Primary Financial Statements
Issues Paper – Research activities

Objective

1 The objective of this paper is to provide EFRAG TEG members with a summary of the research work conducted on the *Primary Financial Statements* project since the EFRAG TEG meeting in June 2016.

Key findings from the IASB's research activities

Financial statements presentation

2 The IASB Staff performed an analysis on the presentation of financial statements of 25 entities that report in accordance with IFRS Standards. The key findings can be summarised as follows[1]:

(a) the IASB Staff noted significant variations in the structure and content of the statements of financial performance, even for entities within the same industry. For example, entities provide different subtotals, labelling, level of detail and displayed different practices in terms of presentation;

(b) the IASB Staff observed that many entities present an "operating profit" subtotal that corresponds broadly to earnings before interest and tax (EBIT). However, the IASB Staff noted that these subtotals were often calculated differently. For example, the location of some line items such as fair value gains and losses from financial instruments, share of results of associates and joint ventures and net interest cost on the net defined benefit liability causes differences in the calculation of subtotals;

(c) many entities present an adjusted operating profit (e.g. operating profit before non-recurring items). However, IASB Staff noted that the adjustments vary, lack transparency and are presented differently. The IASB Staff also noted that some items labelled as "non-recurring" could arise year after year and that some entities did not provide any conceptual basis for excluding items;

(d) for the statement of cash flows, the starting point for determining net cash flow from operating activities varies (the indirect method). For example, entities used either "profit or loss", "profit attributable to shareholders", "profit from continuing operations", "profit before tax", "operating profit" or "cash generated from operations";

(e) the IASB Staff noted that the presentation of interest and dividends in the statement of cash flows varies. Only in some cases the choice was consistent among entities in the same industry;

[1] More detailed information can found in the IASB's agenda papers for November 2016 meeting (click here)

(f) the IASB Staff found no major inconsistencies in the presentation of the statement of financial position. Nonetheless, the IASB Staff observed that some entities had large "other" items; and

(g) the number of line items presented in segment information varies. The IASB Staff observed that some entities presented most of the line items from their statement of financial performance within the segment information section. Other entities presented only some line items.

Use of performance measures in communications with stakeholders

3 The IASB Staff also performed an analysis of the performance measures used by these 25 entities that report under IFRS Standards when communicating with investors. The key findings can be summarised as follows:

(a) in their communications with stakeholders (inside and outside the financial statements), entities use performance measures based on "IFRS-specified information" (e.g. revenue); "not explicitly required IFRS information" (e.g. gross profit) and "non-IFRS information" (e.g. adjusted operating profit);

(b) the IASB Staff identified some commonly used non-IFRS performance measures such as adjusted revenue, adjusted operating profit, adjusted EBITDA, adjusted profit and adjusted basic earnings per share (EPS). Nonetheless, the IASB Staff observed that these performance measures are often calculated differently as they may exclude or include the effects of foreign currency exchange rates, the effects of changes in the scope of consolidation, the results from associates and/or joint ventures, restructuring costs, impairment of goodwill and acquisition related costs;

(c) some non-IFRS measures can conflict with IFRS Standards because they are, for example, measured on a different basis to IFRS or provide information that undermines information provided in accordance with IFRS (e.g. adjusted "revenue" that includes share of revenue from associates);

(d) outside the financial statements (e.g. in management commentary, investor presentations and press releases), there is widespread use of performance measures based on non-IFRS information; and

(e) performance measures presented outside the financial statements are sometimes also presented in the financial statements.

Literature review

4 The IASB Staff reviewed existing studies focused on the issues that arise in practice and possible improvements to the primary financial statements.

5 In terms of issues that arise in practice, the IASB Staff mentioned the Securities and Exchange Commission Staff Paper *Work plan for the consideration of incorporating IFRS into the financial reporting system for US issuers: An Analysis of IFRS in Practice* issued in 2011 (consolidated financial statements of 183 companies domiciled in 22 countries). This reported highlighted the following:

(a) the nature of subtotals reported on the face of the income statement varied greatly by company (18 different subtotals were observed);

(b) most companies reported profit and loss subtotals that excluded certain income and expense items. Many also presented a measure of net profit or loss that excluded costs necessary to generate revenue, such as depreciation of equipment or labour costs. Some companies presented subtotals that they explicitly characterised as non-GAAP measures on the face of the income statement. Most companies did not disclose an accounting policy that explained the basis they used to determine which income and expense items to exclude;

(c) The SEC Staff noted six different classifications that companies used to report the share of profit or loss from associates on the face of the income statement[2].

