EFRAG Secretariat: Filipe Alves,
Albert Steyn

Primary Financial Statements
Issues Paper – Use of additional subtotals in the Statement of Financial Performance

Objective

1 The objective of this session is to discuss the use of additional subtotals, including their definitions, in the statement of financial performance.

Introduction

2 In January and February 2017, EFRAG Secretariat presented the outcome of EFRAG and IASB research activities to EFRAG TEG and noted that the requirements in IAS 1 *Presentation of Financial Statements* are often criticised, particularly by users of financial statements and regulators, for allowing too much flexibility which impedes comparability. Many users and regulators expressed support for having more guidance in IAS 1 on minimum required line items and subtotals for the statement of financial performance. By contrast, preparers have often pointed out their preference for more flexibility to tell their own story. Therefore, EFRAG Secretariat highlighted that there is a tension between comparability and relevance and highlighted the need for the IASB to balance their competing demands.

3 To address these issues, the IASB is currently exploring the introduction of subtotals in the statement of financial performance, in particular the use of Earnings before Interest and Taxes (‘EBIT’) and ‘management operating performance measures’. The objective is to bring more clarity, consistency and transparency on how these subtotals are used in the statement of financial performance (both over time and between entities), to provide a comparable starting point for users’ analysis and, at the same time, provide some flexibility to preparers. The IASB is also considering allowing performance measures which exclude infrequently occurring items and present them separately.

4 EFRAG Secretariat notes that there is a link between the *Primary Financial Statements* project and the *Principles of Disclosures* project. Both projects refer to primary financial statements, subtotals and performance measures. However, this agenda paper is only focused on requiring and defining some subtotals in the statement of financial performance, which is not within in the scope of the *Principles of Disclosures* project. Interim financial statements are not addressed in this agenda paper.

Current requirements and guidance on subtotals

5 Currently IAS 1 requires the following subtotals for the statement of financial performance:

(a) profit or loss;

(b) total other comprehensive income;

(c) comprehensive income for the period; and

(d) an allocation between non-controlling interests and owners of the parent of both profit or loss and comprehensive income for the period.

6 Nonetheless, paragraph 85 of IAS 1 permits additional subtotals in the statement of financial performance when such presentation is relevant to an understanding of the entity's financial performance. When an entity presents additional subtotals, those subtotals should, in accordance with paragraph 85A of IAS 1:

(a) be comprised of line items made up of amounts recognised and measured in accordance with IFRS Standards;

(b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

(c) be consistent from period to period;

(d) not be displayed with more prominence than the subtotals and totals required in IFRS Standards; and

(e) be reconciled to subtotals required by IFRS Standards.

7 Finally, an entity shall present the line items in the statement(s) presenting profit or loss and other comprehensive income that reconcile any subtotals presented in accordance with paragraph 85 with the subtotals or totals required in IFRS Standards for such statement.

Most commonly used subtotals and existing practice

8 In its research performed in January 2017, EFRAG Secretariat observed that the selected entities used many different subtotals in their statement of financial performance. These included:

(a) *Gross profit:* all the entities that presented their analysis of expenses by function presented this subtotal although their calculation and definition varied. For example, the inclusion or exclusion of share of results of associates as revenue or the inclusion or exclusion of depreciation as part of cost of sales;

(b) *Operating profit*: this subtotal was used by the majority (82%) of the entities. However, their definition and calculation varied. For example, some entities excluded the share of profit from associates from operating profit while others included it within the operating profit. We also noted that only some entities included interest on pension cost in their operating profit. More recently, EFRAG Secretariat analysed the statement of financial performance of six financial institutions and we noted that these financial institutions used mainly an 'operating profit' subtotal and not EBIT since finance income/expenses arise from ordinary activities; and

(c) *EBIT*: Only 12% of the entities made explicit reference to EBIT, nonetheless we noticed that in many cases the "operating profit" subtotal was very similar to EBIT. More specifically, most entities that presented an operating profit subtotal had subsequent line items related only to profit from equity accounted investments, non-recurring items, finance costs and taxes.

9 As a starting point, the IASB could explore requiring specific subtotals and/or providing additional guidance on the subtotals referred above. Although some of these subtotals seem to be straightforward (e.g. EBIT), obtaining a definition that can be used across different industries may be challenging. For example:

(a) there is no definition in IFRS Standards and no consistency in practice on the use of 'finance income/expense' or 'interest expense';

(b) there is lack of guidance on the calculation of 'cost of sales' and 'gross profit';

(c) EBIT and EBITDA may not be relevant for some specific industries such as banking and insurance;

(d) EBITDA can only be used when an entity presents their results by nature;

(e) the location of certain line items such as share of profit or loss from associates and joint ventures and impairments may depend on the entity's business model;

(f) the definition of operating profit may involve management judgment, which could have a negative impact on comparability between entities; and

(g) changes in the content of the statement of financial performance may create the need to change other primary financial statements such as the cash flow statement.

