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Primary Financial Statements Issues Paper – Scope of the project

Objective

- 1 The objective of this paper is to discuss the scope of the IASB's research project *Primary Financial Statements*.

IASB's approach to the project

- 2 The IASB tentatively decided to focus on targeted improvements to the statement of financial performance and to the statement of cash flows (rather than a fundamental revision of the presentation of all the primary financial statements).
- 3 The IASB will decide at a later stage of the project whether it will issue a Discussion Paper or an Exposure Draft as the first due process output of the project.

Scope of the IASB's research project

- 4 In its December 2016 the IASB tentatively decided to:
 - (a) **Statement of financial performance:**
 - (i) explore requiring additional subtotals in the statement of financial performance - earnings before interest and tax (EBIT) and/or operating profit;
 - (ii) explore removing some of the options for presentation of income and expenses in existing IFRS Standards (e.g. presentation of net interest cost on the net defined benefit liability);
 - (iii) explore providing guidance on the use of performance measures, including separate presentation of non-recurring, unusual or infrequently occurring items;
 - (iv) explore better ways to communicate information about other comprehensive income (OCI);
 - (b) **Statement of financial position**
 - (i) not to consider targeted improvements to the statement of financial position unless work on other areas of the primary financial statements identifies possible improvements to that statement;
 - (c) **Statement of cash flows**
 - (i) explore the elimination of options for the classification of the cash effects of interest and dividends in the statement of cash flows;
 - (ii) explore the alignment of the operating section across the statement of cash flows and the statement of financial performance;

Primary Financial Statements - Scope of the project

- (iii) explore requiring a consistent starting point for the indirect reconciliation of cash flows in the statement of cash flows;
- (d) **Segment reporting or the presentation of discontinued operations**
 - (i) not to consider improvements to segment reporting or the presentation of discontinued operations (should not be part of the scope of the project);
- (e) **Other areas on primary financial statements**
 - (i) explore the development of templates for the statement of financial performance, the statement of cash flows and the statement of financial position for a small number of industries; and
 - (ii) explore the development of a principle for aggregating and disaggregating items in the primary financial statements.

EFRAG Secretariat analysis

IASB's approach to the project

- 5 The research activities described in agenda paper 10-03 and the feedback received by EFRAG and the IASB in the past (e.g. agenda consultations) clearly indicate that there is a need for the IASB to improve the existing guidance on financial statement presentation. In particular, on different occasions, users and regulators have highlighted that this is an area that needs to be improved and have called for progress on the IASB's research project *Primary Financial Statements*. Therefore, EFRAG Secretariat welcomes the IASB's research activities on this project.
- 6 The IASB is restricting the scope of the project to targeted improvements to the *Statement of Financial Performance* and *Statement of Cash Flows* (rather than a fundamental revision of the presentation of all the primary financial statements). This is in line with the view of many respondents to the IASB's 2015 Agenda Consultation who considered that the project should focus on specific aspects of financial performance reporting and asked for specific improvements to the statement of cash flows.
- 7 We also recall that in June 2016 EFRAG TEG and EFRAG CFSS members generally supported the IASB's intention to focus on the structure and content of the statement of financial performance and investigating whether there is any demand for changes in the statements of cash flows and of financial position.
- 8 Although the IASB is initially restricting the scope of the project, targeted improvements to the *Statement of Financial Performance* and *Statement of Cash Flows* can still be considered challenging, particularly when considering industry-specific needs. We highlight that future changes to financial statement presentation will have to be applied across different industries. Similarly, any changes will also be applied to separate and consolidated financial statements.
- 9 Therefore, the EFRAG Secretariat highlights the need for the IASB to consider whether any new proposal will create difficulties or implementation issues for those who prepare and use separate financial statements or belong to a specific industry such as banking, insurance or financial conglomerates.

Statement of financial performance: additional subtotals

- 10 The IAS 1 *Presentation of Financial Statements* requirements are often criticised, particularly by users and regulators, for allowing too much flexibility which impedes comparability. Many argue that the lack of formats and disaggregation affects comparability amongst entities.

