views on Financial Statement Presentation*, published by the IASB in October 2008, proposes to take this a step further by requiring OCI items to be included in the same performance statement (the statement of comprehensive income) with the net income items. The resulting increased prominence that is accorded to OCI items would indicate an IASB view that they are, in some sense at least, part of an entity's performance over a period.

3.16 However, neither the September 2007 revision to IAS 1 nor the recent discussion paper discuss what performance means in the context of reporting income and expenses. Therefore, the notion of performance in the conceptual framework and existing and proposed accounting standards remains under-developed.

How managements adjust GAAP to describe performance: analysis of survey results

3.17 Current financial reporting standards (IFRS, US GAAP and many other national GAAPs) allow management wide latitude in presenting the performance of the entity, in the sense that they are not restrictive as to methods of presentation nor of presenting information in addition to GAAP results.[11] Managements use this opportunity to present so-called 'alternative performance measures' (APMs) in addition to their GAAP financial reporting.[12]

3.18 As noted in the CESR recommendation on Alternative Performance Measures,[13] APMs "can either be derived from the audited financial statements[14] or stem from other sources or alternative methodology to conventional accounting". Examples of the first category would be "operating earnings", "cash earnings", "EBITDA" and similar items.[15] While operating earnings could be a sub-line of the income statement, most of the other items require adjustment from GAAP because they exclude information that GAAP would have included at that level. These are hereafter referred to as "non-GAAP measures".

3.19 The second category encompasses indicators relating to business activity, such as production levels or market share, employee turnover, customer turnover, non-recognised assets (such as gas reserves) and so on, and are hereafter referred to as "other key performance indicators". These other key performance indicators are not discussed further in this discussion paper because, although they provide

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11 IFRS 8 also permits a management approach to segment reporting.

12 Regulators in some jurisdictions place restrictions on the use of these measures, but IFRSs do not, other than to deal with alternative EPS figures (IAS 33 paragraphs 73 and 73A).

13 CESR, CESR Recommendation on Alternative Performance Measures, October 2005.

14 For US reporting purposes, entities need to provide reconciliations to the income statement, while this is currently not mandatory for companies listed in Europe.

15 CESR, CESR Recommendation on Alternative Performance Measures, October 2005, p.3. See also Wallace, W., Pro forma before and after the SEC's warning: A quantification of reporting variances from GAAP, 2002, which provides an exhaustive list of labels used under US GAAP reporting.

valuable insights into performance as a whole, they do not derive from GAAP financial statements.

3.20 As it seems reasonable to assume that managers produce non-GAAP measures to provide stakeholders with what they believe is more relevant information about the performance of the entity, looking at which measures are used ought to tell us something about how management views performance.

Reviews of how companies report performance

3.21 In order to get some kind of overview of the performance measures presented by entities in their communications with their stakeholders, a review was carried out of a sample of European listed entities that have reported since 2005 under IFRS. For this purpose, fifteen groups were selected on a random basis from the EuroStoxx 50.[16] The survey looked at the companies' financial highlights announcements, not their annual financial statements.

(a) The review revealed that all surveyed entities report “sales” as an indicator of their performance.

(b) 86% of the companies included “net income” in their financial highlights, although approximately a third presented “adjusted net income” figures as their key financial figures. 40% reported “EBIT” (or operating income); 40% reported “EBITDA” or “adjusted EBITDA” as a headline number; and 40% reported variations of net income, such as “income before taxes”.

(c) Just over a quarter included in their financial highlights information referring to “continued/discontinuing” activities.

(d) Around 30% presented variations on “operating margin” and 20% referred to the financial income and expenses as being part of their headline figures.

(e) 60% reported Earnings per Share information and six pro-forma Earnings per Share.[17]

3.22 A more comprehensive study of Spanish listed companies was performed.[18] In this sample, all companies, except financial and insurance companies, used EBITDA and EBIT as non-GAAP measures. Spanish regulation requires disclosure of Net and Gross Operating Income. In press releases, companies refer to EBITDA as the Gross Operating Income, and to EBIT as the Net Operating Income. Some companies further disclosed Gross Margin (sales less cost of sales). As was the case in the more general study, some companies disclosed adjusted EBITDA and EBIT. Perhaps due to the regulatory background, it seems that Spanish managers do not disclose other non-GAAP measures as often as in other countries.

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16 Details of the basis of the review and the companies selected are given in Appendix 1.

17 Note that non-GAAP measures presented were calculated differently by different companies.

18 A comprehensive overview of the findings is in Appendix 1.

3.23 Finally, in order to cover some banks, the financial information of Deutsche Bank (Germany), Banko Popular (Spain) and Barclays (UK) were examined. In that information, items such as net income and income before taxes were cited as much as revenues (and similar items) and all three banks reported return on equity (RoE), although sometimes before and sometimes after tax. Other typical figures found revolve around the term "underlying profit".[19]

3.24 In relation to EBIT or Operating Income, feedback received on the first discussion paper indicates that preparers believe this to be an important headline number in communication with investors. This number excludes the impact of financing from the income statement GAAP figures, as well as tax and discontinued operations. In other words, it attempts to isolate the results of ongoing operations, while leaving the financing structure and taxation of the entity to be considered separately.

3.25 In relation to the adjusted GAAP figures that are presented, all these measures eliminate certain gains or losses of the current reporting period. The items excluded are nearly always items that would normally appear within the lines of the income statement dealing with operating items (i.e. rather than financing items). These often include certain "non-cash" items—such as impairments amortisation charges, (during the period where goodwill amortisation was still permitted by IFRS)—as well as restructuring charges and other "non-recurring" items.

3.26 It would appear that these adjustments to GAAP figures are generally designed to eliminate items that management believe would mask what they consider to be the impact of the ongoing performance of the reporting period for future cash flows. For that reason, a REBIT ("Recurring EBIT") figure or similar is often given.[20,21] Adjusted earnings are also often used for presenting alternative Earnings per Share (EPS) figures.

3.27 However, there seems to be different views as to which items should be excluded, Furthermore, the items adjusted for vary not only between different companies (including within the same market segment), but also sometimes over time. In other words, although there seems to be some agreement as to what the objective is—to isolate the items that are thought to be recurring and to have a cash effect—from other items, there are different views as to which income and expense items make up this recurring cash impact measure of performance. Different items are relevant to different activities and in different circumstances. An element of personal preference might also be involved.

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[19] It is interesting to note that ABN Amro published IFRS compliant financial statements in 2005, but the measured used to highlight the bank's performance were Dutch GAAP figures. See Ernst & Young, The impact of IFRS on European banks – 2005 reporting, p. 55.

[20] See for further details e.g. Ernst & Young, Observations on the Implementation of IFRS, 2006, p. 13 or Bhattacharya et al., Empirical Evidence on Recent Trends in Pro Forma Reporting, August 2003, p. 10.

[21] When doing certain spot checks on UK listed companies, we noted that some of them (e.g. TESCO) present the non-GAAP measure "Underlying Profit", which excludes e.g. IAS 32 / 39 adjustments and / or differences between the cash contributions and IAS 19 compliant expenses.

The value relevance of reported performance measures

3.28 Finally, the authors attempted to look at which measures of performance were viewed by users as most useful.

3.29 Empirical results seem to show that most of the performance measures used by companies and analysts have their merits. Current empirical evidence does not show a greater value relevance of non-GAAP figures compared to other performance measures.[22]

3.30 In the previous section it was noted that the feedback received on the first discussion paper indicates that preparers believe EBIT or Operating Income to be an important headline number in communication with investors. This emphasis on Operating Income confirms a study by the FASB staff in 2002, which indicated that it was one of the key metrics used by most of the analysts interviewed.[23] Cheng et al.[24] came to the conclusion that Operating Income has a higher relevance than net income, but only where Operating Income is not impacted by other so-called "non-operating items" (i.e. these are excluded). Investors apparently attach more value to operating items than to non-operating.[25] However, other studies seem uncertain as to the value of the insights resulting from EBIT or Operating Income compared to net income.

3.31 According to PwC value-relevance studies,[26] users appear to have little interest in comprehensive income[27] as a key performance measure. (Thus, going back to the debate about management vs. entity performance for a moment, even if users take the view that everything that happens in the company is ultimately an outcome of management decisions taken at some point in time, they are apparently not using comprehensive income as a proxy for management performance.)

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22 Other companies may nevertheless do so and this does not take into account that some entities will give completely reworked figures, for example insurance companies often give embedded value information.

23 FASB staff paper, Summary of User Interviews Reporting Financial Performance by Business Enterprises, http://www.fasb.org/project/interviews.pdf , p. 3 (questions asked November 2001/December 2001)

24 On the Usefulness of Operating Income, Net Income and Comprehensive Income in Explaining Security Returns, Accounting and Business Research, Vol. 23, No. 91, pp 195-203, 1993. Biddle/Choi, Is Comprehensive Income Irrelevant?, 2002.

25 Security Returns, Accounting and Business Research, Vol. 23, No. 91, p 201.

26 The results of value relevance studies rely on the assumption that there is an information-efficient capital market. The studies therefore measure the association of information available to the market with market shares prices and returns. Consequently, as the data is based on current accounting rules, a change in such rules might lead to different conclusions. Further, value relevance studies assume equity investors to be the primary users of financial statements, while different users groups exist, which have different interpretations of value relevance. An interesting overview of the relevance of such studies for standard setting can be found in Holthausen et al., The Relevance of the Value Relevance Literature For Financial Accounting Standard Setting, Journal of Accounting and Economics, 31, September 2001, pp. 3 – 75.

27 Comprehensive income is defined, according to the FASB, as "the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners."

3.32 There is some academic research available on the value relevance of "net income" and "comprehensive income". After the introduction in the USA of SFAS 130 Reporting Comprehensive Income, a significant amount of empirical research was performed, mainly on US companies, in order to gauge whether net income or comprehensive income has a higher value relevance. The results are mixed: while several studies show that, at least for financial entities such as banks, net income has higher value relevance than comprehensive income, other studies have produced the opposite view.[28]

3.33 From a continental European perspective, Zimmermann and Volmer[29] show that comprehensive income and net income have the same value relevance and another mainly European study performed by Wang[30] shows that in the majority of the investigated European countries[31] comprehensive income is value relevant, but less than reported net income.

3.34 Such value relevance studies, however, cannot identify whether comprehensive income is able to alert users to risks that it would not be possible to identify by using net income alone. Studies show that, at least for the banking sector, items of comprehensive income can indeed do so.[32] In addition, even those studies that find net income is of greater value relevance comprehensive income do not (and probably could not) deal with the question of whether net income is the *best* sub-division or category of income and expenses for performance measurement, nor whether its value relevance has varied over time as its composition has altered through changes in measurement and recognition rules in accounting standards. Another major question that remains unanswered is whether or not OCI items needs to be recycled into net income on some specified basis, in order for net income to achieve maximum value relevance.

