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Primary Financial Statements
Issues Paper

Objective

1 The objective of this session is :

(a) to provide an update on the recent IASB staff proposals, which include introducing an 'investing' category and two subtotals - 'profit before investing, financing and income tax' and EBIT (or 'profit before financing and income tax') - into the statement(s) of financial performance; and

(b) to ask for EFRAG TEG and EFRAG CFSS members' feedback on the IASB staff proposals.

Agenda papers for this session

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

(a) Agenda Paper 10.02 – ASAF 01 PFS cover note for – for background only

(b) Agenda Paper 10.03 – ASAF 01A PFS investing category – for background only

(c) Agenda Paper 10.04 – ASAF 01B PFS defining financial income expenses - for background only

Background

3 The *Primary Financial Statements* project is currently examining potential targeted improvements to the structure and content of the primary financial statements. For example, the IASB is exploring whether it can develop new presentation requirements for the statement(s) of financial performance[1] and whether it can reduce presentation choices for items in the statement of financial performance and statement of cash flows to make it easier for investors to compare companies' performances and future prospects.

4 The IASB staff papers for the IASB November 2017 meeting are going to be discussed at the ASAF meeting in December 2017. At the time of writing this agenda paper, the IASB November 2017 meeting had not taken place. Therefore, EFRAG Secretariat will provide EFRAG TEG-CFSS an oral update at our meeting.

[1] Statement of profit or loss and other comprehensive income for the period.

Presentation of an investing category in the statement of financial performance (Agenda Paper 10.03)

5 In previous meetings the IASB agreed to explore the introduction of an investing category into the statement(s) of financial performance as it could:

(a) provide additional structure to the statement(s) of financial performance;

(b) provide clear information about investing income and expenses, particularly when considering the introduction of the subtotal EBIT. For example, it would enable users to more easily make adjustments to the EBIT subtotal to exclude investing income/expenses; and

(c) could provide a suitable location for the share of profit or loss of associates and joint ventures.

6 The IASB is now discussing the definition and presentation of this category. At this stage, the IASB is not discussing whether the investing category is relevant for financial institutions and other entities providing financing services. This will be considered in future meetings.

Issue 1 and 4: Definition of investing income/expenses and labelling

7 In Agenda Paper 10.03, the IASB staff recommended the introduction of an additional category into the statement(s) of financial performance called ‘income from investments’. The labelling of the investing category as ‘income from investment’ is meant to avoid confusion with the well-established notion of investing activities in IAS 7 *Statement of Cash Flows*. The definition of ‘income from investments’ in the statement of financial performance would be differ from than the definition of ‘investing activities’ in the statement of cash flows as it would include returns from a variety of short-term and long-term investments.

8 The IASB staff also recommended defining ‘income/expense from investments’ using a principle-based approach as ‘income/expenses from assets that generate a return for the entity individually and largely independently from other resources held by the entity’.

9 It is argued that, for investment activities, little value is created through the combination of different resources and it is each individual investment on its own that generates a return to the entity. In contrast, for operating activities, the return is generated from a combination of different resources and not from each of them individually.

EFRAG Secretariat analysis on definition of investing income/expenses and labelling (issue 1 and 4)

10 EFRAG Secretariat discussed the primary financial statements project with investors and analysts during EFRAG User Panel meetings and outreaches (*Disclosure Initiative - Principles of Disclosure* project*)*. Investors and analysts often considered that there is room to improve the structure and content of the statement of financial performance and called for more disaggregation and presentation of commonly used subtotals such as EBIT or EBITDA. Nonetheless, investors and analysts did not specifically mention or called for an investing category.

11 To understand current practice, EFRAG Secretariat undertook limited research activities. We started by analysing the illustrative examples developed by the main auditing firms and noted that only one of them provided an ‘investment income’ separate line item, which was disaggregated in the notes.

12 We subsequently analysed the financial statements of 34 listed companies included in the S&P Europe 350 Index to understand whether any of these companies presented an ‘income from investments’ category/subtotal in their statement of financial performance. From our analysis, we observed that only one company

presented an 'investment income' line item in their statement of financial performance which was placed below operating income and above finance costs – this line was further disaggregated in the notes. Most of the other companies included a mixture of finance and investment items within a 'finance income/expense' subtotal.

