

PRIMARY FINANCIAL STATEMENTS

SUMMARY REPORT

FIELD-TEST WORKSHOP

24 August 2020



Introduction

EFRAG, in close coordination with European National Standard Setters and the IASB, is conducting a field-test of the IASB proposals included in the Exposure Draft ED/2019/7 *General Presentation and Disclosures* (ED), which have been published in December 2019.

The purpose of the field-test is to identify potential implementation and application concerns, determine whether there is a need for additional guidance and estimate the effort required to implement and apply the proposals.

The participants involved were asked to apply the IASB's proposals to their financial statements and answer a questionnaire from EFRAG and the IASB. The results were discussed in a workshop on 24 August 2020.

The following companies participated in this workshop:

- Fraport AG (Germany)
- Merck Group (Germany)
- Deutsche Post DHL (Germany)
- DSM (The Netherlands)
- ABN AMRO Bank NV (The Netherlands)
- Banca Monte dei Paschi di Siena (Italy)

This report has been prepared for the convenience of European constituents to summarise the workshop and will be further considered by the involved organisations in the respective due process on the IASB's proposals.

Results of the field-test

Chiara Del Prete, EFRAG TEG Chairwoman welcomed participants, introduced the speakers, and provided an overview of the agenda.

Rika Suzuki, IASB Board member, thanked participants for their participation and time devoted to the preparation of the workshop and explained the objective of the field-test.

Filipe Camilo Alves, EFRAG Senior Technical Manager, presented the key themes identified in the feedback received for each topic (please see Appendix 1 – Slides for Discussion).

Nick Barlow, IASB Technical Staff, introduced the points for discussions for each topic (Appendix 1 – Slides for Discussion).

TOPIC 1: New subtotals and categories: Classification of income and expenses

The ED proposes that an entity presents three new subtotals and that applying these proposed new subtotals, an entity would present in the statement of profit or loss the categories operating, investing and financing.

Participants in the field-test broadly agreed that the proposed requirements on classification of income and expenses were clear and well understood. However, they commented that the requirements leave room for interpretation and suggested some areas for improvement.

Many participants concurred that the allocation of income and expenses to the different categories involved some judgement and that more guidance, relating to the classification of income and expenses to the operating, investing and financing categories, would be useful.

Investing category

Some participants called for more guidance and examples on the definition of the investing category.

One participant considered that having more guidance on the investing category (e.g. more examples for the investing category in the ED and Illustrative Examples) would help companies to decide the reallocation of their income and expenses. This participant mentioned that in his case, the classification of the fair value changes of investments in debt instruments, which were currently presented in 'net finance income/costs', would have to be reclassified to the investing category. Also, the income and expenses from 'other investments', which were currently presented in 'other operating income/expenses', would have to be reclassified to the investing category. Finally, this participant noted that, for the statement of cash flows, no information was available for the proceeds from disposal of integral associates/joint ventures and other investments, as well as cash paid to acquire integral associates and joint ventures and other investments. Currently, this distinction was not possible.

Another participant considered that this classification would require a significant level of judgement for certain types of investments. (more details are below in the section 'Operating category').

Financing category

Participants acknowledged that by definition, the financing category would mainly include interest on liabilities and interest on cash and cash equivalents.

However, a few participants questioned the misalignment between the classification of interest expense on trade payables with extended credit terms (in the financing category) and interest income on trade receivables (in the operating category).

These participants also pointed out that the IASB's proposals did not address whether contingent consideration under IFRS 3 *Business Combinations* should be classified in the operating or financing category (this is an existing classification issue). There were also questions on whether the items mentioned in paragraphs B34 to B37 of the ED were only examples for the categories or an exhaustive list.

Similarly, one participant added that it was not clear whether the allocation of interest on tax receivables belonged to the financing or operating category.

Aida Vatrenjak, IASB Technical Staff, clarified that the only interest income in the financing category is from cash and cash equivalents.

Operating category

One participant had not experienced difficulties in applying the IASB definition of operating profit as it was aligned with their current practice.

