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# Primary Financial Statements
# Issues Paper

## Objective of this section[1]

1 The objective of this paper is to discuss:

(a) the possibility of introducing two additional subtotals in the statement(s) of financial performance:

(i) earnings before finance income/expenses and tax (EBIT)

(ii) management (operating) profit measure (‘MOPM’);

(b) additional guidance on adjusted earnings per share (‘adjusted EPS’); and

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

## Agenda papers for this session

2 In addition to this issues paper, agenda papers for this session are:

(a) Agenda paper 07B-02 ASAF 06A – for background only

(b) Agenda paper 07B-03 ASAF 06B – for background only

(c) Agenda paper 07B-04 ASAF 06C – for background only

(d) Agenda paper 07B-05 ASAF 06D – for background only

(e) Agenda paper 07B-06 ASAF 06E – for background only

(f) Agenda paper 07B-07 ASAF 06F – for background only

## Objective of the project and summary of recent discussions

3 The *Primary Financial Statements* project is an early-stage research project that is currently examining potential targeted improvements to the structure and content of the primary financial statements.

4 EFRAG TEG-CFSS members discussed in February 2017 the key findings of the IASB and EFRAG Secretariat’s research activities and the IASB’s tentative decisions on the scope of the project. Members highlighted the importance of this project and generally agreed with the IASB’s tentative decisions on the scope of the project.

[1] 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. This agenda paper will cover mainly the definition and presentation of subtotals in the statement of financial performance.

5 In March 2017 the IASB continued its discussions and agreed to explore:

(a) requiring the presentation of **earnings before interest and tax** (**EBIT**), defining it as 'profit before finance income/expenses and tax' and describing finance income/expenses as income/expenses related to the entity's capital structure;

(b) requiring the presentation of a management (operating) profit measure **(MOPM)** and allowing items to be excluded from the MOPM as long as the subtotal meets the requirements in existing paragraphs 85 - 85B of IAS 1 *Presentation of Financial Statements*; and

(c) requiring additional disclosures to provide transparency around presentation of the MOPM.

6 By proposing a comparable EBIT subtotal in combination with a MOPM, the IASB is addressing the needs for both comparability and flexibility in the statement(s) of financial performance:

(a) the EBIT subtotal would provide users a relatively comparable anchor point and facilitate comparisons of entities with different capital structures; and

(b) the MOPM would provide flexibility to preparers to 'tell their own story'.

**EBIT - approaches for describing capital structure[2]**

7 The IASB Staff provides three approaches for describing capital structure:

(a) **Approach 1**: management's view of what capital structure is (e.g. management view on the debt and equity when calculating the WACC).

(b) **Approach 2**: strict definition of capital structure (e.g. provide a list of items considered to be part of capital structure such as own equity instruments, bank loans, bonds, leases liabilities, own shares classified as liabilities, accrued interest payable, derivatives relating to items of capital structure, cash, deposits and listed securities).

(c) **Approach 3**: principles based approach of what capital structure is for management to apply, particularly on which assets and liabilities should be considered as part of capital structure.

8 The IASB Staff expressed a preference for Approach 3 as it would provide users with a relatively comparable starting point for their analysis, would be easier to apply to more complex cases and would be consistent with IAS 7 *Statement of Cash Flows.* In addition, it was noted that a principles-based approach has already been supported by some advisory and consultative groups (ASAF, CMAC and GPF).

9 Consequently, the IASB Staff recommends:

(a) a principles-based approach to describing capital structure (i.e. the way an entity finances its business); and

(b) defining capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents;

*EFRAG Secretariat analysis*

10 The subtotal EBIT is currently widely used by investors as it provides comparability of financial performance between entities with different capital structures. Thus, EFRAG Secretariat welcomes the IASB developing additional guidance on the definition and presentation of EBIT.

[2] At this stage the IASB is focusing on determining a suitable approach for non-financial entities. In the future, the IASB is going to discuss how this approach could be applied or adapted to more complex scenarios.

11 EFRAG Secretariat also agrees with defining EBIT as 'earnings before finance income/expenses and taxes'. As there is no definition in IFRS Standards and no consistency in practice on the use of 'finance income/expense' or 'interest expense', we welcome the IASB Staff approach to define and relate 'finance income/expenses' to an entity's capital structure and having a principles-based definition of capital structure.

12 However, we note that the definition of 'finance income/expenses' will depend on the definition of 'capital structure', which in turn will depend on the definition of 'financing activities'. A different approach would be relating 'finance income/expenses' directly to 'financing activities' and improving the definition of 'financing activities' in IAS 7 based on the notion of an entity's capital structure.