13 Finally, we analysed the presentation of investment income cash flows in the statement of cash flows. We observed that more than 60% of those companies, presented interest received from debt investments, dividends received from equity investments, and dividends received from joint ventures or associates in operating activities, while the others used investing activities.

14 Therefore, EFRAG Secretariat anticipates that the introduction of an 'income from investments' category/subtotal could represent a significant change to current practice. We also note that "income from investments" and "investing activities" are similar terms even though the presentation requirements of investments in statement of financial performance and statement of cash flows are different.

15 However, the introduction of the subtotal 'profit before investments, financing and income tax' together with the subtotal 'profit before financing and income tax' would have the benefit of providing more structured information to users of financial statements. This could be complemented by the introduction of a separate line item labelled as 'income from investments' together with disclosures on its disaggregation and general guidelines on its use).

16 EFRAG Secretariat notes that, according to Appendix A – *Illustrations of the presentation of income from investments* (or Appendix 1 below), the presentation of an 'income from investments' category would not mean an additional subtotal or line item with an amount associated and the introduction of this category would not be followed by the presentation of a 'finance income' category'. Therefore, EFRAG Secretariat questions the need for a separate category labelled 'income from investments'.

17 Although EFRAG Secretariat supports the use of a principle-based approach to define 'income from investments', we note that the definition of 'income/expense from investments', provided in paragraph in paragraph 8 above, seems to be generic and subjective, which may lead to different interpretations. For example, the combination of different types of investments in a portfolio may eliminate unsystematic risks through diversification without reducing the average return. EFRAG Secretariat highlights the importance of defining 'income/expense from investments' to avoid tensions with the definition of 'finance income/expenses'.

Issue 2: List of items that would typically be (or not) treated as investing

18 The IASB staff recommended a principle-based approach for defining 'income/expenses from investments' and a list of the items that would typically be treated as 'investing' and a list of the items that would typically not be treated as 'investing' for non-financial entities.

19 Items that would be typically be treated as investing:

(a) interest income (e.g. interest income on debt investments) and other income on financial assets that is not finance income;

(b) income/expenses from other investments such as:

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

(ii) fair value changes and rental income on investment property for companies that do not treat such investments as a significant part of their operations; and

(iii) dividends and fair value changes on equity investments.

(c) other speculative investments, such as investments in artwork; and

(d) disposal gains and losses associated with the sale of an investment.

20 Items that would typically not be treated as investing:

(a) income/expenses from financial and non-financial assets involved in the production of goods and delivery of services (e.g. income from long-term trade receivables or income/expenses from property, plant and equipment).

(b) income/expenses from 'excess cash'. This would be included as part of finance income/expense.

EFRAG Secretariat analysis on list of items that would typically be (or not) treated as investing (issue 2)

21 If the IASB decides to include an investment income category/subtotal (or even a separate line item), EFRAG Secretariat considers that it could useful to have a list of items that would be typically treated as 'income/expenses from investments'. We note that other IFRS Standards, such as IAS 16 *Property, Plant and Equipment*, already provide examples of specific types of incomes/expenses (e.g. directly attributable costs in IAS 16).

22 When analysing the illustrative example developed by the auditing firm that presented an 'investment income' line item (paragraph 11 above), we observed that its disaggregation in the notes included examples similar to those suggested by the IASB staff. These include rental income, interest income on financial assets, royalties, dividends on equity investments and gains (losses) on financial assets.

23 One of the analysed companies, mentioned in paragraph 12 above, presented a line item that included income items similar to the items proposed by the IASB staff, i.e. interest received from short-term investments/bank deposits/government bonds, fair value changes on these investments, dividends from equity investments and results from foreign exchange contracts which are used to hedge net debt. However, most of the other companies presented the items mentioned above in a 'finance income/expense' subtotal, except for rental income which was presented in operating profit.

24 We note however that in both cases (paragraphs 11-12 above) the income that arises from cash and cash equivalents were included within the 'investment income' category rather than in the 'finance income/expense' subtotal. This is likely to be a tension point between the finance and investment categories. It also raises an issue whether the depreciation on the leased properties should also be included in investing category part of the statement.

25 In addition, we highlight that the classification income/expenses will always depend on the entity's business model, particularly for investment properties.

26 Finally, we note that discussions are focused on consolidated financial statements. However, we point-out that the IASB would have to consider how these requirements would apply to separate financial statements, particularly when considering associates and joint ventures.