A number of participants referred to implementation challenges with respect to the definition of operating category. For example, these participants:

- asked for more guidance on the definition of operating profit or loss, in particular for the notion of 'entity's main business activities', which raised practical difficulties in the case of groups with very different business areas;
- detailed that the operating category was one of the most important categories for users and considered that operating profit should be defined positively to ensure consistency in practice. Currently, the IASB started by defining the operating category positively and then introduced a residual element in its definition. As a dual category, the operating category would include both information about income and expenses from an entity's 'main business activities' as well as

items that were not classified to investing or financing categories. The participant considered that it was not clear for preparers which approach (direct or residual) should be applied;

- noted that the IASB's proposed definition did not provide a clear answer as to whether income and expenses, that do not arise from an entity's main business activities, should be presented in the operating or investing category. More specifically, in some industries it is quite common for entities to engage not only in their respective main business activity but also establish venture capital funds. Often, these strategic corporate venture capital funds invest minority stakes in transformational ideas with a high-risk / high return profile:
 - on the one hand, it could be argued that these investments are commonly made in the same industry, and as such the activities of these investments are closely related to and therefore made in the course of the entity's 'main business activities' (i.e. operating category); and
 - on the other hand, however, these investments are commonly formally separated from the 'core' business by 'Chinese walls' in order to avoid conflicts of interests. Furthermore, these venture funds typically have an entirely different business model compared with the traditional 'core' business in terms of time frame risk-return profile, etc. Thus, these investments could be seen as generating a 'return individually and largely independently of other resources held by an entity' (i.e. investing category).
- questioned the lack of categorisation in Other Comprehensive Income (OCI) similar to the operating, investing and financing categories introduced in the statement of profit or loss. This participant commented that this might lead to inaccuracy of the operating result especially relevant when significant amounts were involved; and

A financial institution detailed that whether an item, particularly an investment, should be presented in the operating or investing category (i.e. what is of the 'entity's main business activities') will involve judgement.

One participant also pointed out the practical difficulties related to the allocation of exchange rate differences to the new categories, such as the effects of translating the functional currency of subsidiaries. These new presentation requirements would require changes in the chart of accounts which would be both time consuming and costly. Accordingly, the implementation of this requirement would require a longer lead time to reconfigure the IT systems, which was expected to be a one-time effort.

One participant from the financial industry commented that most of their income and expenses would be reflected in the operating category (only non-integral associates and joint ventures would be presented outside of operating profit).

TOPIC 2: Integral and non-integral associates and joint ventures

The ED proposes to require separate presentation of equity-accounted associates and joint ventures as either integral or non-integral to the entity's main business activities. The proposals would also require separate disclosures for integral and non-integral associates and joint ventures.

In general, the objective of the proposals was well understood and clear. Nonetheless, a number of participants highlighted that:

- the application of the definitions of integral and non-integral in practice might result in significant judgment, where the ability to reflect management's view is considered positive in this regard;
- the IASB's definition of integral associates and joint ventures seemed to be narrow as it might exclude associates and joint ventures that, in the view of the participant, should be considered

as integral. This is because integral associates and joint ventures are characterised as being an investment that does not generate a return individually and largely independently of other resources held by the entity. Therefore, an associate or joint venture that generates independent returns would automatically be non-integral even though they were active in the same business area as the entity. Considering this, the IASB should provide additional guidance on the distinction between integral and non-integral;

- if a significant/material investment is classified as non-integral, users of financial statements may raise questions on why such an investment was being made;
- there is lack of guidance on the reclassification of integral and non-integral associates and joint ventures. For example, it was not clear when integral associates and joint ventures should be reclassified to non-integral ones in the case of spin-off or divestiture. The participant raised the concern that such a reclassification of investment to non-integral might be seen as an entity that would be spun-off in the future;
- classifying an investment as non-integral could be seen as a first step to disinvest something and other complex/political discussions (e.g. employees in the investees would be concerned);
- it is not clear how to distinguish non-integral and other investments; and
- the income from investments accounted for using the equity method is already a separate line item in the statement of profit or loss and for the field-test exercise it was assumed, that these investments are all integral due to materiality reasons.

