# Primary Financial Statements
# Issues Paper

## Objective

1 The objective of the session is to provide EFRAG TEG-CFSS members with an updated overview of the project *Primary Financial Statements* and seek feedback on the IASB's discussions, particularly on the IASB's latest tentative decisions.

2 With the feedback received from EFRAG TEG-CFSS members, the EFRAG Secretariat intends to complete Appendix 1 – *Effect Analysis Matrix*, which will be shared with the IASB Staff before the ASAF meeting.

## Agenda Papers

3 In addition to this agenda paper, the agenda papers for this session are:

(a) Agenda paper 11-02 – Summary of the IASB and EFRAG TEG-CFSS discussions - for background; and

(b) Agenda paper 11-03 – ASAF Agenda Paper 1 Primary Financial Statements - for background.

## Background

4 The IASB's *Primary Financial Statements* project is examining possible changes to the structure and content of the primary financial statements, particularly the statement of financial performance. This project is part of the IASB's response to investors' demand for the IASB to undertake a project on performance reporting and is a part of the IASB's *Better Communication in Financial Reporting* initiative.

5 The EFRAG Secretariat has provided updates to EFRAG TEG-CFSS members on several occasions. In July 2018, EFRAG TEG-CFSS members received an overview of the IASB's tentative decisions and discussed whether the IASB should move the project from its research agenda to a standard-setting agenda (a summary of the IASB and EFRAG TEG-CFSS discussions can be found in agenda paper 11.02)

6 The main topics for discussion today are:

(a) Presenting subtotals in the statement of profit or loss;

(b) Disclosures of management performance measures; and

(c) Improving disaggregation.

7 The IASB decided to move the project from its research agenda to its standard-setting agenda, however the IASB has not yet decided whether it will publish a Discussion Paper or an Exposure Draft. The IASB will continue its discussions and is expected to publish a consultation document in the first half of 2019.

### Subtotals in the statement of profit or loss

*Labelling of the additional subtotals*

8 For the **statement(s) of financial performance**, the IASB tentatively decided to introduce three additional defined subtotal(s) in the statement(s) of financial performance to increase comparability. These subtotals have already been discussed by EFRAG TEG-CFSS members. More recently, the IASB discussed their scope and labelling and tentatively decided to provide new labels:

| Previous description | New description | Description |
|---|---|---|
| 'Business profit from consolidated entities' | 'Operating profit or loss' | Residual category that excludes share of profit from all joint ventures (JVs) and associates |
| 'Profit before income/expenses from investments, finance income/expenses and income tax' | 'Operating profit or loss and share of profit or loss of integral associates and JVs' | Excludes income and expenses from investing and financing activities, including share of profit from non-integral associates and JVs |
| 'Profit before finance income/expense and income tax' (proxy of EBIT) | 'Profit or loss before financing and income tax' | Excludes income and expenses from financing activities, those related to cash and cash equivalents and unwinding of discount of asset/liabilities |

9 An illustrative example presenting the location of the additional subtotals is provided below

| | |
|---|---|
| Revenue | 10,000 |
| Cost of goods sold | -4,000 |
| Gross profit | 6,000 |
| Selling, general and admin costs | -3,000 |
| **Operating profit** | **3,000** |
| Share of profit of **integral** joint ventures and associates | 500 |
| **Operating profit and share of profit or loss of integral associates and joint ventures** | **3,500** |
| Changes in the fair value of financial assets | 250 |
| Dividend income | 50 |
| Share of profit of **non-integral** joint ventures and associates | 100 |
| **Profit before financing and income tax** | **3,900** |
| Interest income from cash and cash equivalents | 100 |
| Expenses from financing activities | -1000 |
| Unwinding of discount | -100 |
| Profit before tax | 2,900 |