3.35 Apart from these modest findings, users apparently do not find any performance measure—GAAP or non-GAAP—significantly better than others; rather, they invariably need to employ several measures in their analysis of entity performance, which requires the use and manipulation of the raw material of reported information as required by accounting standards.

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28 For example: Dhaliwal et al, Is comprehensive income superior to net income as a measure of firm performance?, Journal of Accounting and Economics 26, 1999, pp. 43-67; Cheng et al., On the Usefulness of Operating Income, Net Income and Comprehensive Income in Explaining Security Returns, Accounting and Business Research, Vol. 23, No. 91, pp 195-203, 1993. Biddle/Choi, Is Comprehensive Income Irrelevant?, 2002, find that comprehensive income as defined by SFAS 130 dominates over net income for explaining returns. Criticism of the approaches used can also be found: Skinner, D.J., How well does net income measure firm performance? A discussion of two studies, Journal of Accounting and Economics, 26 (1999), pp. 105-111.

29 Zimmermann / Volmer, Performance Reporting in Need of Repair? Comparing Accounting Performance Measures in the German Capital Market, 2005.

30 Wang, Yue, The Magnitude and Relevance of Dirty Surplus Accounting Flows in EU Countries", Paper presented at the EAA Congress in Gothenburg, Sweden, May 2006.

31 Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, The Netherlands, Portugal, Spain, Sweden and the UK.

32 Hodder et al, Risk-Relevance of Fair Value Income Measures for Commercial Banks, 2005.

Summarising remarks

3.36 In this chapter the authors have considered whether there is general agreement at a detailed level as to what performance is, because without that general agreement it seems difficult to argue that any particular disaggregation model or key line encapsulates performance.

3.37 It can be observed that different users of financial statements have different approaches to what constitutes 'performance' and diverging views exist with respect to what are the most relevant attributes of corporate performance. Managers, when they communicate with stakeholders about performance, do not use the same performance measures as each other; there seem to be differences between entities within the same industries, between different industries, and also over time. And users do not seem to find any particular performance measure significantly better than any other.

3.38 In summary, there is no common detailed understanding as to what constitutes performance. Or, to put it another way, there are many components of, and aspects to, an entity's performance and those components and aspects are given different weight by different people. For investors and analysts the ultimate goal of performance measures is not performance per se, but value; such performance metrics are only 'raw material' for valuation models and tools leading to valuation.

3.39 What this demonstrates is that performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers, however they are formulated.

Question 2: Do you agree with the observation in this chapter that, at the level at which standards are written, there is no generally agreed notion of what represents 'performance' and that in fact performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers? If you do not, please explain your reasoning.

4 KEY LINES, BOTTOM LINES AND RECYCLING

Even if it is not possible to encapsulate performance in one or a few numbers, it does not follow that key line(s) are not useful. So, are key lines useful? And, if they are, is it important that the bottom line of a performance statement is a key line? And where does recycling fit into all of this?

Introduction

4.1 Chapter 3 observed that performance is "a complex, multi-faceted issue that cannot be encompassed in one or a few numbers, however they are formulated." There are many components of, and aspects to, an entity's performance—and indeed different views as to what 'performance' entails—and it is not reasonable to expect all those components, aspects and views to be encapsulated in one or a few numbers.

4.2 In the current performance reporting model, items of income and expenses are disaggregated, ordered, and grouped (henceforth referred to simply as 'disaggregated') so as to enable certain sub-totals to be treated as key lines. The key line that is probably most commonly presented—indeed is one of the few key lines required by IFRS—is 'net income'; in other words, items of income and expense are aggregated so as to distinguish 'net income' items from items that are not net income (ie OCI).

4.3 One implication of the discussion in the previous chapter is that it is not reasonable to expect the net income number to encapsulate an entity's performance. It does not necessarily follow however that there is no need for key lines to be presented in the performance statement(s). Nor does it necessarily mean that, if one or more key lines are still needed, some sort of net income notion should not be the basis for one of those key lines.

4.4 This key line issue is of fundamental importance to performance reporting because, if key lines are needed, the disaggregation model used needs to be designed to ensure that those key lines are presented. So, for example, if it is decided that a net income key line is needed, the primary disaggregation will be designed to distinguish between net income items and other items. Further disaggregation of net income and of OCI might be useful, but the primary disaggregation will be between net income and other.

4.5 This chapter starts by exploring whether key lines are needed and, if they are, what attributes they should have.

4.6 A related issue and one of the performance reporting issues that is most debated is whether there should be one performance statement or two. This chapter suggests that this issue is in fact about whether it is necessary for the bottom line of the performance statement(s) to be a key line, and it makes some observations about that issue.

4.7 In the first PAAinE paper on Performance Reporting, the authors noted that, although some commentators seem to view recycling as bad in itself, in fact it is the recognition criteria and measurement basis or bases being used for performance reporting purposes that they have a problem with; recycling is simply a consequence of those criteria and bases. This chapter discusses this further in the context of the various observations it makes about key lines and bottom lines.

What is a key line for?

4.8 Financial reporting involves taking a vast amount of data and aggregating, disaggregating, and ordering it in a way that maximises its usefulness. The alternative would be to present an unordered list of the items. For example, it is often suggested that developments in technology will radically alter financial reporting, that the advent of real-time, internet based reporting will enable investors to get whatever information they want whenever they want it and that all they need to be provided with is unfiltered raw data.

4.9 However, such suggestions would not provide a widely-accepted starting point for the initiation of public discussion and for comparisons by differing parties, and that is something that it appears both preparers and users want. In particular, even though an entity's performance is multi-faceted, there is still a clear demand—from the media, from users and from preparers themselves—for preparers to be able to communicate some basic facts about that performance in some sort of headline number. Empirical studies indicate that non-sophisticated users make their investment decisions based on a very limited amount of information, often relying on headline information published in the media.[33] Even for sophisticated users, such key lines are important because, even though they will usually adjust the numbers they receive, they still want to be provided with a number that they can easily understand and work with as a common starting point for that analysis.[34]

4.10 In other words, key lines are thought by both preparers and users to be useful. For preparers they represent a headline number for communication purposes; and for users they represent a common starting point for analysis. Ideally of course, the key line will be suitable for both purposes, but that will depend on the attributes such numbers are required to have.

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[33] See exemplary for the German market, but with reference to international studies: Ernst et al., Verhalten und Präfernzen deutscher Aktionäre (Behavior and preferences of German shareholders), Studien des Deutsche Aktieninstituts, No. 29, January 2005.; also: Amir et al., What Value Analysts?, 1999.

[34] Ernst et al. also investigated the usage of financial information by professional investors and compared the German results with international studies. The result showed that the vast majority use the income statement the most. However, international investors use the statement of cash flows as the second most important statement for performance measurement, while German investors use the statement of financial position. Interestingly enough, only a very small number of professional or private investors (independent their origin) actually use the management report when making investment decisions; see Ernst et al., Verhalten und Präfernzen deutscher Aktionäre (Behavior and preferences of German shareholders), Studien des Deutsche Aktieninstituts, No. 29, January 2005, p. 35.

What criteria should be used to specify key line(s)?

4.11 As already noted, users and preparers want key lines to convey and receive 'headline' messages and to provide a starting point for analysis. Users will obviously want for this purpose a number (or numbers) that are useful. That means they need to be relevant (we will discuss this in the next chapter), but what other attributes should these key lines possess? The authors suggest:

(a) A key line should be understandable, which means it must be underpinned by a principle that explains the significance and the characteristic that this line has compared to other items. Various principles that might be used are discussed in Chapter 5.

(b) Key lines should <u>to some extent</u> be standardised, to increase transparency and comparability. Of course, standardisation can be taken too far; uniformity does not result in comparability, and there is very little comparability between entities in different industries any way. Nevertheless, a degree of standardisation helps users.

4.12 Even though it is not realistic to expect key lines to be a succinct summary of performance, preparers will still want them to focus on what they view as the key aspects of performance. As chapter 3 makes clear, those key aspects will vary depending on circumstances and opinion, which suggests that an additional attribute that preparers want a key line to have is flexibility as to its content. And users understand that relevance in many cases requires at least a degree of flexibility, so it is not only preparers that benefit from flexibility.

How should the tension between 'standardisation' and 'flexibility' be dealt with?

4.13 There is some potential for conflict between the desire for standardisation and the desire for flexibility. This is an area that the standard-setters will need to take a view on. The purpose of the discussion below is to explore, without reaching any conclusions, some of the possible approaches that could be adopted. Option A involves the most standardisation/least flexibility; Option B involves less standardisation/more flexibility and so on; and Option D involves the least standardisation/most flexibility.

Option A	Standard-setter identifies certain key lines as mandatory and prescribes their content. Preparers are not permitted to present additional key lines.
Option B	Standard-setter identifies certain key lines as mandatory and prescribes their content, but preparers are permitted to present additional key lines.
Option C	Standard-setter identifies certain key lines but allows preparers to determine their content.
Option D	Standard-setter identifies certain key lines but allows preparers to use others instead.

4.14 Option A involves the standard-setter identifying the key lines to be provided, specifying the content of those key lines, and prohibiting preparers from providing any additional key lines.

(a) If the standard-setter sets out in detail exactly which items should be included in which key line, this approach would be extremely prescriptive and would remove any freedom entities have in their financial statements to communicate the key lines they think are appropriate for them. Although such an approach would result in standard key lines, it would not allow differences in business activities to affect the presentation of the statement(s) of income and expense. This would be very rigid and rule-driven as it would have to override the natural diversity between different types of business.

(b) On the other hand, the standard-setter could be less precise as to exactly which items should be included in which key line. The more the standard-setter does this, the more like Option C this approach becomes.

4.15 Under Option B, specific key lines would be prescribed but, as is the case now under IFRS, the standard-setter would not prohibit preparers from presenting additional key lines of their own choice.

(a) One of the problems with this approach might be that the alternative key lines that management wish to present could not be encompassed easily in one or more statement that has other mandated key lines, because of cross-over between the categories. Either an entity would have to resort to complicated columnar presentation or one or other set of key lines would have to be reported outside the performance statement(s). Reporting a key line outside the performance statement(s) largely defeats the object of having it as a key line.

(b) A variation on this approach that might not be so problematical would be to allow preparers to present additional key lines of their own choice, but only if and to the extent that they could be encompassed in the performance statement(s) along with the mandated key lines.