(d) The SEC Staff noted that some companies, mostly in one country, disclosed earnings per share for alternative earnings measures. Alternative measures of earnings per share included "operating profit per share", "normalized earnings per share", "earnings per share before exceptional items", and "earnings per share before restructuring, disposals, and other one-off items".

6 The IASB Staff also examined studies that focused on possible improvements to the primary financial statements and segments. The key findings were:

(a) users need more subtotals, disaggregation and structure than specified in IFRS Standards;

(b) separating operating from financing activities is value relevant;

(c) investors often do not use OCI;

(d) aligning primary financial statements can add value;

(e) allowing choice in reporting interest in the statement of cash flows hinders comparability;

(f) primary financial statement information is used differently for different industries (e.g. banking, insurance and property); and

(g) users would like more detail in the segments notes.

Outreaches on the scope of the project.

7 The IASB undertook a number of outreach activities with users of financial statements and formal advisory bodies of the IASB such as the IFRS Advisory Council, Accounting Standards Advisory Forum (ASAF), Capital Markets Advisory Committee (CMAC), Global Preparers Forum (GPF) and IFRS Taxonomy Consultative Group (ITGC).

8 Most stakeholders expressed support for a project to improve the structure and content of the primary financial statements beginning with the statement of financial performance. This is because those statements contain the least structure under current IFRS requirements and most Alternative Performance Measures (APM) are based on those statements[3].

9 There were fewer concerns about the structure and content of the other primary financial statements except for the operating section of the statement of cash flows.

10 The IASB Staff also received a number of suggestions on how to improve the structure and content of the primary financial statements. There was support for:

(a) improving comparability by including more guidance in IAS 1 on minimum required line items and subtotals for the statement of financial performance (e.g. EBIT, operating profit, gross profit, COGS and some management view of profit such as recurring operating profit). Nonetheless, some expressed a preference for principle-based descriptions rather than detailed rules, with additional details in the notes and advised the IASB to ensure that new requirements do not undermine entities' ability to 'tell their own story'. The IASB Staff also learned that regulators and standard-setters provided

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[2] While IFRS Standards require the investor's share of the profit or loss of associates to be disclosed separately, it does not specify where to report this amount on the face of the statement of financial performance.

[3] As an example, representatives of a data aggregator stated that companies that use US GAAP and Japanese GAAP present relatively standardised financial statements. However, IFRS financial statements are quite diverse and fragmented by country and regions and non-recurring items can be presented in various places in financial statements.

additional structure via their local regulations or IFRS implementations, but they would prefer having such structure coming directly from IFRS;

(b) adding a new earnings per share (EPS) measure which reflects the management view of profit. Many users stated that alternative EPS measures were often reported outside the audited financial statements without adequate transparency;

(c) changing the definition of "operating cash flows" and aligning the new definition with a new "operating profit" subtotal in the statement of financial performance;

(d) removing the presentation options for dividends and interest in the statement of cash flows as any variation among entities is often not meaningful and makes comparative analyses more difficult;

(e) developing templates or formats for the primary financial statements for a limited number of industries (e.g. corporates, banks, insurance and real estate entities); and

(f) requiring additional line items and subtotals in segment disclosures. Many users attempt to understand the reported segments in some detail and find the current requirements to be generally inadequate. They stated that the current requirements also result in a considerable variation even among peer entities, making comparative analysis difficult. Many users also want more information about discontinued operations which could be included in the segment note to the financial statements.

11 In terms of APMs, some users stated that these were useful and should not be prohibited. They also highlighted the importance of having information about the sustainability of an entity's financial performance. However, users have also suggested that the quality and transparency of APMs should be improved.

12 Some preparers welcomed the idea that some APMs would be brought into audited IFRS financial statements. Some national standard setters noted that defining APMs would be difficult. Nonetheless, they expressed a preference for principles for presenting them similar to the guidelines from IOSCO or ESMA.

13 Finally, the IASB Staff noted that many users did not understand what is currently presented in OCI and did not include OCI items in their analysis.