Issue 3: Location of the share of profit or loss of associates and joint ventures

27 In the agenda paper 10.03 the IASB staff discussed two approaches:

(a) to require an entity to present the share of the profit or loss of all associates or joint ventures in a single location (i.e. the 'investing category') irrespective of whether those associates or joint ventures are considered integral to the entity's business operations; or

(b) to require an entity to present the share of the profit or loss of integral associates or joint ventures outside the 'investing' category and the share of the profit or loss of non-integral associates within the 'investing' category.

28 On balance, the IASB staff recommended Approach (a) as it would:

(a) be consistent with the way most users treat the results of associates and joint ventures for purposes of their analysis;

(b) make it easier for users to locate and assess investments in associates and joint ventures; and

(c) provide greater consistency in the presentation of the share of profit or loss of associates and joint ventures and would eliminate the existing diversity in practice in the presentation of this item(even thought it might not be the best reflection of how an entity conducts its business activities).

29 The IASB staff also considered that the simplicity of this approach would outweigh the advantages of separating integral associates and joint ventures from non-integral investments.

EFRAG Secretariat analysis on location of the share of profit or loss of associates and joint ventures (issue 3)

30 In the analysis to the financial statements of 34 listed companies included in the S&P Europe 350 Index, EFRAG Secretariat observed diversity in practice on the presentation of share of the profit or loss of associates and joint ventures accounted for using the equity method. 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 and industries.

31 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. 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.

32 EFRAG Secretariat considers that presenting the share of the profit or loss of all associates or joint ventures in a single line item would have the benefit of improving comparability and help users clearly identify the income/expenses related to equity accounted for investments. The IASB staff recommendation to include it together with 'income/expenses from investments' in a separate line item seems to be conceptually correct.

33 Nonetheless, we acknowledge that there are mixed views on this area. For example, 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.

34 By contrast, in June 2017 EFRAG TEG discussed this issue and considered that the IASB should explore further the presentation of investments in associates and joint ventures as its presentation could depend on whether an investee is 'embedded' within the operations of the investor or is similar to an investment.

Issue 5: Labelling the subtotal above the 'income from investments' section as 'operating profit'

35 The IASB staff noted that for many entities, 'profit before investments, financing and income tax' could be viewed as equivalent to their 'operating profit'. Labelling this subtotal as operating profit could be seen as responsive to those who call for a

definition for operating profit. Nonetheless, the IASB staff also highlighted the substantial difficulties of trying to define operating profit (even if considered as a residual category as in IAS 7[2]) due to the different views on what should be included in operating profit.

EFRAG Secretariat analysis on labelling the subtotal above the 'income from investments' section as 'operating profit' (issue 5)

36 We highlight that in February 2017 some EFRAG TEG-CFSS members considered that it would be challenging to define an 'operating profit' subtotal and recalled that past standard-setting activities on the definition of operating profit had been unsuccessful.

37 Considering this, if the IASB decides to introduce an investment category, the use of the subtotal 'profit before investments, financing and income tax' may be less controversial.

Questions for EFRAG TEG and EFRAG CFSS members

38 Does EFRAG TEG-CFSS agree with the IASB staff proposal to introduce an 'investing' category into the statement(s) of financial performance called 'income/expenses from investments'?

39 Does EFRAG TEG-CFSS support the IASB staff proposed approach to defining 'income/expenses from investments?

40 Does EFRAG TEG-CFSS support the IASB staff proposed approach to require the presentation of the share of profit or loss of associates and joint ventures in 'income/expenses from investments'?

41 What does EFRAG TEG-CFSS think the IASB should call the subtotal before 'income/expenses from investments' — i.e. 'profit before investing, financing and income tax'? Would you support this subtotal being described as 'operating profit'?

Definition of finance income/expenses (Agenda Paper 10.04)

42 The IASB is currently discussing the introduction of the subtotal EBIT and its definition. In previous meetings, the IASB supported:

(a) defining EBIT as 'profit before finance income/expenses and income tax';

(b) describing finance income/expenses as including income/expenses related to capital structure and interest on other liabilities;

(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) requiring additional separate line items for finance income/expenses (that use the term 'capital structure').