- 11 From EFRAG, the IASB and Mazars' research activities¹, we note that companies have been using many different subtotals (e.g. operating profit, EBIT, gross profit and profit before tax) that are not defined in IFRS. We also note that there is little consistency in the approach on how to measure such subtotals, which reduces understandability and comparability of the information provided to users. Finally, research activities have also shown that the location of line items and subtotals on the face of the statement of financial performance varies by company.
- 12 To address these issues, the IASB plans to explore requiring additional subtotals in the statement of financial performance. The EFRAG Secretariat notes however that it is equally important to explore requiring additional line items, including their location, within the statement of financial performance. The location of such line items may depend on the options to present the information by nature or by function and on the subtotals that the IASB intends to develop.
- 13 In terms of additional subtotals, EFRAG Secretariat notes that the IASB will have to decide whether the objective is to have principle-based definitions (and general guidelines) to assist entities to disaggregate information or to provide required definitions. This will also be closely linked to the developing of principles for aggregating and disaggregating items in the primary financial statements and the existing options on presentation of expenses by nature or by function. In June 2016, many EFRAG TEG and EFRAG CFSS members seemed more in favour of having general principles that would assist entities to disaggregate information in the statement of financial performance.
- 14 As already mentioned in paragraph 11 above, subtotals such as gross profit, operating profit or EBIT are often used by preparers, even though there is not a generally agreed definition for such terms. We highlight however that in many cases operating profit is similar or equal to EBIT. Providing guidance on any of these subtotals, which could include disclosures on their definitions, would provide a comparable starting point for users' analysis as they often use an EBIT or EBITDA when developing estimates of future cash flows for their valuation purposes. It would also provide a comparable starting point for data aggregators, which typically have their own templates. Still, developing such guidance could be challenging as the IASB would have to define, for example, what should be included in finance-related items.
- 15 Finally, EFRAG Secretariat also highlights the tension between comparability and relevance and the need for the IASB to balance their competing demands.

Statement of financial performance: use of options

- 16 The IASB intends to explore removing some of the options for presentation of income and expenses in existing IFRS Standards.
- 17 EFRAG Secretariat notes EFRAG User Panel members have recently raised concerns about the existing accounting options in IFRS Standards, including presentation options, as they tend to reduce comparability across countries and industries.
- 18 The presentation options within the statement of financial performance include:
 - (a) *presentation of a single statement or two statements*: paragraph 10A of IAS 1 gives companies the choice to present a single statement or two statements. Research activities indicate that the majority use a two statements approach; and
 - (b) *presentation of expenses by function or by nature*: paragraph 99 of IAS 1 gives companies the choice to present expenses by nature or by function. Research

¹ detailed analysis in agenda paper 10 – 03.

activities indicate that there is a mix practice as companies present by function, by nature and a mix of both.

- 19 The lack of guidance in certain areas also provides implicit options for preparers, particularly when considering presentation of subtotals such as operating profit. For example:
- (a) *presentation of net interest cost on the net defined benefit liability* as IAS 19 *Employee Benefits* does not specify how an entity should present net interest cost on the net defined benefit liability; and
 - (b) *presentation of share of profit/loss of equity-accounted investments* as IAS 1 does not prescribe where the share of results of associates and/or joint ventures should be presented.
- 20 When considering whether to eliminate explicit options permitted in IFRS Standards, the EFRAG Secretariat notes that the IASB will need to consider the potential benefits to users and how this compares to potential additional costs to preparers. If the IASB decides to provide more guidance on the location of certain line items, it will first need to decide which additional subtotals it will focus on and consider the implications for different business models.

Statement of financial performance: use of measures of financial performance

- 21 The IASB intends to explore developing guidance on the use of performance measures, including separate presentation of non-recurring, unusual or infrequently occurring items.
- 22 EFRAG Secretariat recalls that many EFRAG TEG and EFRAG CFSS members considered that a practice statement setting out general principles on the use of Alternative Performance Measures (“APM”) could be useful, particularly when these measures are mentioned in the primary financial statements. The IASB’s tentative decision seems to be aligned with this view.
- 23 As we have highlighted in paragraph 13, EFRAG Secretariat notes that the IASB will have to decide whether the objective is to have general guidelines on the use of alternative performance measures (e.g. within a practice statement) or specific requirements within IFRS, particularly when dealing with alternative performance measures that are mentioned in the primary financial statements and do not comply with IFRS requirements (e.g. adjusted IFRS numbers).
- 24 EFRAG Secretariat also highlights the difficulties related to having specific guidance on recurring, non-recurring, one-off or extraordinary items, particularly if these are to be presented in the statement of financial performance. It may prove difficult to define non-recurring, unusual or infrequently occurring items as stakeholders have different views regarding which items fall into these categories in terms of frequency, materiality and future expectations. Finally, we recall that most of the companies that the EFRAG Secretariat analysed² did not make an explicit reference to non-recurring on the face of the statement of financial performance. Instead, many companies referred to such items in the notes to financial statements.

Statement of financial performance: Better ways to communicate information about OCI?

- 25 The IASB is going explore better ways to communicate information about other comprehensive income (OCI). The IASB is expected to focus on improving the presentation of items currently reported in OCI rather than on which items should be included in OCI.
- 26 EFRAG Secretariat notes that OCI includes important information about financial performance and that users tend to dismiss information included in OCI. Improving

² paragraphs 16 to 38 of agenda paper 10-03.

the presentation of items included in OCI, including the use of recycling, might help users to better understand the entity's financial performance and reduce the tension related to the distinction between profit or loss and OCI.