4.16 Under Option C, the standard-setter would mandate the key lines to be presented and, probably, the attributes of those key line(s) identified and/or the principles to be followed in determining their content; and preparers would have the flexibility, subject to fulfilling those attributes and principles, to decide on the composition of the key lines.

(a) Such an approach would require a clear definition of the key lines—standardisation of purpose in effect—while also allowing a more flexible system to develop.

(b) A variation on this approach might be for the standard-setter to require certain items always to be included in specific categories, but leave others to be determined by each company.

4.17 Under Option D, preparers would in effect have the flexibility to choose which key lines to present and what to include in them.

(a) Although this appears very flexible, the expectation would be that market demand would eventually establish certain key lines at least for each industry sector to report and departure from these would result in negative market feedback.

(b) However, there may be uncertainty as to what the market wants—or differences of view amongst users—and this could affect comparability.

4.18 Earlier in this chapter (paragraph 4.4), the authors discussed the possibility that there would be a primary disaggregation method (net income and OCI was the primary disaggregation method used in the example) and further disaggregation within each of those categories ('a secondary disaggregation method'). It might be that an approach could be adopted that would allow relatively little flexibility at the primary level of disaggregation but much more flexibility at a secondary level of disaggregation, or vice versa.

4.19 This need to find an appropriate balance between standardisation and flexibility will play a significant role in determining the approach to be taken to disaggregation and categorisation of items of income and expense, which is discussed in the next chapter.

Bottom lines

4.20 One of the performance reporting issues that is most debated is whether there should be one performance statement or two. Two questions underlie this debate.

4.21 The first question is whether some items of income and expense are so different from other items that they need to be separated from those other items in a separate primary statement. However, bearing in mind what chapter 3 observed about the nature of performance, the authors believes this is just another aspect of the disaggregation/key lines debate already discussed (and discussed further in the next chapter).

4.22 The second question is whether it is important that the bottom line of a performance statement is a key line, or perhaps more specifically a particular key line. For example, it is sometimes argued that it is important for a particular key line to be a bottom line because it will be easier for users to find if it is a bottom line. Perhaps at this point it is necessary to say something about what this paper means when it talks of users. In practice, different types of person use financial statements in different ways. For example, some users do not carry out a detailed analysis of the financial statements and instead rely heavily on the totals they expect to find at the bottom of the primary financial statements. Other users carry out a more in-depth study of the financial statements. This paper assumes, like the IASB's Framework, that users have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.[35] Such users do not require key lines to be at the bottom of

[35] Paragraph 25 of the Framework.

primary statements in order to be able to find them; they examine and analyse sub-totals higher up the current income statement, for example operating profit, as well as looking at net income, which is the current bottom line. The authors are however not aware of any other reason why bottom lines need to be key lines.

4.23 It would appear therefore that there is no reason to believe it is necessary for the bottom line of a performance statement to be a key line. The important issue for users is whether the disaggregation of income and expenses is done in a meaningful way that produces the key lines that are required. Compared to this, whether one or two performance statements is or are provided is of little significance.

Recycling

4.24 So, the debate about the net income notion and about whether there should be one or two performance statements is really a debate about disaggregation: which disaggregation model should be used to ensure the appropriate key lines are presented. The next chapter explores various disaggregation models in greater detail. However, before doing that it is useful to understand the implications of the observations in this chapter for recycling.

4.25 As was explained briefly in chapter 2 (and at greater length in the first PAAinE paper on Performance Reporting), recycling in effect involves an entity recognising an item of income and expense in one part of the performance statement(s) in one period and in another part of the performance statement(s) in a later period.

4.26 For this to be possible, it means that there is not a single set of recognition criteria and measurement bases that is applied to all parts of the performance statement(s); thus, although an item of income and expense is eligible on initial recognition to be recognised in one part of the performance statement(s), at that point it is not eligible to recognised in the part of the performance statement(s) that it will later be recycled to. For example, if the recognition criteria for one part of the performance statement(s) require that income is realised, it follows that any unrealised income has to be recognised in another part of the performance statement(s).

4.27 However, that is not sufficient in itself to make recycling necessary, as can be seen from a quick look at the approaches that different standard-setters currently apply to recycling. Under US GAAP, recycling is required for all items recorded in OCI. However, UK GAAP permits no recycling. IFRS has a hybrid approach, requiring recycling of certain items, while other items will never be recycled.[36] Recycling all OCI items means that all income and expense items will eventually get reported in net income; recycling only some—or even no—OCI items means that there will be some income and/or expense items that will never be reported in net income. This shows that whether recycling is necessary depends on whether the recognition criteria or disaggregation model used <u>requires</u> the comprehensive reporting of all items that meet the criteria for that part of the performance statement(s) are met.

[36] Of the items currently included in OCI, actuarial gains and losses and revaluation gains and losses of tangible and intangible assets are never recycled, i.e. such items bypass net income on a permanent basis.

For example, if a disaggregation model is used that requires all realised gains and losses to be recognised in one part of the performance statement(s) as soon as they have been realised, unrealised gains and losses recognised in another part of the performance statement(s) will have to be recycled. However, it might be that the disaggregation model prohibits unrealised gains and losses from being recognised in one part of the performance statement but does not require gains and losses to be recognised there when they are realised if they have already been recognised as unrealised gains and losses.

4.28 Therefore, the key determinant as to whether recycling is necessary is the disaggregation model being used. If the model adopted involves different recognition criteria and/or a different basis and requires all items that meet the recognition criteria of each disaggregation category to be recognised in that category, recycling will be necessary.

4.29 Setting aside cash flow hedges for a moment, it is models that involve some sort of realised/unrealised split that will cause most recycling. So, for example, if the primary disaggregation is between realised and unrealised and comprehensive reporting of realised items is required, recycling will be necessary because otherwise the realised category will not show all the gains and losses that have been realised. Similarly, if the primary disaggregation is between core and non-core, but both those categories are further disaggregated between realised and unrealised and comprehensive reporting of realised items is required, there will need to be recycling between the subcategories for the same reason.

4.30 On the other hand—and again cash flow hedges apart—if the disaggregation model involves no explicit or implicit realised/unrealised split, it is unlikely that recycling will be necessary. For example, if the only disaggregation is an operating/financing/investment disaggregation model, recycling will not be necessary because an item that is, say, financing will not become an investment or operating item in a subsequent period.

4.31 It follows that recycling is not about the number of performance statement(s) presented; it is, like the net income debate and the one or two performance statements debate, about the disaggregation model being applied.

4.32 Most of those responding to the first PAAinE paper on Performance Reporting argued that an exception would probably need to be made to the 'normal' disaggregation model in relation to cash flow hedges. This paper does not discuss cash flow hedging but it is still not difficult to see that such hedging is likely to be an anomaly under any disaggregation system. Therefore, if cash flow hedging, particularly for forecast operating transactions, continues to be permitted, it is likely to be the one item that would have to be recycled under any of the disaggregation systems discussed in the next chapter.[37]

[37] A UBS paper that puts forward a model discusses recycling and cash flow hedges in some detail and, under its model, it would also continue to recycle foreign currency translation differences for foreign subsidiaries. See UBS Investment Research – Financial Reporting for Investors – Performance measurement for equity analysis and valuation, 16. April 2007.

Summarising remarks

4.33 Although no key line can capture everything about a company's performance that a user will need—because of the complex and multi-faceted nature of company performance—there is still a need for key lines to provide a basis for communication to the market and as a starting point for users' analysis. Those key lines need to be relevant and understandable, but also need to strike an appropriate balance between standardisation of the key lines and allowing preparers to focus on what they view as the 'headline' aspects of performance. This will be explored further in the next chapter.

4.34 It is not necessary for the "bottom line" of a performance statement(s) to be a key line. Bearing that in mind, the issue of whether there should be one performance statement or more than one is of little significance; the key issue is to ensure that the information within the statement(s) is disaggregated and categorised in a useful way so that the right key lines appear.

4.35 The disaggregation model is also the key determinant in whether or not recycling is needed and, if it is needed, when items are recycled.

Question 3: Do you agree that key lines are still useful, though only because of their value as a basis for communication to the market and as a starting point for analysis and comparison? If you do not, please explain your reasoning.

Question 4: Do you agree that, in order to fulfil this function, it is important that there are clear principles that underpin what is included and excluded from the key line(s) (in order to make their content understandable) and those principles need to be such that the content of a key line is standardised to a fair degree (in order to ensure the necessary comparability).

Question 5: This chapter discusses the need for standard setters to balance the competing demands of comparability and flexibility, in order to give users fairly consistent starting points for analysis, while allowing management to present income and expenses in a manner that reflects the particular circumstances of the entity. Has the range of approaches to flexibility and comparability given in the chapter been appropriately described? What do you believe would offer the best approach in practice?

Question 6: This chapter finds no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line. Do you agree that it is not important for the "bottom line" of statement(s) of income and expense to be a key line? If you do not, please explain your reasoning.

Question 7: Assuming it is correct that there is no evidence that it is important for the "bottom line" of statement(s) of income and expense to be a key line, do you agree that it follows that the number of performance statements provided is not particularly important either. And thus that the one or two performance statements debate is a non-issue; the real issues relate to the key lines. Do you agree with this analysis and conclusion? If you do not, please explain your reasoning.

Question 8: Do you agree that recycling is mainly an issue if a realised/unrealised split is the main disaggregation criterion for the statement(s) of income and expense, that therefore recycling is really a secondary issue and that the main issue is which disaggregation model should be used? If you do not, please explain your reasoning.

Question 9: Would the issue of recycling on its own affect your decision as to the best approach to disaggregation? Please explain your reasoning.

5 POSSIBLE MODELS FOR DISAGGREGATING INCOME AND EXPENSE

So, the issues of the number of performance statements presented, which key lines are shown and the extent of recycling relate to the disaggregation model chosen. What are the advantages and disadvantages of the various types of disaggregation model?

Introduction

5.1 As a result of the discussion to date, it has become clear that the key performance reporting issue is which disaggregation model should be used. The other debates—about net income, one or two statements and recycling—are sub-issues of the disaggregation debate. This chapter focuses on the disaggregation debate; in other words, on the various ways in which items of income and expense can be disaggregated, ordered, grouped and totalled.

5.2 The disaggregation model chosen needs to be one that results in key lines that meet the needs of users and preparers. That means, inter alia, that those key lines need to be relevant, understandable, and standardised to some extent, and that they give preparers sufficient flexibility to be able to present key lines that focus on what preparers see as the headline aspects of performance.