10 As the IASB is currently focusing on EBIT and 'management operating performance measures', EFRAG Secretariat has focused its analysis on these two issues.

Focusing on EBIT

11 The subtotal EBIT and EBITDA is currently widely used by investors and mentioned in academic literature and databases. Investors often use EBIT and EBITDA to assess an entity's profitability, determining the free cash-flows, interest cover ratios, valuation ratios and break-even points, etc. EBIT is also a useful subtotal because it provides comparability of financial performance between entities with different capital structures.

12 The term EBIT represents, by definition, earnings before interest and taxes. Nonetheless, in practice the term 'EBIT' is also often considered as earnings before finance-related items and tax, which encompasses more than interest-related items (e.g. income and expenses that arise from cash management and investments). The IASB Staff proposed requiring the use of EBIT and defining it as profit before finance income/expenses and tax.

13 Although there are some IFRS Standards that deal with issues related to finance income/expenses or require some specific expenses to be included in finance costs (Appendix 1), the issue is that IFRS Standards do not provide a clear definition of finance income/expenses. As a result, EFRAG Secretariat noted, during the research activities, that a variety of items are classified as finance related items. For example, interest income/expense on financial instruments, interest income/expense on leases, unwinding of discounts on provisions, pension interest expense, foreign currency gains/losses, impairment losses on financial assets, gains/losses on financial assets/liabilities, fair value changes of financial instruments recognised in profit and loss, fair value changes on cash flow hedge of borrowings, gain recognised on extinguishment of a liability, share of profit of associates and joint ventures, financial income from derivatives, and interest on tax expense, etc. EFRAG Secretariat observed that the selected entities classified these line items differently within the statement of financial performance.

14 To improve comparability and transparency on the calculation of EBIT, the IASB Staff proposed defining 'finance income/expenses' as income and expenses related to the entity's capital structure. This definition would include income and expenses that arise from cash held and short-term investments. This is because the way an entity manages its cash and short-term investments is interrelated with its decisions on debt and equity financing.

15 Based on this definition, the classification of some items as finance income/expenses may be straightforward for non-financial institutions. For example, interest expenses from bank loans and debt instruments issued in financial markets are often classified as finance income/expenses. In addition, the income and expenses related to these liabilities could also be considered as finance income/expenses. For example:

(a) debt extinguishment and debt restructuring costs;

(b) fair value gains and losses from these liabilities;

(c) foreign currency gains or losses on these liabilities;

(d) gains and losses on derivatives related to these liabilities (e.g. interest rate swaps).

16 In regard to income and expenses that arise from cash held and short-term investments, the following items could be considered:

(a) interest and dividend income from short-term investments;

(b) gain and losses on disposal of short-term investments;

(c) impairments of short-term investments;

(d) foreign currency gains or losses on cash and short-term investments; and

(e) fair value gains and losses on short-term investments.

17 Nonetheless, to ensure consistency in practice the IASB may need to develop additional guidance on what is part of an entity's capital structure (including cash and short-term investments) and explore whether there are some line items that need to be specifically addressed. For example:

(a) *Share of profit of associates and joint-ventures*: research activities revealed that the presentation of share of the profit of associates and joint ventures varied. For example, certain entities regarded them as an extension of their operations and included their results in operating profit while others included them within total revenue and other income. In addition, this is an after tax result so one could argue that it is conceptually incorrect to include it in a pre-tax and pre-finance cost number. The IASB will consider the location of this line item in a future meeting.

(b) *Defined benefit plans interest*: IAS 19 *Employee Benefits* does not specify where interest[1] from defined benefit plans should be located within profit or loss. Some entities presented it as finance cost while others present them as operating cost. In its agenda paper, the IASB Staff suggested that this line item should be presented within finance cost/income. It is argued that most users and data aggregators present it as a finance cost and this approach is also consisted with a recent FASB decision[2].

(c) *Long term investments and related impairments*: The IASB might need to develop guidance to help management identify short-term investments, the distinction between long-term investments and short-term investments and related impairments (e.g. impairments of equity accounted investments).

18 At this stage, the IASB Staff is considering the use of EBIT for entities that do not provide financial services since EBIT may not be relevant for financial institutions.