13 In addition, EFRAG Secretariat highlights that relating 'cash management' and investments to capital structure raises some challenges. For example, the definition of 'finance income/expenses' would step away from the current definition of 'financing activities' in IAS 7 and it would raise questions whether fair value gains and losses and impairments of investments would be considered as finance income/expense. Instead, the IASB could focus more on the notion of interest, including the existing presentation option in IAS 7.

14 EFRAG Secretariat also recalls that, from our initial research activities, we observed that the majority of the companies analysed did not specifically use the subtotal EBIT and others used the subtotal 'finance results'. Therefore, requiring the use of EBIT could be a significant change in practice and may raise industry-specific issues.

**Questions for EFRAG TEG-CFSS**

15 Does EFRAG TEG-CFSS agree with having a principles-based approach to describing capital structure?

16 Does EFRAG TEG-CFSS agree with defining capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents?

## EBIT – Development of principles-based approach

*Financing activities*

17 IAS 7 defines financing activities as those that 'result in changes in size and composition of the contributed equity and borrowings of the entity'. The IASB Staff noted that this definition is broad and subject to different interpretations. To ensure consistent interpretation, the IASB Staff recommended clarifying the notion of financing activities by indicating that the nature of financing activities involve:

(a) the receipt or use of a resource from a provider of finance;

(b) the expectation that the resource will be returned to the provider of finance; and

(c) the expectation that the provider of finance will be appropriately compensated through a payment of a finance charge. The finance charge is both dependent on the amount of credit and duration.

*Capital structure*

18 For the description of capital structure, the IASB Staff recommended that income/expenses related to capital structure should include:

(a) all income and expenses on items of capital structure that solely arise from financing activities (e.g. income and expenses related to a bank loan such as interest, foreign exchange gains or losses and fair value gains and losses); and

(b) income and expenses related to the funding aspect of items of capital structure that do not solely arise from financing activities (e.g. interest expenses on trade payables on extended credit terms and lease liabilities).

*Interest on assets and liabilities not part of an entity's capital structure*

19 Entities often recognise interest that results from the timing difference between the date of recognition and the date of settlement of a liability. The IASB Staff concluded that it would not be useful for users and would be a change in practice to exclude such interest from finance income/expenses and recommended that the definition of finance income/expenses should also include interest on assets and liabilities that are not part of an entity's capital structure (including net interest on defined benefit plan assets). Due to their different nature, the IASB Staff recommended requiring separate presentation of:

(a) income related to capital structure;

(b) expenses related to capital structure;

(c) interest income on assets outside capital structure; and

(d) interest expenses on liabilities outside capital structure.

*EFRAG Secretariat analysis*

20 EFRAG Secretariat notes that the definition of financing activities is key for the definition of EBIT and considers that the definition of IAS 7 is a good starting point for developing principles over the calculation of EBIT, particularly because it would link the statement(s) of financial performance and the statement of cash flows. EFRAG Secretariat acknowledges that in 2013 the IFRS Interpretations Committee ('IFRS IC') already discussed ways to make the definitions of financing activities to achieve consistency in application and agrees that past IFRS IC discussions could be followed-up by the IASB in future meetings. Therefore, we welcome the IASB Staff recommendation to improve the definition of financing activities. However, we consider that a key feature of 'financing activities' is the maturity of the amount due to be paid (i.e. long-term liabilities), which is not identified in paragraph 17 above.

21 EFRAG Secretariat agrees that the classification of some items (e.g. interest on bank loans, borrowings, bonds, debt instruments issued, deferred payments, advance payments, collaterals, dividends related to own shares accounted for liabilities and leases) are fairly straight forward for non-financial entities. We also agree that costs related to financing activities (e.g. debt restructuring costs) can be considered as finance expenses as they arise from financing activities.

22 However, there are items which classification is less straightforward as the guidance in IFRS Standards is not clear. For example, when there is an increase of the carrying amount due to passage of time (e.g. provisions for decommissioning) and net defined benefit liabilities. In such cases, the IASB Staff recommendation in paragraph 18 for separate presentation would provide a practical solution. Nonetheless, we consider that such information could be provided within the disclosures to avoid an overload of line times.

**Questions for EFRAG TEG-CFSS**

23 Does EFRAG TEG-CFSS agree with clarifying the current description of financing activities as described in paragraph 17 above?