Issue 1: Composition of finance income/expense

43 Although the IASB staff considered that the approach in paragraph 42 above is conceptually correct, it was concerned about the challenges of defining 'capital structure'. Therefore, the IASB staff presented a number of alternative simplified approaches (paragraphs 17-34 of Agenda Paper 10.03) and asked the IASB

[2] operating activities are the main revenue-producing activities of the entity that are not investing or financing activities

whether the outcome of previous discussions should be revisited (paragraph 42 above) and the alternative simplified approaches considered.

44 On balance, the IASB staff recommended a simplified approach where finance income/expenses consist of the following separate line items:

(a) interest income from cash and cash equivalents calculated using the effective interest method (IFRS 9 requires separate presentation of interest revenue calculated using the effective rate);

(b) other income from cash, cash equivalents and financing activities;

(c) expenses from financing activities;

(d) other finance income; and

(e) other finance expenses.

45 This simplified composition avoids the use of the term ‘capital structure’ however the IASB will have to define the terms ‘excess cash’ and ‘financing activities’.

EFRAG Secretariat analysis on composition of finance income/expense (issue 1)

46 EFRAG Secretariat notes that the subtotal EBIT is currently widely used by investors as it provides comparability of financial performance between entities with different capital structures and that many investors have called for (in different outreaches and meetings) additional guidance on subtotals such as EBIT or EBITDA.

47 As there is no definition of EBIT in IFRS Standards, there is no consistency in practice on the use of ‘finance income/expense’ or ‘interest expense’. EFRAG Secretariat noted, during the research activities, that a variety of items are classified as finance related items. For example, interest income/expense on financial instruments, interest income/expense on leases, unwinding of discounts on provisions, pension interest expense, foreign currency gains/losses, impairment losses on financial assets, gains/losses on financial assets/liabilities, fair value changes of financial instruments recognised in profit and loss, fair value changes on cash flow hedge of borrowings, gain recognised on extinguishment of a liability, share of profit of associates and joint ventures, financial income from derivatives, and interest on tax expense, etc. EFRAG Secretariat observed that the selected entities classified these line items differently within the statement of financial performance.

48 Therefore, we welcome the IASB staff approach to provide guidance on EBIT and ‘finance income/expenses’, which we consider interrelated with the notion of capital structure.

49 The definition of IAS 7 can be 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. For example, the IASB could relate the definition of ‘finance income/expenses’ directly to ‘financing activities’ and improve the definition of ‘financing activities’ in IAS 7 based on IFRS Interpretations Committee (IFRS IC) discussions in the past and on the notion of an entity’s capital structure. However, we note that a prescriptive definition of EBIT and ‘finance income/expenses’ (including the requirement to introduce specific separate line items) could raise industry-specific issues (e.g. financial institutions).

50 EFRAG Secretariat also notes that the classification of some items (e.g. interest on bank loans, borrowings, bonds and debt instruments issued) are fairly straight forward for non-financial entities. However, there are items which classification is less straightforward. For example, when there is an increase of the carrying amount due to passage of time (e.g. decommissioning liabilities and increases of provisions), net defined benefit liabilities and interest income on trade receivables (which for example could be considered as an investment income).

51 In such cases, we agree that the IASB should provide additional guidance on which items should be included below EBIT, nonetheless we consider that such information could be provided in the disclosures to avoid an overload of line times.

Issue 2: Cash and cash equivalents as a proxy for 'excess cash'

52 The way an entity manages 'excess cash' is often considered to be interrelated with its decisions on debt and equity financing. In previous meetings the IASB staff recommended the use of 'cash and cash equivalents' as a proxy for cash and temporary investments of excess cash (collectively 'excess cash') in the definition of finance income/expenses.

53 The IASB expressed concerns that 'cash and cash equivalents' could be too restrictive as a proxy for 'excess cash'. The IASB staff acknowledged that identifying excess cash and temporary investments of excess cash that are held to service debt and equity financing, is likely to be very subjective and involve significant management judgement. The IASB staff is now presenting a number of alternatives that could be considered for a reasonable and comparable proxy of excess cash (paragraph 39 of Agenda Paper 10.03).

54 The IASB staff confirmed their previous recommendation to use of 'cash and cash equivalents' as a proxy for excess cash, because:

(a) it acknowledges that most preparers and users view cash and temporary investments as financing in nature;

(b) using 'cash and cash equivalents' would not involve significant judgement in application for most entities and the term 'cash and cash equivalents' under IAS 7 seems to be relatively consistently applied in practice.