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[1] IAS 19 defines interest cost as the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

[2] The FASB decided that when an entity presents operating profit, the interest cost of pensions should be presented below operating profit.

Similarly, application issues could arise with conglomerates that contain a mixture of financial and non-financial operations. The IASB will discuss these issues in a future meeting.

19 EFRAG Secretariat did not find, from its research activities, any significant issue with the 'income tax expense' line item. Entities have to use the guidance in IAS 12 *Income Taxes* when determining the tax line item. Nonetheless, it is worth noting that the IFRS Interpretations Committee received a request to clarify whether interest on a tax payable should be presented together with tax or as interest expense. Currently there is no clear guidance in IFRS Standards on where entities should include this expense in their statement of financial performance. In addition, the fact that the interest may not always be separately identifiable makes it difficult to conclude if it should be included in tax or interest expense.

20 Currently the IASB Staff is not proposing to require presentation of EBITDA because it will only be relevant for entities that use the "by nature" presentation option. In addition, as EBITDA is often considered as a proxy to cash measurement, there is the concern that it might conflict with the information provided by the statement of cash flows.

21 Finally, EFRAG Secretariat notes that improved guidance on EBIT in the statement of financial performance could have an impact on other primary financial statements, such as the statement of cash flows, particularly when the indirect method is used. This is because investors have often highlighted the importance of the linkage between the two statements and reconciliations with key line items in other primary financial statements such as profit, EBIT and working capital.

Focusing on operating profit

22 Investors often use operating profit to understand the profitability and cash flows generated by the entity's 'current operations' or 'primary business activities' that have the potential to provide a sustainable positive expected return in the future. It is therefore useful to them to forecast future earnings and assess the effectiveness of management.

23 As mentioned in paragraph 8(b) above the subtotal operating profit was used by the majority (82%) of the entities, even though there were differences in the labelling and their calculation. For example, in some cases the operating profit subtotal was similar to EBIT; in other cases entities would exclude items that were not considered as part of the operating activities (e.g. share of profit from associates and joint ventures) or items that were not recurring (e.g. restructuring costs). Similarly, users have devised their own way of defining what operating profit is. For example, some look at the cash flow statement classification for guidance on operating profit while others have internal formal guidelines for classification purposes. This is related to the fact that currently[3] IFRS Standards do not define or require disclosure of operating profit; they only define operating activities in IAS 7 *Statement of Cash Flows*[4].

24 In recent discussions, EFRAG TEG, EFRAG CFSS and EFRAG User Panel members have highlighted the importance of Non-GAAP performance measures, such as operating profit. However, they also expressed concerns around their communication, consistency, comparability and transparency and believed that general principles on the use of alternative performance measures could be useful.

25 When referring specifically to operating profit, members noted that it would be challenging to define "operating profit" and recalled that past standard-setting

[3] Prior to 2003, IAS 1 required entities to present the results of operating activities as a line item in the statement of profit or loss. However, when IAS 1 was revised in 2003 that requirement was removed.

[4] Operating activities are the main revenue-producing activities of the entity that are not investing or financing activities.

activities on the definition of operating profit had been unsuccessful. This is because the process of identifying an entity's primary activities depends significantly on the entity's business model and management's judgement, and makes an operating profit definition that applies across industries controversial. Some also noted that an overly prescriptive approach to the presentation of line items and subtotals would not provide preparers with sufficient flexibility to explain their business model. Finally, members questioned whether the IASB should focus on non-recurring, unusual or infrequently occurring items, as it would be difficult to define non-recurring items and noted the tendency of entities' excluding mainly expenses.

26 Currently, the IASB is considering whether it should allow (explicitly) the presentation of 'management operating performance measures' (e.g. operating profit and core operating profit) rather than seeking to define operating profit. It is also considering whether IAS 1 should allow items to be excluded from the management operating performance measures as long as the subtotal meets the requirements in paragraphs 85, 85A and 85B of IAS 1. This is because users of financial statements often want information about events and transactions that are unusual or infrequent, because this enables them to identify the recurring/sustainable numbers and use those to make assessments about future cash flows.

27 Finally, the IASB is considering additional disclosures to provide transparency around presentation of management operating performance measures, including requirements to:

(a) clearly label the subtotal;

(b) describe and explain each management operating performance measure;

(c) disclose whether the entity uses the same performance measure inside and outside the financial statements; and

(d) provide a historical summary of items excluded from management operating performance**.**

Ways of moving forward

28 EFRAG Secretariat can see two general approaches for moving forward:

(a) One possibility, as proposed by the IASB Staff, is to require the use of EBIT, allow the presentation of management operating performance measures (e.g. 'operating profit' or 'operating results') and explore potential restrictions and/or disclosures on the use of 'management operating performance measures'. Requiring and defining EBIT would have the benefit of providing a comparable starting point to users of financial statements, avoid the need to define operating profit (management would define it according to their business model) and require appropriate disclosures, including those that have been excluded from management operating profit. Investors would still be able to make their own adjustments to the subtotals provided to fit their needs with the advantage of having more transparent information.