24 Does EFRAG TEG-CFSS agree that income/expenses related to capital structure should include the income and expenses described in paragraph 18 above?

| | |
|---|---|
| 25 | Does EFRAG TEG-CFSS agree that the definition of finance income/expenses should include interest on assets and liabilities that are not part of an entity's capital structure? If so, do you agree with separate presentation requirements suggested in paragraph 19 above? |

**Management (operating) performance measure (MOPM)**

26 The IASB is exploring the use of a MOPM as it would provide flexibility to preparers to 'tell their own story. Nonetheless, guidance on such a measure raises a number of practical issues:

(a) should entities present an operating profit subtotal defined by the IASB?

(b) what constraints should there be on items excluded from MOPM?

(c) how should the items between the MOPM and EBIT be presented?

(d) should the MOPM subtotal be required or allowed and how it should be labelled?

27 To address these issues, the IASB Staff recommended:

(a) *not requiring an entity to present an operating profit subtotal defined by the IASB (between the MOPM and EBIT subtotal)*: some IASB members suggested requiring a defined operating profit subtotal as it would provide a comparable measure to users. However, the IASB Staff noted that such an approach would require the IASB to define operating profit and prescribe the classification of items as operating and non-operating. This would be difficult considering the differences among businesses and industries and could lead to additional complexity;

(b) *prohibiting exclusion of items from the MOPM solely because the items are considered to be outside of management control*: some IASB members suggested such prohibition as what is within or outside of management control is too judgemental;

(c) *adding management-defined constraints that would be required to be applied consistently over time (e.g. management's definition of performance and infrequently occurring items) when an entity presents a MOPM*: to promote consistency as management would need to present their definitions and calculate the performance measures on the same basis over time.

(d) *requiring an entity to separately present infrequently and frequently occurring items between the MOPM and EBIT subtotal*: users need information about which items occur infrequently in order to assess the persistency of income and they are often concerned about unjustified exclusion of frequently occurring items from MOPMs. The IASB Staff is also considering additional disclosures on infrequently occurring items such as a five year history.

(e) *requiring an entity to label the MOPM to reflect whether that measure only excludes infrequently occurring items or also excludes frequently occurring items*: Although the IASB Staff does not propose a specific label it recommends that subtotal should indicate what is being excluded.

(f) *requiring an entity to present the MOPM as a subtotal if the entity uses the measure outside the financial statements but within the annual report, provided that measure does not contradict with the constraints in IFRS Standards*: a narrower approach when compared to the possibility of requiring its presentation in all circumstances, which would also bring transparency;

(g) *recommend keeping the existing requirements for, and constraints on, the presentation of subtotals in paragraphs 85, 85A and 85B of IAS 1(see Appendix A).*

*EFRAG Secretariat analysis*

28 EFRAG Secretariat generally agrees with the proposal to focus on MOPM rather than an operating profit defined by the IASB. We recall that in February 2017 some EFRAG TEG-CFSS members considered that it would be challenging to define an 'operating profit' subtotal and noted that an overly prescriptive approach on the presentation of line items and subtotals would not provide preparers with sufficient flexibility to explain their business model.

29 In February 2017, some EFRAG TEG-CFSS members also considered that it would be useful to have general principles on the use of Alternative Performance Measures (APMs) and suggested that 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 MOPM.

30 EFRAG Secretariat notes that 'requiring an entity to present MOPM as a subtotal if the entity uses the measure outside the financial statements' would increase the likelihood subtotals overload on the face of the financial statements, particularly if EBIT is also required together with separate presentation of different types of income and expenses. In addition, if EBIT is also required the IASB would have to consider whether new guidance on EBIT would impose restrictions on MOPMs.

31 We also highlight the challenges of introducing guidance on the presentation of non-recurring items and relying at the same time on management definition of non-recurring items. EFRAG Secretariat is concerned that it may lead to mislabelled items and how such guidance would interact with paragraph 87 of IAS 1 on extraordinary items.

**Questions for EFRAG TEG-CFSS**

32 Does EFRAG TEG-CFSS agree with the IASB Staff recommendations as stated in paragraph 27? If not, why?

**Additional guidance on adjusted EPS**

33 The IASB is exploring the possibility of requiring entities to calculate an adjusted Earnings per Share (EPS) and a MOPM consistently when both are presented in the financial statements. This would mean that any constraints applied to the MOPM will also apply to the adjusted EPS calculation. The IASB is currently only considering changes to the numerator of the adjusted EPS and not proposing changes to the calculation of the denominator.