5.3 In the discussion that follows, it needs to be borne in mind that the optimal disaggregation might well be a disaggregation model with several layers. For example, the primary disaggregation could be core and non-core, but the items within each of those two categories might be further disaggregated (the secondary disaggregation level). Those secondary level categories might even be further categorised. However, in this chapter we try as much as possible to discuss the disaggregation approaches in a way that is equally applicable whether they are used as the primary or secondary disaggregation. We return briefly to the subject of disaggregation models with several layers at the end of the chapter.

Possible disaggregation criteria

5.4 An important objective of the disaggregation model chosen should be to ensure that the key lines that are needed are presented and are 'fit for purpose'. Chapter 4 discussed some of the attributes that key lines need to have to be fit for purpose: understandable, some degree of standardisation, and some degree of flexibility. It is also important however that the key lines are useful. In this context, research findings[38] indicate the following common themes in relation to user needs:

(a) Items having higher predictive value in terms of expected cash flows should be distinguished from those having lower predictive value (i.e. relative predictive value should be distinguished).

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[38] Johnson & Lennard, Reporting Financial Performance: Current Developments and Future Directions,1998, p 27.

(i) One aspect of this is that items of income and expense that are persistent or permanent should be separated from those that are not. This is sometimes referred to as the recurring vs non-recurring model.

(ii) Another aspect is that some items of income and expense might not be indicative of expected future cash flows because the underlying assets or liabilities are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured in the financial statements. (For example, if a liability is measured in the statement of financial position at, say, its transfer value when the entity's business model envisages that the liability will be settled as and when it falls due, changes in the liability's transfer value that do not reflect changes in its ultimate settlement value might represent an item of income and expense that is not indicative of expected cash flows.) This is sometimes referred to as the business model approach, because the business model of an entity usually has a strong influence on how its assets and liabilities are managed.

(b) Unrealised items should be reported separately from realised ones.

(c) Central operating or trading activities should be reported separately from other activities. This could be done by separating:

(i) core activities and non-core activities;

(ii) operating activities and non-operating activities. This can be further disaggregated into operating, financing and investing activities; or

(iii) holding and non-holding activities.

5.5 Although a longer list of possible disaggregation criteria can be formulated,[39] those given above are probably the most interesting to investigate further at this stage. For example, when expenses should be disaggregated by function or by nature is an important issue, but is a more detailed issue compared to the one we are discussing; disaggregation models designed to enable the appropriate key lines to be presented. Some other disaggregation approaches are more closely related to internal management accounting, for example differentiating between fixed and variable expenses. And some other disaggregation approaches are broadly similar to ones mentioned above. For example a "certain/uncertain" split is similar in many ways to a "realised/unrealised" split.

5.6 Before looking more closely at some disaggregation models, it is worth returning briefly to the standardisation vs flexibility debate discussed in the previous chapter to make two further points.

(a) Some of the approaches discussed <u>inevitably</u> involve a fair degree of flexibility, while others could involve flexibility depending on how precisely the terms are defined. For example, an approach based on a core/non-core

[39] The Johnson & Lennard paper did so.

split requires entities to take a view as to which of their own activities are core and which are non-core, and that view will depend partly on the business model involved and also on judgement; as a result, two entities that are in the same industry will not necessarily categorise income and expense items in the same way. The same is true of disaggregation models that focus on whether the items of income and expense are indicative of expected cash flows. On the other hand, if an operating/non-operating split is used but entities are left to decide for themselves what 'operating' means, the approach will be as flexible as the core/non-core and indicative of future cash flows/not indicative approaches; but if the model specifies exactly which items are to be categorised as operating and which as non-operating, there will be considerably less flexibility.

In this context it is important to bear in mind that flexibility has its advantages and should not necessarily be seen as a bad thing. It enables preparers to present information in the way they believe is most useful for users, and it ensures, from a user's perspective, businesses that are different can be seen to be different.

(b) Although the next section discusses the various disaggregation models in isolation from each other, some of them are not mutually exclusive and as a result could be combined into a multi-level disaggregation model.

Recurring vs non-recurring

5.7 The general purpose of the separate presentation of recurring and non-recurring income and expense is to help users to identify 'permanent' (or ongoing or sustainable) results. The underlying key characteristic is the degree of expected repetition of the activity in question. Depending on exactly how the terminology is used, 'recurring items' could be those transactions and events which are considered to occur on a regular basis, or perhaps merely those that are expected to occur again. Thus, non-recurring items are those that result from one-off or more unusual events in the business, for example fixed asset impairments, restructuring costs and perhaps gains and losses on fixed assets if the business model does not envisage such gains and losses occurring on a regular basis.

5.8 At a June 2005 meeting of the IASB Joint International Group on Performance Reporting, an example of what a recurring/non-recurring disaggregation model might look like was presented, and it is included below for illustration purposes. It needs to be noted however that some would argue that the illustration is incomplete or perhaps under-developed because:

(a) it treats items such as litigation costs and restructuring costs as recurring items, even though they might be rare. This is discussed further below.

(b) the illustration is actually of a disaggregation that has a primary disaggregation based on a net income/OCI split, a secondary disaggregation based on a financing/non-financing split, and the recurring/non-recurring split is at the third level of disaggregation and is of only the operating part of the net income category.

(c) 'discontinued operations' are shown separately. The definition and presentation of 'discontinued operations' is an important issue, because of the information it provides users about sustainability. It is however just another aspect of the disaggregation issue.

(d) the tax expense is shown on a single line as a deduction before discontinued operations and OCI. Thus, continuing net income items are presumably shown before deduction of tax and discontinued operations and OCI are presumably shown net of tax. The presentation of the tax expense/benefit for the period is an issue that is not discussed in this paper.

Model based on a Recurring/Non-recurring distinction

Item	Amount	Total	
Recurring			
Revenue	1000		
Cost of sales	(600)		
Distribution costs	(80)		
Administrative expenses	(120)		
Actuarial loss on pension	(100)		
Fair value gain in trading securities	20		
Gain from the sale of securities	120		
Foreign currency exchange related loss	(60)		
Dividend received	25		
Litigation liability	(15)		
Share of net income of associates (equity investees)	55		
Restructuring losses	(45)		
Large environmental liability	(55)	**145**	
Non-recurring			
Gain from the sale of PP&E	120		
Impairment of PP&E	(20)	**100**	
Financing			
Interest income	20		
Interest expense	(50)	**(30)**	
(Less: Tax expense)		(20)	
Discontinued operations loss		(50)	
NET INCOME			**145**
Fair value loss in AFS securities		(30)	
Foreign currency translation adjustment on net investments		(80)	
Cash flow hedges loss		(25)	
COMPREHENSIVE INCOME			**10**

Advantages

5.9 As already mentioned, separating ongoing items from those that do not occur regularly or are one-off is helpful to users because it seeks to distinguish between items that are relevant in making assessments about future earnings and cash flows and items that are not. Management already often exclude one-off items to the extent they can when communicating performance information, so this approach would incorporate that into mainstream GAAP.

5.10 A recurring/non-recurring disaggregation does not in itself require the use of recycling—except for cash flow hedges. Those who believe recycling adds to the complexity of financial reporting would see this as an advantage.

Disadvantages

5.11 We discussed earlier the fact that the degree of flexibility inherent in a disaggregation model will often depend on how precisely the key terms and categories are defined, and that is true in this case. However, with a recurring/non-recurring split the issue goes deeper than that, because the recurrence/non-recurrence of an event is so specific to individual companies. For example, a transaction that is recurring in one industry might be non-recurring in another industry. Furthermore, what is recurring will depend on circumstances in the reporting period and what happens to an entity in several consecutive periods. One example, which is often cited, is restructuring. "How unusual does organisational change have to be before it becomes classified as a one-off restructuring, and is a series of restructurings in consecutive years a recurring activity, or is it a collection of one-off events?"[40]

5.12 Some would argue that this means that this disaggregation approach is highly subjective and will result in financial information that is unlikely to be comparable over time or between different companies. However, an alternative view is that the approach enables the differences between companies to be highlighted. For example, if two companies undertake exactly the same transactions, are subject to exactly the same events as each other and have exactly the same view as to what a recurring/non-recurring split entails, they would still categorise, say, restructuring costs differently if one company has an ongoing restructuring programme and the other one does not. Some might argue that this is a comparability concern, but others would say the two companies are not the same and the disaggregation model helps to highlight that difference.

5.13 Another possible disadvantage of a recurring/non-recurring split—and of some, but not all, of the other disaggregation models discussed in this chapter—is that the approach treats as a dichotomy (ie either it is recurring or it is non-recurring) something that is not really a dichotomy. Thus items of income and expense that are only slightly different in terms of frequency of occurrence or likelihood of recurrence will be categorised differently. Exactly how this is done will depend on how the terms and categories are defined.

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[40] "Reporting Financial Performance", Richard Barker, 2004

5.14 The recurring/non-recurring split would also give rise to a number of detailed implementation issues that would need to be resolved. For example, what should one do with a sale of products in the normal course of business but at an exceptionally favourable price when it is clear that such a price will never be achieved again? However, it is probably fair to say that all the approaches discussed in this chapter—and probably all the conceivable disaggregation approaches—give rise to detailed implementation issues.

A split based on the business model approach

5.15 Earlier we explained that research indicates that users find disaggregation models that distinguish between Items that have a higher predictive value in terms of expected cash flows and items having a lower predictive value. Although the recurring/non-recurring model is traditionally the one used to illustrate this type of disaggregation, an alternative (or perhaps complementary) approach could be a disaggregation model that separates items of income and expense derived from assets or liabilities that are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured from other items of income and expense.

5.16 Again this approach could take a variety of forms, and the simplest would probably involve allocating each item of income and expense between the two categories without splitting any items. Thus a gain or loss arising on, say, the remeasurement to fair value of an asset that is managed within the business on a cost basis would be included in a separate category from a gain or loss arising on the remeasurement to fair value of an asset that is managed within the business on a fair value basis.

Advantages

5.17 This approach, like the recurring/non-recurring approach, seeks to distinguish between items that are relevant in making assessments about future earnings and cash flows and items that are not; something that is of fundamental importance to users.

5.18 It also has another advantage: because the focus of the approach is on how the assets and liabilities are managed within the business, the approach is likely to result often in a disaggregation that is consistent with the entity's internal reporting and also with the segment reporting information being provided, which existing IFRS also requires to be prepared on a management approach basis. From a preparer's point of view, this enables them to disaggregate the income and expense items in a way that is as consistent as possible with the way they have assumed stewardship responsibility; and from a user's point-of-view it will mean that the cohesiveness of the financial statements is advanced, thus improving the usefulness of the information generally.