(b) Alternatively, EFRAG Secretariat considers that the IASB could consider not requiring additional subtotals (e.g. EBIT or operating profit) and focus instead on providing general guidelines on their calculation that improve the principles in paragraphs 85, 85A and 85B of IAS 1 (e.g. subtotals should be calculated and presented in an unbiased way; expenses necessary to generate related income should not be excluded) and improving disclosures on their calculation. ESMA's *Guidelines on Alternative Performance Measures* (or the IOSCO equivalent) could be considered by the IASB when developing presentation principles and disclosures on EBIT and management operating performance measures. Such an approach would have the benefit of decreasing the likelihood of having many subtotals on the face of the financial statements and would avoid industry specific issues.

29 In previous meetings, EFRAG TEG members considered that it would be useful to have general principles on the use of alternative performance measures, such as EBIT and operating profit, within the financial statements to address the existing concerns around the lack of consistency, comparability and transparency of non-GAAP financial measures. EFRAG Secretariat agrees that a principles-based approach is preferred (as in paragraph 28(b)), particularly when considering that new subtotals such as EBIT may not be applicable to all industries and/or jurisdictions.

Questions for EFRAG TEG

30 Do EFRAG TEG members consider that it would be useful to require the subtotal EBIT for non-financial institutions? If so:

(a) Do EFRAG TEG members view EBIT as 'profit before finance income/expenses'?

(b) Do EFRAG TEG members consider 'finance income/expenses' as those related to the entity's capital structure (including income and expenses that arise from cash held and short-term investments)?

(c) Do EFRAG TEG members consider that the IASB should define operating profit?

31 Do EFRAG TEG members consider that, whether or not EBIT is required, it would be useful to allow 'management operating performance measures' (i.e. allow management to define their own operating performance measure) as long as they comply with paragraph 85, 85A and 85B of IAS 1?

32 Do EFRAG TEG members consider that there should be additional constraints and disclosures attached to the presentation of management operating performance measures in the statement of financial performance (e.g. infrequently occurring items)?

33 Do EFRAG TEG members have any other comments?

Appendix 1: IFRS Standards that deal with issues related to finance income/expenses or require some specific expenses to be included in finance costs

34 IFRS Standards do not provide a definition for finance income/expenses. However, there are some IFRS Standards that deal with issues related to finance income/expenses or require some specific expenses to be included in finance costs. For example:

(a) non-authoritative guidance on implementing *IFRS 7 Financial Instruments: Disclosures*, paragraph IG13 states that the total interest expense for financial liabilities that are not measured at fair value through profit or loss is a component of finance costs and the line item for finance costs may also include amounts associated with non-financial liabilities.

(b) IAS 23 *Borrowing Costs* refers to interest using the effective interest method (IFRS 9 *Financial Instruments*), interest in respect of lease liabilities (IFRS 16 *Leases*) and exchange differences on foreign currency borrowings that relate to an adjustment to interest costs[5].

(c) IFRS 9 states that interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. An item does not need to contain all the elements to be interest but the primary indicators are normally time value of money and credit risk.

(d) There are other IFRS Standards and an IFRIC Interpretations that require some specific expenses to be included in finance costs:

  (i) increases in the carrying amount of provisions that reflect the passage of time (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* paragraph 60). This requirement uses the wording 'recognised as borrowing cost' rather than 'finance cost';

  (ii) unwinding of the discount on decommissioning, restoration and similar liabilities (IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities,* paragraph 8);

  (iii) increases in the present value that arise from the passage of time of the costs to sell a non-current asset (or disposal group) classified as held for sale (IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, paragraph 17); and

(e) IFRS 15 requires the separate presentation of the effect of financing (interest revenue or interest expense) from revenue, when a significant financing component exists in contracts with customers. In the Basis for Conclusions on IFRS 15, paragraph BC247 clarifies that when entities regularly enter into financing transactions as part of their ordinary activities (e.g. banks), interest could be part of income arising from ordinary activities and presented as a type of revenue.

[5] There is no clear guidance on how entities determine what exchange rate differences relate to adjustments on interest costs and currently it is a matter of accounting policy.