Key findings from Mazars's research activities

14 Mazars presented in Milan a study on the use of APMs by a number of European listed entities. Mazars analysed the financial statements, press releases and presentations to the analysts of all companies within the EUROSTOXX 50 index, covering the year-end of 2015 and the first half of 2016[4].

15 Some of the key findings were:

(a) APMs play a key role in financial communication and there is a certain level of consistency per segment in the indicators used. EBIT, Operating Income, Operating profit, EBITDA, Net Debt and Free Cash Flow are the most common APMs used within the industrial segment;

(b) there is divergence in the labelling of APMs (i.e. similar APMs can be named differently). For example, entities often use labels such as EBIT, profit before finance results and taxes, operating profit or operating income;

[4] More details can be found here.

(c) there is divergence in the calculation of APMs. More specifically, there are significant differences in the calculation of the APMs despite the use of the same label, particularly when considering the share of profit/loss of equity-accounted investments, interest expenses on external debt, fair value gains or losses from financial instruments, non-recurring items, etc;

(d) none of the entities commented on OCI in their management commentary, press releases or presentations. In addition, the APMs presented made no reference to components of OCI;

(e) management tends to focus on adjusted earnings indicators (i.e. net of items qualified as non-recurring or extraordinary). In the industrial segment, 32 entities out of 37 used adjusted performance indicators and 12 present it on the face of the financial statements. In 83% of the cases, the adjustments resulted in positive effects and 6 entities changed the result from negative to positive. Some of items adjusted include disposal of businesses, litigation costs, impairment of PPE, disposal of PPE, acquisition related costs, restructurings and impairments of intangibles (including goodwill); and

(f) Although APM definitions are generally provided and worded clearly, APMs are often presented with more prominence than their IFRS most reconcilable indicator, especially in the press releases and in the presentations to analysts.

Key findings from EFRAG's initial research activities

Statement of financial performance

16 The EFRAG Secretariat undertook limited research activities focused on a number of European listed companies. We analysed the statements of financial performance of 34 listed companies[5] included in the S&P Europe 350 Index in order to understand current practice on presentation. At this stage, we have excluded companies that belong to the banking, insurance industries or financial conglomerates. We also note that the sample is not statistically representative of all European listed companies.

17 More specifically, we analysed the:

(a) use of the presentation options for the analysis of expenses, which can be presented either by their nature or their function;

(b) use of performance measures on the face of the statement of financial performance, including:

(i) exceptional items, and

(ii) recurring and non-recurring;

(c) use of subtotals;

(d) use of the option to present a single statement of comprehensive income or two statements;

(e) presentation of share of the profit or loss of associates and joint ventures accounted for using the equity method;

(f) number of line items used;

(g) number of subtotals used;

(h) any other form of earnings per share presented; and

(i) performance measures used in two financial databases available to the public.

[5] Selection based mainly on size (market capitalization) and industry.

18 We have not been able to confirm whether any of the line items, subtotals and totals have been calculated in accordance with IFRS requirements.

19 The companies analysed represented the following sectors/industries and countries of incorporation respectively:

Sector/Industry	**Number of companies**
Consumer Discretionary	4
Consumer Staples	8
Energy	2
Healthcare	5
Industrials	2
Information Technology	5
Materials	1
Telecommunication Services	5
Utilities	2
Total	**34**

Country of Incorporation	**Number of companies**
Belgium	1
Finland	1
France	6
Germany	6
Italy	2
Luxembourg	1
Netherlands	2
Spain	2
Switzerland	3
United Kingdom	10
Total	**34**

Statement of financial performance: *presentation by nature and by function*

20 Our research revealed the following:

(a) the majority (44%) of the companies presented their analysis of expenses using the classification based on their function. Of the remaining companies, 26% used a classification based on their nature and 24% used a combined approach by mixing the nature and function presentation. There were two cases where the companies only included a subtotal named operating profit without disaggregation. We have also noted a trend within some industries, which contributed to comparability within those industries:

(i) *Consumer Discretionary*: No clear preference;

(ii) *Consumer Staples*: preference for presentation by function;

(iii) *Energy*: combined approach by mixing nature and function presentation;

(iv) *Healthcare*: preference for presentation by function;

(v) *Industrials*: preference for presentation by function;

(vi) *Information Technology*: preference for presentation by function;

(vii) *Telecommunication Services*: preference for presentation by nature; and

(viii) *Utilities:* preference for presentation by nature.