Disadvantages

5.19 This approach also has the same sort of disadvantages as the recurring/non-recurring approach: potential issues concerning comparability and implementation issues.

5.20 The main source of these potential comparability issues is that companies that are in the same position as each other might categorise the same items of income and expense differently. For those who would prefer a high degree of uniformity, this will be a disadvantage. However, in many cases those differences in categorisation will arise because the entities are managing the assets or liabilities involved in different ways and the disaggregation model is merely highlighting that. In other words, the approach enables the differences between companies to be highlighted. A second—probably much less significant—source of comparability issues is that not all business models are so straight-forward or clear-cut that judgment is not involved at least to some extent in the categorisation process. Thus, although companies with the same business model and in the same position as each other should categorise income and expenses in the same way, that will not necessarily be the case.

5.21 In Chapter 4 we explained that the key determinant of whether recycling is necessary is the disaggregation model being used. If the model adopted involves different recognition criteria and requires all items that meet the recognition criteria of each disaggregation category to be recognised in that category, recycling will be necessary. Some versions of the business model approach could involve recycling.

> For example, assume a reporting entity acquires a particular asset for €100 on the first day of year one with the intention that the asset will be used until it has been fully consumed. The asset is managed on a cost basis. However, for various reasons the entity is required to measure the asset at fair value in its financial statements, and the fair value of the asset at the end of year one is €110. Assume also that on the first day of year two the entity sells the asset for €110. Under the business model approach, in year one a gain of €10 will be classified amongst the items of income and expense derived from assets or liabilities that are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured from other items of income and expense.

(a) It could be argued that there has been no gain in year two, so there is no gain to report and no recycling is necessary.

(b) However, an alternative approach would be to report a gain of €10 in year two amongst the items of income and expense arising from assets and liabilities that are managed on the same basis as they are measured. If such a gain is to be recognised, it will need to be recycled from the category it was reported in in year one.

5.22 It can be the case that, whilst an item of income or expense as a whole might not have arisen from an asset that is being managed on the same basis on which it is being measured, a component of that item of income or expense might be measured and managed on the same basis. (For example, a liability might be measured on an market-based transfer value basis but managed on an eventual settlement value basis. If that is the case, a change in the liability's market-based transfer value would be an example of an item of income or expense that has arisen from a liability that is not managed on the basis on which it is measured. But if the whole of that income or expense is classified in that way, any change in the eventual settlement value will not be reported—even though it is relevant to an assessment of expected future cash flows. Another example might be defined benefit pension liabilities, where the reporting entity might not be managing the liability on the measurement basis required by IAS 19.) There are probably two points to bear in mind here:

(a) It might be that a more evolved version of the approach so far described could be developed to address these implementation issues in a way that does not make the whole approach too complex.

(b) Most of the approaches described will, if implemented, have to be implemented in a way that is pragmatic and involves a degree of approximation. This approach is no different. The information about performance provided in the financial statements can only ever be the raw material for users' assessments; it cannot take the place of those assessments.

Realised vs unrealised

5.23 Earlier in the chapter we explained that, although users like items that have a higher predictive value in terms of expected cash flows to be distinguished from those having lower predictive value, they also find it useful if unrealised gains and losses are reported separately from realised ones. Such a categorisation helps them to understand which items that have been 'converted into cash' or are close to being converted into cash and which are further away from conversion into cash and provide information about the reduction in uncertainty and release from business risk—-which help in making assessments about past performance and future prospects. It also provides information that helps users to understand an entity's liquidity.

5.24 A key issue in any such model is whether it is a converted to cash/not yet converted to cash model or a could easily be converted into cash/not yet easily convertible into cash model.

(a) Some view 'realised' as meaning that the profits have been converted into cash, and 'realisable' as in addition including items that could be converted easily into cash. Others believe that the term 'realised' includes items that could be converted easily into cash.[41]

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[41] For example, during the IASB Joint International Group meeting on Performance Reporting held in June 2005 it was suggested that "realised is the state that transactions, events, or items are in when they are readily convertible to or have been completed to obtain cash or cash equivalents." Some Group members also suggested explaining that "readily convertible assets and liabilities have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price." Thus, income and expenses originating from the current value measurement of statement of financial position items that have not been confirmed yet through a sale transaction would generally be treated as unrealised (for example revaluations of property, plant and equipment). However, income and expenses arising from current value changes of financial instruments that are fungible and traded on an active market would be treated as realised.

(b) Certainly the meaning attributed to the notion of "realisation" varies significantly between jurisdictions and in some is connected to legal concepts of capital maintenance, creditor protection and distributions.[42]

(c) If the disaggregation model was a converted to cash/not converted to cash model, it would be moving much closer to the notion of a cash/accruals distinction. Although some might argue that a distinction between cash flows and accruals is already achieved by the requirement to produce a statement of cash flows, it is understood that at least some users would welcome a disaggregation model that distinguished between cash and accruals.

5.25 An illustrative example of a realised/unrealised disaggregation model, again taken from the papers of the June 2005 meeting of the IASB Joint International Group on Performance Reporting, is shown below. Several points about the illustration are worth noting.

(a) As with the earlier illustration, a primary disaggregation based on a net income/OCI split and a secondary disaggregation based on an operating/financing split is used; the realised/unrealised split is actually the third level of disaggregation and is of only the operating part of the net income category.

(b) The illustration treats fair value gains in trading securities as unrealised. This implies either that a fairly narrow definition of the word 'realised' is being used, or that the securities involved are not easily convertible into cash.

(c) Although the illustration treats the entity's share of an associates' net income as unrealised, under some definitions this would be a realised item.

(d) The illustration does not show any recycling. Recycling will be discussed further in a moment.

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42 This is the case in EU law under the Second Company Law Directive and its impact is also felt in the Fourth Company Law Directive: see for example Rickman "Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance", BIICL, 2004.

A model based on a Realised/Unrealised distinction

Item	Amount	Total	
Realised Profit			
Revenue	1000		
Changes in inventories	(110)		
Work performed by the entity and capitalised	100		
Employee expense	(500)		
Depreciation	(100)		
Write-down of accounts receivables	(10)		
Other costs	(160)		
Actuarial loss on pension	(100)		
Gain from the sale of securities	120		
Foreign currency exchange related loss	(60)		
Dividend received	25		
Litigation liability	(15)		
Gain from the sale of PP&E	120		
Restructuring losses	(45)		
Large environmental liability	(55)	**210**	
Unrealised Profit			
Inventory impairment	(20)		
Fair value gain in trading securities	20		
Impairment of PP&E	(20)		
Share of net income of associates (equity investees)	55	**35**	
Financing			
Interest income	20		
Interest expense	(50)	**(30)**	
(Less: Tax expense)		(20)	
Discontinued operations loss		(50)	
NET INCOME			**145**
Fair value loss in AFS securities		(30)	
Foreign currency translation adjustment on net investments		(80)	
Cash flow hedges loss		(25)	
COMPREHENSIVE INCOME			**10**

Advantages

5.26 As already explained, the realised/unrealised disaggregation model—like all the disaggregation models discussed in this chapter—meets an information need. In addition:

(a) It is also a relatively straight-forward approach to adopt, assuming the terms being used are defined clearly—indeed, it has been applied in some form in certain jurisdictions (usually under specific legal rules) for many years.

(b) The approach will also generally involve less flexibility and subjectivity than the other approaches discussed so far (although, if a closeness to cash test is involved, judgment will still be needed). Items would be accounted for consistently regardless of the purpose for which they are being used to extract value—unless of course another disaggregation level distinguishes between items on the basis of the purpose for which they are being used. For example, current value changes of trading securities are, under existing standards, included in net income, but current value changes for available-for-sale securities are included in OCI; using a realised/unrealised split as the primary disaggregation model could eliminate such divergence if the sets of securities are as close to cash as each other. Of course, some would not see this as an advantage, believing that the best disaggregation models take account of the way the entity envisages using an asset or exiting from a liability.

Disadvantages

5.27 Realisation has traditionally been seen as the triggering event for recognising profits, because it demonstrates that the earnings process for goods or services is complete and profits have been "made". With the development and use of active markets in financial instruments, however, the realisation principle has lost its universal validity. If an asset can be realised at will, realisation represents not so much the end of a selling process as a decision by management to change from one form of asset to another. Some would argue that it is not obvious why such a decision should make a difference to how an item of income or expense is presented. The timing of a realisation is also often at the discretion of management, thus reducing the validity of the realised/unrealised split further. However, including a close to cash test (either by applying a broad definition of realised or by applying a realisable/non-realisable split) deals with most of these concerns.

5.28 Some argue that "realisation merely represents confirmation of a gain".[43] It does not give any additional information regarding the nature of the gain, especially regarding probability of its recurrence. For example, realisation of a revaluation gain presented in OCI in a previous period does not give any additional information about how likely such a gain is to recur in the future. "If measurement is sufficiently certain for recognition of the gain or loss to be possible, then it is the nature of the item itself that should determine how it is classified in a statement of

[43] Cearns, G4+1, Paragraph. 4.12 f.

financial performance."[44] According to this view, realisation is not a financial performance concept and so should not be used as a fundamental criterion in a performance reporting model. However, the authors believe this argument is more about whether unrealised gains and losses should be recognised, than about how they should be presented if recognised.

5.29 Some argue that under a realised/unrealised split, items with different characteristics will be grouped together and that will reduce the usefulness of the information provided. However, that would be the case only if the realised/unrealised split is the only disaggregation model applied; in a multi-level disaggregation model that need not be the case.

5.30 As previously explained, if a disaggregation model involves different recognition criteria and requires all items that meet the recognition criteria of each disaggregation category to be recognised in that category, recycling will be necessary. A realised/unrealised split involves different recognition criteria. Therefore:

(a) recycling will be necessary if the model requires all realised gains and losses to pass through the realised category. Some believe that recycling adds complexity to financial reporting and would therefore prefer a model that involves as little recycling as possible.

(b) if, on the other hand, the model could require gains and losses to be recognised only once—and in the realised category only if they are realised on initial recognition—the realised category would not report all realised gains and losses and the result might be that the model will not provide all the benefits for users described earlier.

Core vs. non-core

5.31 So far in this chapter we have discussed disaggregation methods that either separate items that have a higher predictive value in terms of expected cash flows from those having lower predictive value or separate realised items from unrealised items. Research suggests that users also like to see central operating or trading activities reported separately from other activities. As explained earlier in this chapter, such a separation could take a number of different forms:

(a) core activities vs non-core activities;

(b) operating activities vs non-operating activities. Sometimes this is further disaggregated into operating, financing and investing activities; or

(c) holding activities vs non-holding activities.