TOPIC 3: Analysis of expenses

Some participants in the field test already presented analysis of expenses by nature in the statement of profit or loss and for them the ED proposals would not have a significant effect.

However, participants that applied by function presentation expressed the following concerns:

- the requirement to disclose analysis of expenses by nature, when by function presentation is applied in the statement of profit or loss, would impose significant burden on the systems and process designs, while users of financial statements were not currently asking for this information (i.e. no added value). One participant further elaborated that while operating expenses by nature might be available on a non-consolidated entity level, this was not the case on a consolidated group level. Another participant clarified that it already disclosed a number of line items by nature (e.g. depreciation, amortisation, employee costs, etc), however providing the remaining amount by nature would be difficult;
- for entities presenting by function, the IASB's proposals would require system changes and judgement in determining the by nature amounts in the disclosures (e.g. estimating the cost of raw materials);
- questioned whether the IASB was actually requiring a 'pure presentation' of operating expenses by nature or by function on the face of the statement of profit or loss. If so, then one participant considered the line item 'other operating expenses' could not be presented in a by function presentation as they would typically include by nature items (e.g. impairments, litigation, etc). Thus, a pure presentation might not provide the most useful information;
- the allocation of some by nature expenses (e.g. impairment losses, restructuring expenses, litigation expenses) to functional line items would lack a conceptual basis and could be arbitrary. Furthermore, in their view such allocation would create volatile line items across reporting periods, which was not desirable in their view.

With respect to the proposals, participants in the financial industry did not see any significant changes in practice (banks typically present operating expenses by nature). However, there were questions on whether banks could continue to present the line item 'administrative expenses' (this could be seen as by function in accordance to paragraph 103 of IAS 1 *Presentation of Financial Statements*). Alternatively, they could be presented within 'other operating expenses' and then disclosed in the notes.

TOPIC 4: Management performance measures

In general, participants had no difficulties in identifying the Management Performance Measures (MPMs) in their public communications.

However, participants expressed a number of concerns:

- many corporate entities considered that the proposed scope of MPMs was narrow and precluded some key performance indicators of being identified as MPMs, particularly those from the statement of financial position and statement of cash flows. These participants noted that the most used Alternative Performance Measures (APMs) which did not qualify as MPMs were related to assets (e.g. return on assets, Return on Capital Employed (ROCE)), net sales (including constant currency and organic growth measures), free cash flows, etc. These participants also questioned whether the required disclosure on MPMs would provide a complete picture on an entity's performance. Nonetheless, it was noted that the IASB was not prohibiting the presentation of other APMs together with the MPMs, which would solve the issue of providing an incomplete picture of an entity's performance;
- similarly, participants from the financial industry noted that for financial institutions most of their key performance measures were related to the statement of financial position and those would not meet the definition of MPM and would not qualify for disclosure under the IASB's proposals. They noted that only performance measures based on the statement of profit or loss would be disclosed which would provide an incomplete picture to users. Nonetheless, it was noted that financial institutions use some performance measures, including ratios, calculated in accordance with Pillar 3 and this raised the question of whether they met the definition of an MPM;
- many queried the interaction between the requirements on MPMs and requirements on performance measures published by regulators. Participants from one jurisdiction added that there were already comprehensive disclosures on MPMs in the management report (audited), which could create some repetition. In addition, these disclosures would have different scopes and would be placed in different sections of the annual report, which could be confusing;
- questioned how the requirements on MPMs relayed the 'management's view' of performance and management of the business in relation to the requirements in IFRS 8 *Operating Segments*, (paragraph 25);
- one participant asked for more guidance on the definition of 'public communications'. It would be useful to define the specific communications more narrowly to prevent entities from analysing all possible communications to which this requirement could apply.

One participant welcomed the ED proposals to disclose MPMs in the notes as this would mean that such measures would be subject to audit.

One other participant was considering moving from Earnings Before Interest and Tax (EBIT) to operating profit or loss as one of its key performance measures.

Aida Vatrenjak clarified that MPMs are different from management measures in IFRS 8. MPMs are used to communicate with the investors while IFRS 8 measures are used by management to manage

its business. Additionally, the required disclosure of MPMs in the notes to the financial statements responded to users' request for more transparency and discipline around MPMs.