34 The IASB Staff recommends requiring that:

(a) entities calculate adjusted EPS and MOPMs consistently when both are presented in the financial statements;

(b) entities reconcile items excluded from the adjusted EPS with items excluded from the MOPM when both are presented in the financial statements (see paragraph 26 of agenda paper 07B-06 for an example). Although the measures need to be calculated consistently there will still be differences. For example items excluded from adjusted EPS can be wider than items excluded from the MOPM.

(c) entities present adjusted EPS in the financial statements if:

(i) the entity presents an adjusted EPS outside the financial statements; and

(ii) the adjusted EPS is calculated consistently with the MOPM presented in the statement(s) of financial performance; and

(d) entities that present an adjusted EPS should present that adjusted EPS in the primary financial statements, rather than just in the notes, if the MOPM is presented in the primary financial statements.

35 The IASB Staff is of the view that ensuring the consistency in the application of a MOPM and an adjusted EPS could achieve greater transparency in the items excluded and discipline around the measures because these performance measures are similar in nature and both management-defined.

36 The IASB Staff states that by presenting the adjusted EPS in the primary financial statements, users will clearly see any differences between the IASB-defined EPS and the adjusted EPS. In addition, items between the MOPM and EBIT in the statement(s) of financial performance mostly explain the source of differences between the IASB-defined EPS and the adjusted EPS.

*EFRAG Secretariat analysis*

37 In its February 2017 meeting, some EFRAG User Panel members were not in favour of an adjusted EPS measure due to the lack of transparency of such measures. These members gave the example of a company that had excluded restructuring costs that actually tended to appear every year and had a significant impact on the reported performances measures and adjusted EPS.

38 EFRAG Secretariat acknowledges the need for consistency in the application of performance measures and requests from users for greater discipline around the use of APMs in the annual accounts.

39 The inclusion of the adjusted EPS measure in the financial statements together with specific guidance could improve the transparency of such measures. However, EFRAG Secretariat notes that requiring an entity to present an adjusted EPS in the financial statements (if the entity uses the measure outside the financial statements) would increase the likelihood of overload of line items on the face of the financial statements and runs the risk of giving a legitimacy to any adjusted EPS figure. EFRAG Secretariat is concerned with having both IFRS EPS and adjusted EPS figures presented in the statement(s) of financial performance as they could be inconsistent or even in conflict with each other. This could lead to a decrease of understandability of the financial statements. In addition, placing restrictions on an adjusted EPS could render the performance measure useless because it does not present the management's view on EPS.

40 EFRAG Secretariat notes that paragraph 73 and 73A of IAS 33 *Earnings per Share* already requires a reconciliation if an entity presents an adjusted EPS and considers that an additional reconciliation could be burdensome for prepares and not be useful to users of the financial statements.

41 Lastly, the IASB's project on *Financial Instruments with Characteristics of Equity* is currently considering potential changes to presentation in the statement(s) of financial performance, on the calculation of EPS and information about dilution.

**Questions for EFRAG TEG-CFSS**

42 Does EFRAG TEG-CFSS agree with the IASB Staff recommendations as stated in paragraph 34? If not, why?

**Presentation of the share of the profit or loss of associates and joint ventures accounted for using the equity method**

43 The IASB is going to discuss the location of the share of the profit or loss of associates and joint ventures in the statement(s) of financial performance as requiring a specific location for this line item may help in defining EBIT.

44 In its research activities, the IASB Staff noted diversity in practice in the presentation of this line item. Continuing to allow a presentation option would perpetuate diversity in practice and would not be consistent with the IASB's objective of introducing a comparable EBIT subtotal.

45 Therefore, the IASB Staff recommended that the location of the line item share of the profit or loss of associates and joint ventures should prescribed and presented outside the EBIT subtotal after the entity's income tax expense. The IASB Staff argued that this would best reflect the nature of the results recognised by the entity through the application of the equity method (i.e. that the entity recognises a share in the post-tax results of the investee) and would be consistent with the way most users treat the results of associates and joint venture.

*EFRAG Secretariat analysis*

46 When undertaking its research activities, EFRAG Secretariat noted that the presentation of share of the profit of associates and joint ventures varied. These differences could be related to, for example, how associates or joint ventures are being managed by the entity or presentation practices in different jurisdictions/industries.

47 In February 2017, some EFRAG User Panel members considered that the share of profit from associates and joint ventures and related dividends should not be reported within EBIT because this would help investors to analyse the EBIT subtotal as a margin earned on revenue and allow investors to model their EBIT margin in a cleaner basis. We are therefore of the view that presenting this line item below EBIT is a practical solution for improving the comparability of financial statements between entities. Nonetheless, this could imply that the term EBIT might need to be revised.