In this section we focus on a core/non-core split. In the two sections after that we will consider an operating/financing/investing split, then a holding/non-holding split.

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44 Cearns, Paragraph 4.14.

5.32 A core/non-core approach to disaggregation attempts to focus on the essential business of an enterprise, thereby separating activities that are central to an entity's ongoing operations from those that are deemed to be 'peripheral'. Nevertheless, much will depend on how—and how precisely—the terms are defined. For example:

(a) The AICPA's Jenkins Committee defined "non-core activities" as unusual and non-recurring activities while "core activities" were understood as being usual and recurring transactions.[45] Some treat discontinued operations as non-core activities, regardless of how central those activities were to the business, on the basis that they will not occur again. There is thus a potential overlap with the recurring/non-recurring approach.

(b) A second way of viewing the split is to see it as focusing on operating activities (as opposed to financing, and perhaps also investing). There is thus a potential overlap here with the operating/investing/financing model.

(c) Another way is to ignore the frequency of occurrence and whether or not it is an operating activity and focus instead on whether the income or expense items arise from activities that are central to the entity's purpose.

(d) Of course, a combination of these approaches is also possible. For example, in the AICPA's model referred to earlier, a core vs non-core and financing split is adopted. (This is illustrated below.) Standard & Poor has suggested in the past a measurement of core earnings that excludes any gains related to pension activities, net revenues from the sale of assets, impairment of goodwill charges, prior-year charge and provision reversals and settlements related to litigation or insurance claims. Expenses related to employee stock option grants, pensions, restructuring of present operations or any merger and acquisition costs, R&D purchases, write-downs of depreciable or amortisable operating assets, and unrealised gains/losses from hedging activities are all included in the core earnings.[46]

5.33 As we have already discussed the recurring/non-recurring model and will in a moment be discussing the operating/investing/financing model, we will limit ourselves here to commenting on a core/non-core distinction based on whether the income or expense items arise from activities that are central to the entity's purpose.

5.34 Unfortunately, this terminology is itself rather imprecise. For example, the FASB refers to revenues resulting from 'an enterprise's ongoing major or central operations', as opposed to gains resulting from 'peripheral or incidental transactions'.[47] However, the FASB did not provide further definitions for "major or central operations' or 'peripheral or incidental transactions'. In a similarly imprecise manner, the IASB Framework states that revenue and expenses arise in the

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[45] AICPA, 1994, Improving Business Reporting – A Customer Focus, pp. 80 f.

[46] David M. Blitzer/ Robert E. Friedman/Howard J. Silverblatt, Measures of Corporate Earnings 2002, Standard &Poor's White Paper, May 14 2002.

[47] FASB, 1979, Reporting Earnings. Discussion Memorandum No. 16, Norwalk.

course of the ordinary activities of an enterprise" while gains and losses "may, or may not, arise in the course of ordinary activities". To confuse things further, the G4+1 Position Paper referred to activities as "generally central to the activities of the entity" as 'operating activities'.

Advantages

5.35 A core/non-core approach based on whether the income or expense items arise from activities that are central to the entity's purpose is useful in that it helps users to understand how well the core business of the entity is performing without the distraction of peripheral operations or effects. Some users also apparently believe that such a distinction would also enhance their understanding of what entities believe their business activities are and they would therefore be able to hold management more accountable (i.e. it would be an aid in assessing stewardship).

5.36 Under this approach items of income and expenses would be recognised only once as either core or non-core-, so this disaggregation model in itself would not create a need for recycling,[48] which would reduce complexity.

Disadvantages

5.37 As with the recurring/non-recurring and indicative of future cash flows/not indicative splits, a core/non-core distinction based on whether the income or expense items arise from activities that are central to the entity's purpose is inevitably subjective. Similar items could be categorised differently not only because of differences in the type of business(es) in which the entity is engaged, but also management's view of it. For example, a gain from the sale of PP&E may be considered as being core for a certain type of real estate company, but non-core for other industries. Furthermore, gains or losses from financial assets are core for financial institutions but 'non-core for other industries.

5.38 However, as with those other disaggregation models, although some see this as a disadvantage—arguing that comparability will be reduced as there is no way of distinguishing consistently between core and non-core across all businesses—others argue that these differences in categorisation highlight differences in the way managements manage their businesses.

Operating vs. Investing vs. Financing

5.39 The separation of income and expense items arising from financing activities from other income and expense items (i.e. those arising from operating and investing activities) is a common distinction in finance theory and in practice in the capital markets. It is built on the premise that a distinction is made in the statement of financial position between the assets employed by an entity in its operations and the funding provided for those assets. Correspondingly, a statement of financial performance should distinguish between (i) flows that form part of the return on business assets (i.e. business profits that contribute to the generation of enterprise value) and (ii) flows that form part of the return to providers of finance (i.e. distributions of enterprise value).

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48 The one recycling issue that remains is cash flow hedges, which was discussed in Chapter 4.

5.40 Some favour a further disaggregation of the non-financing category into 'operating' and 'investing'.[49] Several arguments are advanced in favour of such a disaggregation. Some liken it to a core/non-core split, and therefore argue it is useful for the same reasons that split is useful. Some others see investing as a very different activity to operating activity and therefore believe the disaggregation is necessary to ensure that items with different attributes are presented separately.

5.41 These different arguments to some extent involve different understandings on what is meant by the terms 'operating' and 'investing': the core/non-core argument implies 'investing' activities are peripheral, incidental activities, whilst the 'very different activities' argument is probably based more on a view of investing activities as involving holding gains and losses. This emphasises the importance of being clear as the meaning of the terms being used. For example:

(a) IAS 7 defines the three kinds of activities as follows:

- *Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

- *Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

- *Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

So in IAS 7, 'investing' includes capital expenditure and investments in certain types of capital instruments, and 'operating' is the default category.

(b) The recent IASB Discussion Paper describes the terms slightly differently:

- The operating activities are those activities conducted with the intention of creating value that are related to the central purpose(s) for which the entity is in business.

- The investing activities are those activities conducted with the intention of creating value that are unrelated to the central purpose for which the entity is in business.

- The financing category shall include financial assets and financial liabilities that management view as part of the financing of the entity's business (ie operating and investing) and other activities.

Some view the Discussion Paper as proposing that the operating/investing split should be viewed largely as a core/non-core split although, as the Discussion Paper goes on to talk about the investing category in terms of generating "a return in the form of interest, dividends, or increased market prices", the issue is probably not as clear cut as that.

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49 This is the approach proposed in the IASB's recent discussion paper. That paper refers to the 'non-financing' category as 'business'. Such a categorisation is also already discussed in the existing accounting literature within the context of cash flows, in IAS 7 *Statement of Cash Flows*.

5.42 An illustrative example of the Operating vs Investing vs Financing distinction is set out below. In the example, the expense items included in the operating category have been further disaggregated by nature (ie salaries, materials etc).

A model based on an Operating vs Financing vs Investing distinction[50]

Statement of Comprehensive Income (in millions)	2006	2005
BUSINESS		
Operating Income		
Sales	68,222	56,741
Costs and expenses:		
Salaries & Wages	(20,626)	(16,374)
Materials	(7,299)	(7,040)
Depreciation	(4,377)	(3,384)
Pension and other benefits	(3,369)	(3,252)
Advertising Fees	(3,000)	(2,700)
Amortization	(1,000)	(800)
Rent	(1,000)	(1,000)
Energy and Supply Chain	(2,982)	(2,517)
Technology	(3,777)	(3,360)
Other operating expense	(5,392)	(4,714)
Total costs and expenses	(52,822)	(45,141)
Loss on Asset Disposal	(300)	0
Goodwill Impairment	(200)	0
Operating income	14,900	11,600
Investing Income		
Income from minority investment	150	100
Investing income	150	100
FINANCING		
Financing income		
Interest income	250	200
Financing expenses		
Interest expense	(1,119)	(834)
Net financing expense	(869)	(634)
INCOME TAXES		
Provision for income taxes	(3,729)	(3,058)
Comprehensive Income	10,452	8,008

50 As extracted from the IASB Observer Note – January 2007.

Advantages

5.43 This disaggregation criteria distinguishes flows that arise from business assets from those that relate to the financing of the business. It is known that this is useful and relevant to investors because of the extent to which EBIT or Operating Income is often highlighted, as noted in Chapter 3. It matches financial statement presentation to the key drivers of how businesses are generally run. By further disaggregating business into 'operating' and 'investing', items that are very different in nature and have very different 'drivers' are reported separately; in addition, an operating profit key line is provided.

5.44 Another advantage of this distinction—if the categories are defined or described in the way they are in existing IAS 7—would be that the same disaggregation would be adopted in the statement of cash flows and statement of financial performance, allowing both flows statements to become aligned. It is much easier to use financial statements if the relationship between items in the different primary statements is apparent,[51] and one way of doing this can be to adopt the same disaggregation system in the different primary statements.

5.45 Under this approach items of income and expenses would be recognised only once—as operating, investing or financing—so this disaggregation model in itself would not create a need for recycling.[52] Those who believe recycling adds to the complexity of financial reporting would see this as an advantage.

Disadvantages

5.46 The main disadvantage of this approach relates to the allocation of income and expense items between the categories. There are some conceptual issues that would need to be addressed—for example, should financing be defined as interest (including notional interest) on all liabilities or only the servicing of a debt liability, and how should 'investing' be defined—although this could presumably be dealt with in the accounting standard through the use of clear principles and well-defined terminology. Similarly, in certain industry sectors—such as banking and insurance—the lines between the categories might be somewhat blurred, which could perhaps mean that this disaggregation approach would have to be varied when applied (or perhaps simply not applied) to certain industries.

5.47 There is also potential subjectivity involved, depending to some extent on how precisely the principles involved are stated and the terminology is defined. This is of course an issue with many of the disaggregation models discussed in this chapter, and highlights once again the importance of striking a suitable balance between standardisation and flexibility. What is operating, investing or financing will inevitably depend upon the nature of the entity's activities, so it is inevitable that identical items will be categorised differently depending on their purpose. This makes standardisation unattainable, and even undesirable.

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[51] The IASB refers to this in its Discussion Paper as the 'cohesiveness objective'.

[52] The one recycling issue that remains is cash flow hedges, which was discussed in Chapter 4.

Non-holding vs Holding

5.48 Earlier in this chapter we explained that users find it useful if the disaggregation model used enables central operating or trading activities to be reported separately from other activities. We mentioned that one way of doing this would be to adopt a core/non-core split, and another way might be to adopt an operating/non-operating split or a financing/non-financing split—such approaches could be further disaggregated into operating/investing/financing. A further way to separate central operating or trading activities from other activities might be to apply a holding/non-holding activities split.