- 27 Nonetheless, the EFRAG Secretariat notes that it will be challenging to improve presentation of OCI without addressing the definition of performance, use of OCI and the need for recycling.
- 28 Finally, the EFRAG Secretariat highlights that relevant information about OCI is also provided in the statement of financial position (e.g. separate components of equity). Thus, the EFRAG Secretariat considers that it would be useful to consider both the statement of financial position and the statement of financial performance when discussing improvements to the presentation of OCI.

Statement of financial position

- 29 In June 2016, EFRAG TEG and EFRAG CFSS members were in favour of having an investigation on whether there is any demand for changes in the statement of financial position.
- 30 From its initial research, the IASB Staff did not find significant issues within the statement of financial position. This is also in line with the findings of the staff of the U.S. Securities and Exchange Commission in 2011 which noted a "fair degree of comparability associated with asset and liability classification on the face of the statement of financial position"³.
- 31 Considering this, the IASB tentatively decided not to make targeted improvements to the statement of financial position unless work on other areas of the primary financial statements identifies possible improvements to that statement.
- 32 EFRAG Secretariat considers that, although no significant issues were identified, it is important to continue to investigate whether there is any demand for changes in the statement of financial position. For example, there are a number of issues that arise within the banking and insurance industries, which are typically influenced by local legislation. From the EFRAG Secretariat research, we have also observed cases where items described as "others" were higher than 10% of the total assets.
- 33 Finally, we highlight that there are a number of IASB projects that are expected to introduce improvements to the presentation of the statement of financial position (e.g. Insurance Contracts and FICE). Therefore, the EFRAG Secretariat highlights the importance of considering significant changes that new requirements may introduce to current accounting practice.

Statement of cash flows

- 34 In June 2015, EFRAG TEG and CFSS members considered that there was room to improve the Statement of Cash Flows and highlighted a number of specific issues that needed to be addressed, including some of the definitions and options that exist in IAS 7 *Statement of Cash Flows*, the linkage between the different primary financial statements and better articulation of the objective of the statement of cash flows.
- 35 EFRAG User Panel has raised concerns about the existing accounting options, including the existing flexibility for classifying interest paid or received and dividends paid or received as either part of operating, investing or financing activities. There was general agreement that accounting policy choices reduce comparability and requires users to make adjustments to obtain more understandable and comparable financial information through a relatively standard model.

³ "Work Plan for the Consideration of Incorporating IFRS into the Financial Reporting System for U.S. Issuers – An Analysis of IFRS in Practice", report prepared by the staff the US SEC.

- 36 Thus, the IASB's tentative decision to explore the elimination of options for the classification of the cash effects of interest and dividends in the statement of cash flows seems to be in line with feedback from EFRAG constituents.
- 37 The IASB has also tentatively decided to explore the alignment of the operating section across the statement of cash flows and the statement of financial performance. The EFRAG Secretariat recalls that the IFRS Interpretations Committee had difficulties in agreeing on a definition for operating, investing and financing cash flows. During its deliberations, the Interpretations Committee observed that several specific requests regarding the classification of cash flows had been considered individually. The interpretations Committee concluded that amendments to IAS 7 on a piecemeal basis would not be appropriate unless the classification is evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer.
- 38 Finally, the Discussion Paper *Improving the Statement of Cash Flows* prepared by staff of the UK Financial Reporting Council was published in October 2016. The EFRAG Secretariat will closely monitor the outcome in terms of the feedback received by the FRC.

Segment reporting or the presentation of discontinued operations

- 39 From their research activities, the IASB staff noted that some users would like the IASB to reconsider the IFRS Standards dealing with segments and the presentation of discontinued operations.
- 40 The IASB is currently discussing clarification to IFRS 8 *Operating Segments* arising from the post implementation review. In particular, in October 2016 it discussed the number of line items included in segment reporting. Thus, EFRAG Secretariat considers that issues identified related to segment reporting could be considered in this project.

Format of financial statements

- 41 IFRS Standards do not specify precise financial statement formats. Instead, they provide general guidelines regarding the form and content of financial statements.
- 42 Developing templates for the primary financial statements could provide more standardised financial statements that users could analyse and compare more easily. Many jurisdictions already provide in their local GAAP or regulation precise financial statement formats, including formats for financial institutions. Such guidance may already influence IFRS financial statements presentation in some jurisdictions. Finally, developing templates could also help the development of the IFRS Taxonomy.
- 43 However, developing templates could raise a number of issues. For example, the IASB would need to develop different templates for different industries, would have to update them regularly and could, to some extent, restrict the relevance of the information provided to users as it may not provide sufficient flexibility for entities to describe their business model.
- 44 Alternatively, the IASB could focus more on the requirements for aggregation or disaggregation in IAS 1 to make financial statements more comparable and more understandable and update/expand the existing *Guidance on implementing IAS 1* which includes illustrative financial statements structure.