Some participants commented that the requirement to disclose the income tax effect and the effect on non-controlling interest for each item disclosed in the reconciliations for MPMs would raise practical challenges (e.g. restructuring or integration expense on a global company would require drilling down and calculating the tax effect for every jurisdiction). This information was not currently available. Finally, these participants questioned the value of this disclosure and added that it would be costly to provide it.

TOPIC 5: Unusual income and expenses

Participants agreed that the objective of this disclosure was clear and well understood. Some participants explained that they already disclose unusual items in the notes and that the IASB's proposed definition may lead to changes in practice. One participant considered that the scope of the unusual items should not be too wide and suggested an alignment with the ESMA guidelines on APMs.

Participants also provided a number of comments around the definition of 'unusual income and expenses':

- it is not clear whether the proposal required income or expenses with limited predictive value to be similar both in type and amount or only fulfilling one criterion is sufficient to meet the definition of unusual. Paragraphs B68 ('consider both the type of the income or expense and its amount') and B69 ('Income and expenses that are not unusual by type may be unusual in amount') of the ED seemed to be contradictory;
- when considering an unusual item by amount, participants queried whether the whole amount should be recognised as unusual or only the incremental part of it (i.e. costs are outside the range of reasonably expected outcomes and not predictive of future costs) when the amount varied significantly from previous periods. For example, if an entity has litigation expenses, whether a major litigation would be considered as an unusual item in its entirety or whether an entity should only consider the excess amount when comparing to the amounts of litigation expenses that are inside the range of reasonably expected outcomes;
- with the covid-19 pandemic, financial institutions were recognising significant amounts of loan impairments. Identifying the total amount of impairments as unusual, rather than the excess amount of loan impairment costs that are outside the range of reasonably expected outcomes, would mean that financial institutions would disclose huge amounts of unusual items;
- participants cautioned about recognising only the incremental part as unusual would be unpracticable and difficult to audit (i.e. difficulties on assessing what normal is);
- as the definition of unusual income and expenses is not clear, it is difficult to make sure that all subsidiaries make the same assessment as the parent company;
- participants questioned what was meant by the terms 'several future annual reporting periods' and 'predictive value' when assessing whether an item of income or expense should be classified as unusual. For example, some costs such as restructuring costs, covid-19 expenses could have a different period span; participants wondered where the limit would be when identifying the affected future periods.

Aida Vatrenjak clarified that the proposal required unusual income and expenses to be similar either by type or amount and it was not a prerequisite for both criteria to be fulfilled. Regarding definition of

'several future annual reporting periods', an item would be unusual if it is a one-off event. When the item is expected to recur, it is not unusual.

TOPIC 6: Statement of Cash Flows

Some participants noted that the newly created categories of operating, investing and financing were not aligned with the existing sections in the statement of cash flows. Using the same labelling of categories might be misleading and create confusion for users of financial statements.

One participant commented that no information was currently available on the proceeds from disposal of integral associates and joint ventures and other investments as well as cash paid to acquire integral associates and joint ventures and other investments. Consequently, implementing this requirement would require additional costs for setting up new processes.

A participant from the financial industry raised a point that issued debt and subordinated loans would be classified in the operating category, however, the cash flows from those activities met the financing definition.

Aida Vatrenjak clarified that for dividends received, interest paid and interest received if a financial institution classifies related income or expenses in more than one category of the statement of profit or loss, the financial institution shall make an accounting policy choice to classify the cash flows in one of the corresponding categories of the statement of cash flows.

Close of the meeting

Chiara Del Prete thanked participants for their participation in the field-testing of the IASB proposals included in the Exposure Draft ED/2019/7 *General Presentation and Disclosures* (ED) and for the time devoted to the preparation of the workshop, including the preparation of:

- The statement of profit or loss and the statement of cash flows before and after recasting to reflect the proposals in the ED;
- Selected note disclosures affected by the proposals;
- A completed IASB questionnaire covering the recasting and the application of specific aspects of the ED proposals;
- A completed EFRAG questionnaire covering specific areas of European interest.