5.49 This basis of disaggregation distinguishes gains and losses resulting from price changes while assets (or liabilities) are held ("holding gains") from items of income and expense representing business activity. As with the operating/investing/ financing model, it differs from the realised/unrealised split because it classifies gains and losses by their source rather than by the stage that they have reached in their progress to realisation or some other indicator of certainty. A gain arising from the sale of a long-term asset carried at historical cost would be reported in the holding category, along with revaluation gains.

5.50 Items of expense relating to consumption of an asset would nevertheless stay in the non-holding category. Thus, depreciation and amortisation would be appropriately shown in non-holding category because they are not holding gains or losses, but rather indicate consumption of an asset in order to generate profits.[53]

Advantages

5.51 This approach would keep some of those items viewed as "non-operating" or incidental to the drivers of operations out of the core operating numbers, thus encapsulating one of the desires of users in presenting clean operating figures. It also allows some indication of short-term vs long-term income and expenses, reflecting how they have arisen from current and longer term assets and liabilities in the statement of financial position. The disaggregation also ensures that gains and losses that are usually very different in nature are presented separately.

5.52 Under this approach items of income and expenses would be recognised only once as either holding or non-holding—a gain arising on the revaluation of an office building does not cease to be a holding gain when the building is sold. Accordingly, this disaggregation model in itself would not create a need for recycling between categories,[54] thus reducing the complexity that some argue would otherwise arise.

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53 A modified holding/non-holding distinction was put forward by the UK Accounting Standards Board in Financial Reporting Exposure Draft 22 "Revision of FRS 3 'Reporting Financial Performance'", December 2000.

54 The one recycling issue that remains is cash flow hedges, which was discussed in Chapter 4.

Disadvantages

5.53 If this disaggregation approach is viewed as some sort of proxy for operating/non-operating, it will be a better proxy for some industry sectors than for others. For example, revaluation and disposal gains and losses on an office building would always be in the holding gain or loss category but, whilst in the case of a manufacturing company such gains and losses would also be non-operating, for an investment property company they will generally be operating. Of course, this is not an issue if the distinction is not being viewed as a proxy for operating/non-operating and, even if it is, it is possible that the issue could be dealt with by the standard setter: permitting a degree of flexibility in the way items are categorised top reflect their business model.

5.54 Of course, in some cases holding gains arise only because non-holding expenses have been incurred; and in some circumstances holding gains and non-holding gains are almost interchangeable economically. However, whether these are disadvantages in practice will depend on how users intend to use the information.

Disaggregation models with more than one level of disaggregation

5.55 So far in this chapter we have discussed the various disaggregation approaches without considering the possibility that they might in practice be combined in some way in a disaggregation model with more than one level of disaggregation. However, the authors believe that it is highly likely that the optimal disaggregation model will be a multi-level one, especially as such models enable different attributes of the income and expense items to be highlighted. The existing performance reporting disaggregation model is a multi-level model—items are disaggregated into net income, discontinued operations and OCI, and the expense items in net income is further disaggregated by function or nature—and it seems unlikely that any improvement to that model will involve less disaggregation.

5.56 There are an almost infinite number of ways that the various disaggregation models discussed so far—and models not yet discussed, such as disaggregation by nature and disaggregation by function—could be combined. We will therefore limit ourselves here to making just a few general comments.

5.57 Two of the disaggregation approaches we have discussed are recurring/non-recurring and indicative of future cash flows/not indicative. It is unlikely that there would be much merit in trying to combine these approaches in a multi-level model, because both approaches are just versions of the same broad type of disaggregation model—one in which items having higher predictive value in terms of expected cash flows are distinguished from those having lower predictive value. Similarly, it is unlikely that there would be much merit in trying to combine two or more of the core/non-core, operating/non-operating, financing/non-financing, operating/investing/financing and holding/non-holding approaches in a multi-level model, because they too are just versions of the same broad type of disaggregation model—one in which central operating or trading activities are distinguished from other activities.

5.58 However, there could be benefits in combining two or more of the following broad types of disaggregation model:

(a) those that distinguish between items having higher predictive value in terms of expected cash flows from those having lower predictive value;

(b) those that distinguish unrealised gains and losses from realised ones; and

(c) those that distinguish central operating or trading activities should be reported separately from other activities.

5.59 For example, consider the possibility of combining type (a) and type (c) models. To make the discussion simpler to follow, assume also that the type (a) approach to be used is the business model approach and the type (c) approach is the operating/investing/financing approach.

5.60 One way in which these approaches could be combined is to first disaggregate items into 'items of income and expense derived from assets or liabilities that are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured' and 'items of income and expense managed on the same basis that they are measured on'; and then further disaggregate one or both categories into operating, investing and financing items. If all categories are fully disaggregated, such an approach would result in sub-totals for 'operating items from assets and liabilities managed on the same basis that they are measured on', 'investing items from assets and liabilities managed on the same basis that they are measured on', 'financing items from assets and liabilities managed on the same basis that they are measured on', 'total items from assets and liabilities managed on the same basis that they are measured on', 'operating items from assets and liabilities not managed on the same basis as they are measured', 'investing items from assets and liabilities not managed on the same basis as they are measured', 'financing items from assets and liabilities not managed on the same basis as they are measured', and 'total items from assets and liabilities not managed on the same basis as they are measured'. These labels are a bit cumbersome but the additional information that comes from using the two disaggregation layers is immediately clear.

5.61 The alternative way in which to combine the two approaches would be to first disaggregate items into operating, investing and financing items; then further disaggregate one or more of those categories into 'items of income and expense derived from assets or liabilities that are being managed on a basis that envisages a different realisation or settlement scenario to that underpinning the way those assets or liabilities have been measured' and 'items of income and expense managed on the same basis that they are measured on'. If all categories are fully disaggregated, such an approach would result in the same sub-totals as under the preceding paragraph except that, rather than show 'total items from assets and liabilities managed on the same basis that they are measured on' and 'total items from assets and liabilities not managed on the same basis as they are measured', the approach would show totals for 'operating', 'investing' and 'financing'.

5.62 Which of these two ways of combining the two disaggregation methods is preferable will therefore depend primarily on which of these sub-totals—or potential key lines—are considered most useful. This illustrates the point made earlier in the paper that key lines and disaggregation models are not separate issues.

5.63 Of course, the optimal disaggregation model might have more than two levels of disaggregation. For example, it could be that the two-level disaggregation described above could be supplemented by a further disaggregation of some or all of the expense items by function or by category. The most appropriate disaggregation model will depend on users' information needs, and the costs of meeting those needs.

Summarising remarks

5.64 Categorising (i.e. disaggregating) income and expenses is of value to users, but there is a wide variety of possible disaggregation criteria for the statement(s) of income and expenses. Selecting the most appropriate disaggregation model involves understanding user information needs. An equity holder's main objective, when evaluating an entity, is to form opinions about its absolute and relative value. Such investors use a variety of approaches to value entities and equity securities, for example:[55]

- "Apply a multiple to the company's current or projected earnings, cash flows, or adjusted reported equity.
- Project the company's future cash flows and residual value and discount at a risk-adjusted cost of capital.
- Add to or subtract the estimated current or fair values of non-operating resources or obligations from the present value of future core earnings or cash flows.
- Total current or fair values of the company's major assets, and subtract the current or fair value of the company's debt.
- Identify recent favourable or unfavourable developments that are not yet reflected in the market price.
- Identify probable short-term price changes through indicators involving financial measurements, such as the momentum in the company's earnings."

5.65 Another issue that will need to be considered, as highlighted in the first discussion paper, is the extent to which a divergence between internal and external reporting of earnings or profit is reasonable. Such a divergence may result in additional costs for entities, but perhaps more importantly it may interfere in the communication process between preparers and users. It will be important that any change should therefore try to minimise the divergence between internal and external reporting, or at the very least address it. This issue is connected to the question of the level of

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[55] AICPA, Improving Business Reporting – A Customer Focus, 1994, Chapter 3 (http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/ibr/)

flexibility that should be permitted in the disaggregation model. It might be fruitful in this context to consider further research into how external reporting requirements affect internal reporting, and conversely how internal reporting drives external communication to the market. Field-testing across a range of companies would also be vital.[56]

5.66 Whatever approach is adopted will lead to one or more key lines being established, one of which may or may not be similar to the current notion of net income.

5.67 The possible disaggregation criteria discussed in this paper are not fully developed and have been kept deliberately simple. Some groups and individuals have already produced suggestions for models, which could be factored into the future work of the standard setters on this issue.[57]

5.68 Finally, although the authors believe that disaggregation is the single most important performance reporting issue—and the issue that needs to be resolved for most other performance reporting issues to be addressed—they recognise that there are various other issues that would need to be addressed in a comprehensive accounting standard. These might include (but are not limited to):

(a) the treatment of discontinued operations and of the tax benefit or expense for the period;

(b) whether it is more useful to disaggregate expense items by function or by nature; and

(c) the extent to which income and expenses are presented gross or net.

5.69 At the beginning of this paper the authors noted that the paper focuses on the performance statement(s) and does not consider other aspects of the performance reporting model: "it does not address the statement of cash flows, the statement of financial position or the statement of changes in equity. Nor does it address the interaction between the statements." Therefore, having addressed the above issues it would be necessary, in a comprehensive standard on performance reporting, to move on to address issues such as:

(a) the extent to which the other primary statements—the statement of financial position and the statement of cash flows—should be aligned with the statement of financial performance;

(b) the extent of reconciliation required between the primary statements;

(c) what disclosure requirements should be required to accompany the primary statement, for example additional disclosures might be base on a secondary disaggregation criterion; and

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56 This issue was raised by EFRAG in its comment letter to the IASB on Chapters 1 and 2 of the new conceptual framework.

57 See UBS, UBS Investment Research – Financial Reporting for Investors – Performance measurement for equity analysis and valuation, 16. April 2007, pp. 26-27.

(d) the requirements in accounting standards relating to earnings per share and segmental reporting.

Question 10: Do you have any comments on the basic models of disaggregation presented in this chapter? Are there any other broad types of model that would have been worth exploring?

Question 11: Is the discussion of the advantages and disadvantages of each disaggregation model fair and complete? If not, how could it be improved?

Question 12: Which of the models of disaggregation—or combinations of models—do you favour and why do you believe it meets the needs of users better than the alternatives?