48 However, EFRAG Secretariat notes that presenting share of the profit of associates and joint ventures after the tax line item ignores any additional taxes paid by the entity in relation to that investment (depending on the jurisdiction and its tax requirements). Alternatively, it could be presented after finance results but before tax expense.

**Questions for EFRAG TEG-CFSS**

49 Does EFRAG TEG-CFSS agree with proposal to present the share of the profit or loss of associates and joint ventures outside EBIT and below income tax expense?

# Appendix A: Summary of IASB Staff proposals on additional subtotals in the statement of financial performance and illustrative examples.

1 The IASB Staff recommended the following with regards to EBIT:

(a) requiring and defining EBIT as profit before finance income/expenses (broader than only interest) and tax;

(b) defining finance income/expenses as

  (i) income/expenses related to the entity's capital structure; and

  (ii) interest on assets and liabilities not part of an entity's capital structure;

(c) defining capital structure as equity, assets and liabilities arising from financing activities, and cash and cash equivalents;

(d) clarifying the current description of financing activities;

(e) providing guidance that income/expenses related to capital structure includes:

  (i) all income and expenses on items of capital structure that solely arise from financing activities; and

  (ii) income and expenses related to the funding aspect —for example, including the interest of items of that do not solely arise from financing activities.

(f) requiring the separate presentation below EBIT:

  (i) income related to capital structure;

  (ii) expenses related to capital structure;

  (iii) interest income on assets outside capital structure; and

  (iv) interest expenses on liabilities outside capital structure.

2 The IASB Staff recommended the following with regards to a MOPM:

(a) not requiring an entity to present a Board-defined operating profit subtotal in the statement(s) of financial performance.

(b) prohibiting exclusion of items from the MOPM solely because the items are considered to be outside of management control;

(c) adding management-defined constraints that would require to be applied consistently over time (e.g. management's definition of performance and infrequently occurring items) when an entity presents a MOPM in the statement(s) of financial performance;

(d) requiring an entity to separately present infrequently and frequently occurring items (see the example) between the MOPM and the EBIT subtotal in the statement(s) of financial performance;

(e) requiring an entity to label the MOPM to reflect whether that measure only excludes infrequently occurring items or also excludes frequently occurring items;

(f) requiring an entity to label the MOPM to reflect whether that measure only excludes infrequently occurring items or also excludes frequently occurring items; and

(g) requiring an entity to present the MOPM as a subtotal in the statement(s) of financial performance if the entity uses the measure outside the financial statements but within the annual report, provided that measure does not contradict with the constraints in IFRS Standards.

(h) keeping the existing requirements for and constraints on the presentation of subtotals in paragraphs 85, 85A and 85B of IAS 1.

3 The IASB Staff recommend the following with regards to the presentation of the results from associates and joint ventures:

(a) require a specific location for presenting the share of the profit or loss of associates and joint ventures in the statement(s) of financial performance; and

(b) the share of the profit or loss of associates and joint ventures be presented outside the EBIT subtotal after the entity's income tax expense.

4 The below illustrates all the proposals in one statement of financial performance. In this example, the entity uses the classification by function, elected to present a MOPM and makes the distinction between frequently occurring and infrequently occurring items below the MOPM.

| **Statement of profit or loss** |
|---|
| Revenue |
| Cost of goods sold |
| **Gross profit** |
| Selling expenses |
| Administrative expenses |
| **MOPM** |
| Infrequently occurring income and expenses |
| Frequently occurring income and expenses (for example share-based payments) |
| **EBIT** |
| Income related to capital structure[3] |
| Interest income on assets outside capital structure[4] |
| Expenses related to capital structure [5] |
| Interest expenses on liabilities outside capital structure[6] |
| **Profit before tax and results from associates and joint ventures** |
| Income taxes |
| **Profit after tax before results from associates and joint ventures** |
| Share of profit in investments accounted for under the equity method |
| **Profit for the period** |

[3] Interest income on cash; Foreign exchange gain on borrowings; Gain on hedging instruments related to capital structure

[4] Interest income on trade receivables; Interest income on loans to related parties

[5] Interest expense on bank loans, bonds, trade payables and leases; Fair value loss on borrowings measured at FVTPL

[6] Net interest on net defined benefit liability; Unwinding of the discount on decommissioning and warranty provisions