(c) it would help to achieve alignment with IAS 7 guidance, where cash and cash equivalents are required to be presented outside of the investing category.

EFRAG Secretariat analysis on cash and cash equivalents as a proxy for 'excess cash' (issue 2)

55 EFRAG Secretariat highlights that relating 'excess cash and investments to capital structure is likely to be a tension point between the finance income and investment income categories as some may consider the income that arises from all financial assets are investing income.

Issue 3: Clarify the current description of financing activities in IAS 7

56 Many have noted in the past that the definition of financing activities in IAS 7 is broad and is subject to different interpretations by entities, primarily because the term 'borrowings' in the description is not defined. This issue was considered by the 'IFRS IC' in March 2013 and the IASB staff's recommendation at the time was to clarify that the nature of a financing activity involves:

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

(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 finance charge.

57 The IFRS IC decided not to provide guidance on the meaning of 'financing activities' because it considered that such guidance would be too broad for the IFRS IC to address. The IASB staff is now recommending the same clarification to the IASB.

58 The IASB staff noted that according to this definition income/expenses arising from net defined benefit liabilities, decommissioning liabilities, and other long-term provisions such as warranty provisions, would not be considered as financing

activities. However, these could be included in 'other finance expenses' and considered as part of finance income/expense.

EFRAG Secretariat analysis clarify the current description of financing activities in IAS 7 (issue 3).

59 EFRAG Secretariat acknowledges that in 2013 the 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. Such improvements could also consider the notion of capital structure as already discussed by the IASB.

Questions for EFRAG TEG-CFSS members

60 Does EFRAG TEG-CFSS support the IASB staff proposal to clarify 'financing activities'?

61 Does EFRAG TEG-CFSS agree with the IAS Staff proposed approach to present 'interest' on defined benefit and decommissioning liabilities as 'other finance expenses' below EBIT?

62 Does EFRAG TEG-CFSS agree cash and cash equivalents should be used as a proxy for cash and temporary investments of excess cash?

Appendix 1: Summary of the IASB staff recommendations

Agenda Paper 10.03

1 In the Agenda Paper 10.03 the IASB staff recommended:

(a) introducing an additional category into the statement(s) of financial performance called 'income from investments' (previously proposed to be called an 'investing category' at the September 2017 Board meeting).

(b) defining income/expense from investments using a principles-based approach as income/expenses from assets that generate a return for the entity individually and largely independently from other resources held by the entity;

(c) providing a list of some of the items that would typically be treated as 'investing' and a list of some of the items that would typically not be treated as 'investing' for straightforward non-financial entities; and

(d) requiring the inclusion of the share of the profit or loss of all associates and joint ventures accounted for using the equity method within a single category (i.e. 'income from investments') irrespective of whether those associates or joint ventures are considered integral to the entity's business operations.

2 In this agenda paper the IASB staff asks the IASB whether it wants to label the subtotal before the 'income from investments' category as 'operating profit.

Agenda Paper 10.04

3 In the Agenda Paper 21 B the IASB staff recommended:

(a) using 'cash and cash equivalents' as a proxy for cash and temporary investments of excess cash ('excess cash') in the definition of finance income/expenses;

(b) that finance income/expenses consist of the following five line items:

(i) interest income from cash and cash equivalents calculated using the effective interest method;

(ii) other income from cash, cash equivalents and financing activities;

(iii) expenses from financing activities;

(iv) other finance income; and

(v) other finance expenses.

(c) clarifying the current description of 'financing activities' in IAS 7 using the wording recommended to the IFRS IC by the IASB staff in March 2013.

Statement of financial performance

4 Below we illustrate the presentation of the statement of financial performance reflecting the IASB staff recommendations:

Statement of financial performance

Revenue	x
Costs of good sold	x
SG&A Expense	x
Service cost	x
Profit before investments, financing and income tax	**X**
Income from Investments	
Fair value changes in the value of investment property	x
Dividends received on equity investments	x
Interest income on long-term debt investments	x
Gain on the disposal of real estate investment	x
Rental income	x
Share of profit of associates	x
Profit before financing and income tax	**X**
Interest income from cash and cash equivalents calculated using the effective interest method	x
Other income from cash and cash equivalents and financing activities	x
Other finance income	x
Other finance expense	x
Profit before tax	**X**
Income tax expense	x
Profit for the year from continuing operations	**X**
Loss from discontinued operations	x
Profit for the year	**X**