6 CLOSING REMARKS

6.1 As users are primarily interested in financial performance, it is very important that the financial implications of transactions and other events recognised in financial statements are presented in a way that maximises the usefulness of the information provided about financial performance.

6.2 With that objective in mind, the IASB is carrying out jointly with the FASB a major, long-term project that is looking at financial statement presentation. That project is being carried out in phases and in the most recent phase the IASB and FASB have started looking at how income and expense items should be disaggregated, ordered, grouped and totalled. Two key issues have however not yet been addressed:

(a) whether the net income line should be retained and, if it should, what should be the basis determining whether something is within or outside net income;

(b) whether recycling should be retained and, if so, which items should be recycled and on what basis.

6.3 If we are to have performance reporting standards that are 'fit for purpose', we need to get involved in the global debate now. This paper has therefore been prepared to encourage debate within Europe on the key performance reporting issues mentioned above.

6.4 An earlier PAAinE paper (*What (if anything) is wrong with the good old income statement?* (November 2006)) looked at the various arguments that are often heard when people discuss the merits of the existing performance reporting model and concluded that one of the key issues that needed to be explored was what is meant when people talk about performance. For example, it is often argued that the existing performance reporting model is good because it captures financial performance pretty well and the net income notion is good because it succinctly summarises performance. This suggests that such arguments imply there is general agreement as to what 'performance' represents, at a detailed level.

6.5 Chapter 3 explores whether that is in fact the case. It looks at how the term is used currently, what companies report when they report performance, and whether users focus on particular performance numbers. It observes that, in fact, there is no agreement as to what performance represents at a detailed level; different users of financial statements have different approaches to what constitutes 'performance' and diverging views exist with respect to what are the most relevant attributes of corporate performance. Companies use a range of different measures to explain their financial performance, and empirical research suggests that, although most of the performance measures used have their merits, none exhibits much greater value relevance than others.

6.6 In other words, performance is a complex, multi-faceted issue that cannot be encompassed in one or a few numbers. There are many components of, and aspects to, an entity's performance—and indeed different views as to what 'performance' entails—and it is not reasonable to expect all of those components, aspects and views to be encapsulated in one or a few numbers. Therefore, whilst net income might be a useful notion, that is not because it captures financial performance pretty well or because it succinctly summarises performance; if it is useful, it is because it fulfils some other purpose.

6.7 In Chapter 4 we explored whether this meant that there was no need for a net income notion or for any other key line or lines in the performance statement(s). In other words, even though it is not possible for a single line in the performance statement(s) to represent a succinct summary of performance, are key line(s) useful for other purposes? The paper observes that there is a clear need for one or more key lines to provide a basis for communication to the market and as a starting point for analysis and comparison.

6.8 The paper then discusses the attributes such a key line needs to have if it is to fulfil this purpose, because the usefulness of such lines will depend heavily on the way they are defined and understood. The paper notes that to be a starting point for analysis and comparison, it is important that there are clear principles that underpin what is included and excluded from the key line (in order to make their content understandable) and those principles need to be defined such that the content of a key line is standardised to a fair degree in order to ensure the necessary comparability. On the other hand, it is also important that the key lines communicate effectively. The paper discusses various ways of balancing these competing demands.

6.9 Chapter 4 also considers whether it is important for the "bottom line" of statement(s) of income and expense to be a key line, but finds no evidence that it is important as long as the information within the statement(s) is disaggregated and categorised in a useful way so that the right key lines appear. The chapter then observes that, if the bottom line of a performance statement is not important, then the number of performance statements provided is not particularly important either. The one or two performance statements debate is therefore a red herring; the real issues relate to the key lines/disaggregation model debate.

6.10 Chapter 4 goes on to note that, to be useful, key lines like net income need to be underpinned by clear principles as to what is included and excluded; in other words, by clear disaggregation principles. Key lines are therefore a function and outcome of how items of income and expense are disaggregated and categorised. This chapter also notes that whether recycling is needed is also largely about the disaggregation model used. In other words, the only performance reporting issue that really matters is which disaggregation model or models should be used.

6.11 Chapter 4 also discusses recycling and notes that that too—like net income, key lines and the one or two performance statements debate—is about disaggregation.

6.12 Chapter 5 (and the paper) finishes by discussing the advantages and disadvantages of various ways in which income and expenses might be categorised. In other words, various different disaggregation models and, therefore, different key lines. The models presented are relatively simplistic and all would require further development for any decision to be reached. The chapter thus draws no conclusions, but tries to highlight the main advantages and disadvantages of each model considered.

6.13 In many ways the two PAAinE papers on performance reporting represent something of a journey. We started at the beginning of the first paper by noting that a 'lively' debate was taking place about whether the existing performance reporting model is in need of fundamental change. We tried (again in that first paper) to get behind the reasons why some believe it is in need of fundamental change and why some others believe it is not. In this (second) paper we have exposed some myths about bottom lines and about key lines that purport to capture the essence of an entity's performance, and come to realise that the only performance reporting issue that really matters is which disaggregation model or models should be used.

6.14 Therefore, rather than focusing on issues like the nature of performance, the number of performance statements, and recycling, Europe needs to thoroughly engage in the most important performance reporting debate of all—which is about disaggregation.

APPENDIX 1 REVIEW OF EUROSTOXX 50 AND SPANISH LISTED COMPANIES

A1.1 The following reviews were carried out in order to get some indication of the way managements of companies define and describe performance in their results announcements. The commentary on the results can be found in Chapter 3.

Review of Eurostoxx 50 companies

A1.2 The 50 entities included in the index were sorted by market capitalisation. Financial institutions and insurance companies have been excluded, due to their special nature,[58] but otherwise an attempt was made to cover a wide variety of industry sectors. In total approximately 36% of the total Eurostoxx 50 market capitalisation has been included in the exercise. The following groups were reviewed:

- BASF AG (Germany)
- Carrefour S.A. (France)
- DaimlerChrysler AG (Germany)
- E.ON AG (Germany)
- Philips Electronics N.V. (The Netherlands)
- L´Oreal S.A. (France)
- LVMH Moët Henn. L. Vuitton SA (France)
- Nokia Corp. (Finland)
- Sanofi-Aventis S.A. (France)
- SAP AG (Germany)
- Siemens AG (Germany)
- Telefónica S.A. (Spain)
- Total S.A. (France)
- Unilever N.V. (The Netherlands)
- Vivendi S.A. (France)

A1.3 Only items that represent non-owner changes in equity have been analysed, i.e. statement of financial position, cash flow and non-financial items have not been included as part of this research. The information was obtained from the latest financial information available at that time (mainly 2006 half-year or third quarter reports). The key figures selected represent the items described by management as "Financial Highlights" or similar.

58 Some spot checks on banks were carried out, but insurance companies were specifically excluded. Some general observations on insurance companies can be found in Ernst & Young, IFRS Insurance Reporting – Beyond Transition, pp. 10-14.

Review of Spanish listed companies

A1.4 This exercise looked at non-GAAP measures used by Spanish listed companies in the Management Commentary and press releases. Financial statements have not been looked at as the Spanish Security Exchange Commission requires the use of rigid formats for financial statements, thus leaving no room for non-GAAP measures.

A1.5 All 35 companies belonging to the index IBEX 35 were examined. Information was extracted from the company web sites and the Spanish Securities Exchange Commission web site.

Company	*Industry*	*NON-GAAP measure(s)*
FCC	Construction	Gross Operating Income (EBITDA), Net Operating Income (EBIT), stock of orders (cartera)
Ferrovial	Construction	Net Income without non-recurring transactions (listing subsidiaries, reverting provisions, selling subsidiaries), EBITDA (Gross Operating Income), Net Operating Income. Financial income from Investments in Concession companies is disclosed separately
Gamesa	Energy, Technology	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Gas Natural	Energy, utilities	EBITDA (Gross Operating Income)
Iberdrola	Energy, utilities	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Iberia	Airline	Recurring Operating Income
Inditex	Industrial goods	EBITDA (Gross Operating Income, Cash Flow de explotación), EBIT (Net Operating Income), Gross Margin (Sales minus cost of sales)
Indra	Technology	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Metrovacesa	Real State	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
NH Hoteles	Hotels, Real State	Management Income (Beneficio de Gestión), EBITDA (Gross Operating Income; previous minus rent and local non-refundable taxes ("contribución urbana")), EBIT (Net Operating Income), REVPAR (Revenue Per Available Room), "comparable hotels".
Prisa	Communications	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
R.E.E.	Energy, utilities	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Repsol YPF	Petroleum, Energy	Adjusted Operating Income ("adjusted" means excluding non-recurring items)
Sacyr Valle.	Construction, Real State	EBITDA (Gross Operating Income), EBIT (Net Operating Income). Some non-recurring items are excluded in Net Income

Company	*Industry*	*NON-GAAP measure(s)*
Sogecable	Media (TV)	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Telecinco	Media (TV)	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Telefonica	Telecommunications	EBIDA (Gross Operating Income), EBIT (Net Operating Income)
Union Fenosa	Energy, utilities	Contribution margin, EBIDA (Gross Operating Income), EBIT (Net Operating Income)
Bankinter	Financial	ROE (Return on equity)
Banesto	Financial	ROA (Return on assets), ROE (Return on equity), RORWA (Net return on average risk weighted assets), Personnel and other general expenses/ gross operating income
Banco Sabadell	Financial	Personnel and other general expenses/gross operating income, ROE (Return on equity), ROA (Return on assets)
Banco Popular	Financial	ROA (Return on assets), ROE (Return on equity) RORWA (Net return on average risk weighted assets), Personnel and other general expenses/ gross operating income
BBVA	Financial	ROA (Return on assets). ROE (Return on equity) RORWA (Net return on average risk weighted assets) Personnel and other general expenses/ gross operating income
BSCH	Financial	ROA(Returns on assets). ROE(Returns on equity) RORWA (Net return on average risk weighted assets) Personnel and other general expenses/ gross operating income
Acerinox	Industrial goods	EBITDA (Gross Operating Income), EBIT (Net Operating Income) ROE (Return on equity)
ACS	Construction, Real State	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Altadis	Industrial goods	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Antena 3 TV	Media (TV)	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Cintra	Construction	EBITDA (Gross Operating Income EBIT (Net Operating Income)
Cor.Mapfre	Insurance	ROE (Return on equity)
Enagas	Energy	EBITDA (Gross Operating Income), EBIT (Net Operating Income)
Endesa	Energy	EBITDA (Gross Operating Income EBIT (Net Operating Income)
Fadesa	Construction	EBITDA (Gross Operating Income EBIT (Net Operating Income)

APPENDIX 2 ACKNOWLEDGEMENTS

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