Questions for EFRAG TEG

- 45 Do EFRAG TEG members agree with the scope of the project as proposed by the IASB? If not, do you consider that there is a topic that should be removed from, or included in, the scope of the project?
- 46 Do EFRAG TEG members consider that the IASB should explicitly address issues that arise in specific type of industries, including banks and insurance companies?
- 47 Considering the proposed scope, do EFRAG TEG members consider that the next step of the project should be an exposure draft or a discussion paper?

Appendix 1: Key elements of IFRS Standards related to presentation options, line items, subtotals and totals.

Statement of financial performance: number of line items and subtotals

- 1 IFRS Standards specify a number of line items, subtotals and totals that must be presented in the statement of financial performance. These include:
 - revenue
 - gains and losses from the derecognition of financial assets measured at amortised cost
 - finance costs
 - share of the profit or loss of associates and joint ventures accounted for using the equity method
 - certain gains or losses associated with the reclassification of financial assets
 - tax expense
 - a single amount for the total of discontinued items
 - profit or loss
 - total other comprehensive income
 - comprehensive income for the period
 - an allocation of profit or loss and comprehensive income for the period between non-controlling interests and owners of the parent
- 2 Certain items must be disclosed separately either in the statement of comprehensive income or in the notes, if material, including:
 - write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs
 - restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring
 - disposals of items of property, plant and equipment
 - disposals of investments
 - discontinuing operations
 - litigation settlements
 - other reversals of provisions
- 3 Paragraph 85 of IAS 1 *Presentation of Financial Statements*, however, requires an entity to present additional subtotals in the statement of financial performance when such presentation is relevant to an understanding of the entity's financial performance.
- 4 When an entity presents subtotals, those subtotals shall be comprised of line items made up of amounts recognised and measured in accordance with IFRS; be presented and labelled in a clear and understandable manner; be consistent from period to period; not be displayed with more prominence than the required subtotals and totals; and reconciled with the subtotals or totals required in IFRS.

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- 5 Additional line items may be needed to fairly present the entity's results of operations. Items cannot be presented as 'extraordinary items' in the financial statements or in the notes.

Statement of financial performance: single statement or two statements

- 6 An entity has a choice of presenting:
- (a) a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections, or
 - (b) two statements:
 - (i) a separate statement of profit or loss
 - (ii) a statement of comprehensive income, immediately following the statement of profit or loss and beginning with profit or loss [IAS 1 paragraph 10A]

Statement of financial performance: presentation of expenses by nature or function

- 7 Expenses recognised in profit or loss should be analysed either by nature or by function. If an entity presents information by function, then additional information on the nature of expenses – at a minimum depreciation, amortisation and employee benefits expense – must be disclosed.

Statement of financial performance: other comprehensive income

- 8 Entities are required to present line items classified by their nature and grouped between those items that will or will not be reclassified to profit and loss in subsequent periods.
- 9 An entity's share of OCI of equity-accounted associates and joint ventures is presented in aggregate as single line items based on whether or not it will subsequently be reclassified to profit or loss.

Statement of financial position: current and non-current classification

- 10 An entity must normally present a classified statement of financial position, separating current and non-current assets and liabilities, unless presentation based on liquidity provides information that is reliable.
- 11 The line items to be included on the face of the statement of financial position are:
- property, plant and equipment;
 - investment property;
 - intangible assets;
 - financial assets;
 - investments accounted for using the equity method;
 - biological assets;
 - inventories;
 - trade and other receivables;
 - cash and cash equivalents;
 - assets held for sale;
 - trade and other payables;
 - provisions;
 - financial liabilities;

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- current tax liabilities and current tax assets, as defined in IAS 12 *Income Taxes*;
- deferred tax liabilities and deferred tax assets, as defined in IAS 12;
- liabilities included in disposal groups;
- non-controlling interests, presented within equity;
- issued capital and reserves attributable to owners of the parent.

Statement of Cash Flows

- 2 IAS 7 states that cash flows must be analysed between operating, investing and financing activities.
- 3 Paragraph 31 of IAS 7 states that interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period.
- 4 Paragraph 35 of IAS 7 states that cash flows arising from taxes on income are normally classified as operating, unless they can be specifically identified with financing or investing activities.
- 5 In accordance with paragraph 18 of IAS 7, an entity shall report cash flows from operating activities using either the direct method or the indirect method.