Statement of financial performance: Use of performance measures

21 The EFRAG Secretariat noted that the majority of companies (76%) did not include an explicit reference to the term non-recurring, exceptional, non- core items or extraordinary on the face of the statement of financial performance.

22 Nonetheless, we observed that 50% provided information about non-recurring, exceptional or non-core items in their notes under other expenses/income.

23 In regard to the companies that made explicit reference to non-recurring, exceptional or non- core items, we noted that:

(a) the total amount was disclosed in a separate note that listed all the items;

(b) one company used the term “exceptional”, one other the term “non-core items” and six other used the term “non-recurring”;

(c) three companies included these amounts in operating profit, four companies excluded them from operating profit and one company had the effect of non-recurring items after every subtotal;

(d) the nature of the line items included in non-recurring, exceptional or non-core comprised, among others:

(i) restructuring costs;

(ii) profit and loss on disposal of assets;

(iii) impairment of assets;

(iv) losses on derivatives; and

(v) litigation related expenses;

Statement of financial performance: *Use of subtotals*

24 The EFRAG Secretariat noted that companies use many different subtotals on the face of the statement of financial performance. These include:

(a) *Gross profit*: all the companies that presented their analysis of expenses by function presented this subtotal.

(b) *Operating profit*: this subtotal was used by the majority (82%) of the companies. However, their calculation and their definition varied between entities. For example, some entities exclude results from associates and joint-ventures from operating profit.

(c) *Profit before interest and tax or EBIT*: Only 12% of the companies made explicit reference to EBIT. As referred above, in most cases companies would use “operating profit”, term which may in effect be EBIT. For example, in most cases companies that presented the subtotal operating profit had subsequent line items related only to profit from equity accounted investments, exceptional items, finance costs and taxes.

(d) *Finance results*: companies varied in their approach to presenting this as a separate subtotal. However, we note that there is no definition within IFRS Standards of what should be included in finance costs. Financing activities are defined only in IAS 7 as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

(e) *Profit before tax*: all companies used this subtotal.

(f) *Profit for the year*: all companies used this subtotal as required by IAS 1.

25 The EFRAG Secretariat also observed that some entities presented additional information in separate columns. For example, companies displayed the

information, including these subtotals, by segment or by earnings attributed to owners of the parent and non-controlling interest. There was also one case where the entity grouped earnings by transactions with related parties and others.

Statement of financial performance: Single statement or two statements

26 Almost all the companies (97%) in the sample that was analysed used two statements to present their performance, thereby contributing to comparability across countries and industries. However, we note that outreach activities have suggested (paragraph 13 above) that investors do not often use or understand the other comprehensive income part of the statement of financial performance.

Statement of financial performance: Results of associates and joint ventures

27 As referred above, the presentation of results of associates and joint ventures varied. In most cases (59%), the presentation of results of associates and joint ventures was within profit before tax. In such cases, entities would either include them before or after “operating income/profit” (the location varied). However, there were two cases where the line item (net of tax) was included within total revenue and other income

28 There were also other cases where a separate subtotal was created to show the result in performance before and after this had been taking into account.

29 The results of associates and joint ventures were normally included as a figure net of tax in the statement of financial performance.

Statement of financial performance: Number of line items

30 The EFRAG Secretariat noted that in some cases the number of line items was limited and disaggregation level was low. These companies tended to group items together rather than to have separate line items. We observed that the number of line items (excluding subtotals) used were:

(a) Less than 10 line items: 23%

(b) 11 to 15 lines items: 68%

(c) More than 15 line items: 9%

Statement of financial performance: Number of subtotals

31 As mentioned above, the EFRAG Secretariat noted that companies tended to use subtotals. Most of the companies (68%) had at least 4 subtotals i.e.:

(a) Gross profit

(b) Operating profit

(c) Profit before tax

(d) Profit for the year

32 We also noted that 18% also used a subtotal within another subtotal. An example would be with finance costs:

Operating profit

Finance expense

Finance income

Other finance costs

Finance results (net)

Operating profit after finance results

33 There was a limited number of companies that had a line item for interest from defined benefit plans.

Statement of financial performance: performance measures used in databases

34 The EFRAG Secretariat looked at two financial data bases that are partially available to the public to understand which performance measures were used. Typically companies' performance numbers are presented in the form of a template which can vary depending on the data base. For example:

(i) Database 1

- Only profit and loss part displayed (No OCI items)
- Presented by function
- Minimum line items
- The following subtotals:
  - **(a)** Gross profit
  - **(b)** Total operating expenses
  - **(c)** Operating profit
  - **(d)** Profit before tax
  - **(e)** Profit for the year
  - **(f)** No use of extraordinary items
  - **(g)** EBITDA

(ii) Database 2

- Only profit and loss part displayed (No OCI items)
- Presented by function and nature combined
- More line items than database 1
- The following subtotals:
  - **(a)** Total revenue
  - **(b)** Gross profit
  - **(c)** Total operating expenses
  - **(d)** Operating profit
  - **(e)** Profit before tax
  - **(f)** Profit for the year
  - **(g)** Extraordinary and unusual items listed

Statement of financial performance: Earnings per share

35 The 34 companies analysed by the EFRAG Secretariat in general did not present an unusual "earnings per share" figure at the bottom of the statement of financial performance. However, there was one case where an entity presented basic and diluted earnings per share before non-recurring items.

36 In general, companies showed the basic and diluted earnings per share figure as well as the split between continued and discontinued operations. Entities also did not present any other APMs at the bottom of the statement of financial performance.

Statement of financial performance: OCI

37 The EFRAG Secretariat analysed the statement of other comprehensive income of 10 listed companies included in the S&P Europe 350 Index, to understand current practice on presentation, the following was noted:

(a) All entities started the statement with profit after tax for the year;

(b) All entities separate the statement into 2 parts;

(i) Items that cannot be reclassified to profit and loss,

(ii) Items that may be reclassified to profit and loss;

(c) Entities presented the reclassification adjustments to profit and loss under the headings listed above. There was also a description of what the reclassification included. There was only one instance where there was no description to what the reclassification related to.

(d) There were no APMs noted in the presentation of the statement of other comprehensive income;

(e) All entities presented other comprehensive income for the year, net of tax;

(f) The presentation of the tax effect can be divided into three categories:

(i) Showing the effect net of tax (3 cases);

(ii) Showing the tax effect of every line item (1 case);

(iii) Showing the aggregated tax effect of all the items under the category, for example that may be classified to profit and loss (6 cases).

Statement of financial position

38 The EFRAG Secretariat again analysed the same thirty four statements of financial position of listed companies included in the S&P Europe 350 Index. The following could be noted:

(a) all the entities separated the presentation of assets and liabilities by current and non–current;

(b) all the entities used subtotals for total assets, total liabilities and equity;

(c) most of the entities (82%) did not present subtotals and totals other than those required by IAS 1 (e.g. current/non-current, total assets, liabilities and equity). The remaining however presented the following additional subtotals:

(i) Net assets subtotal, immediately after total assets total (3 cases);

(ii) Discontinued operations assets and liabilities subtotal split between items of a financial nature and items that was not of a financial nature (2 cases);

(iii) Disaggregation of all line items on the face of the financial statement and then with a subtotal afterwards. Property, plant and equipment was for example split between items under construction and items in use (1 case);

(d) some entities presented line items referring “other”. In 13 cases, these line items represented more than 10% of net assets (i.e. Equity). In 10 cases, we were able to find disclosures about the nature of such line items. However, there was 3 cases where we did not find additional information within disclosures;

(e) the EFRAG Secretariat noted that there were different methods used to present the equity part of the statement of financial position, in particular the separate component of OCI. All entities made the disaggregation of equity attributable to owners of the parent and non-controlling interest. If the entity did not split there components of OCI completely, there would at least be a separate translation reserve. In particular, we observed:

- (i) Entities that made the split of equity attributable to owners of the parent and non-controlling interest but no other disaggregation (5 cases);
- (ii) Entities that made no separation of retained earnings and other reserves that would include OCI items in the statement of financial position (6 cases);
- (iii) The entities made the separation of retained earnings and other reserves that would include OCI items in the statement of financial position (22 cases); and
- (iv) One entity had a separate reserve for every OCI item.

(f) 79% of the entities that were analysed presented the line items by order of liquidity in their statement of financial position.

Questions for EFRAG TEG

39 Do EFRAG TEG members consider that it would be useful to have further research? If so, what further research would be useful at this stage?