*Scope of the additional subtotals*↑

10 In September 2018, the IASB discussed the scope of the new defined subtotals in the statement of profit or loss and tentatively decided that the sub-totals required of specific sectors should be as follows:

| Industry | Required to present | | |
|---|---|---|---|
| | Operating profit or loss | Operating profit and share of profit from integral A&JV | Profit before financing and income tax |

| **Industry** | **Required to present** | | |
|---|---|---|---|
| | **Operating profit or loss** | **Operating profit and share of profit from integral A&JV** | **Profit before financing and income tax** |
| 1. General corporates | **YES** | **YES** | **YES** |
| 2. Entities whose main business activity is providing financing to customers (e.g. traditional banks) | **YES**, including all income/expenses from financing activities and cash and cash equivalents. | **YES**, unless income/expenses from investments are part of their main business activity | **NO**, if the entity presents 'financing income' separately |
| 3. Entities who invest in the course of their main business activity (eg investment property companies) | **YES**, but 'income/ expenses from investments' that are not part of the main business activity are presented below this subtotal | **NO**, 'income/ expenses from investments' that are part of the main business activity would be presented within 'operating profit' | **YES** |
| 4. Entities whose main business activities are both investing and provision of financing to customers | **YES**, but investment and financing income expenses that are not part of the main business activity are presented below this subtotal. | **NO**, 'income/ expenses from investments' would be presented within 'operating profit' | **NO**, interest income from cash, other income and expenses from financing activities presented within operating profit |
| 5. Entities with more than one main business activity incl. investing and/or provision of financing to customers[1] | **YES** | **YES** | **YES** |

11 Illustrative examples presenting the scope of additional subtotals are available in Agenda Paper 11.03 slides 42 to 52.

12 As already discussed by EFRAG TEG-CFSS members, the IASB tentatively decided to report integral and non-integral investments in associates or JVs in separate sub-totals. More recently the IASB developed a non-exhaustive list of indicators that could be used in making this distinction:

(a) the existence of integrated lines of business across the entity and the associates or JVs that lead to dependency on the associates or JVs;

(b) the associates or JVs' critical supplier or customer status;

[1] IASB Update September 2018: The IASB discussed but did not reach a tentative decision about entities whose main business activities include a non-financial business activity and also include investing or providing financing to customers (or both).

(c) the reporting entity and the associates or JVs' sharing of a name or brand; and

(d) the sharing of capital or borrowing sources, such that the financing for the entity and the associate or JV is interrelated.

13 The classification of an associate or JV as integral or non-integral would only be changed if the relationship between the reporting entity and the associate or JV changes. In addition, the IASB would amend the disclosure requirements of IFRS 12 *Disclosure of Interests in Other Entities* to reflect the introduction of the integral and non-integral categorisation of associates and JV.

*EFRAG Secretariat analysis*

14 The EFRAG Secretariat discussed the primary financial statements project with investors who generally consider that there is room to improve the structure and content of the statement of financial performance. They also call for more disaggregation and presentation of commonly used subtotals such as EBIT and EBITDA.

15 EFRAG TEG-CFSS members have already expressed some support for the presentation of commonly used subtotals. However, there were concerns about how the IASB's approach would apply to non-manufacturing types of entities. There were also concerns on how to provide a reasonable degree of comparability for investors whilst accommodating the range of business models. Finally, EFRAG TEG-CFSS were more supportive of finding a balance between a principle-based definition and one that would lend itself to a reasonable level of comparability. EFRAG Secretariat shares this view and highlights a number of additional comments below.

<u>General corporate</u>

16 In 2017, the EFRAG Secretariat undertook limited research activities focused on **non-financial** European listed companies. We analysed the statements of financial performance of 34 listed companies included in the S&P Europe 350 Index.

17 The EFRAG Secretariat noticed that **'operating profit'** was used by the majority (82%) of the companies. However, their calculation and their definition varied between entities.

18 The IASB's tentative decisions are likely to introduce some discipline into the use of the term 'operating profit', a subtotal that is often used by non-financial entities but typically viewed as a management performance measure. Some EFRAG TEG-CFSS members have already noted that it will be challenging to define an "operating profit" subtotal and recalled that past standard-setting activities on the definition of operating profit had been unsuccessful. The IASB has not at this stage defined operating profit; it would be a residual category (indirectly the IASB has related operating profit to the entity's main business activities).

19 Considering this, EFRAG Secretariat does not expect that the introduction of the subtotal '**operating profit'** would be a significant change in practice or costly. However, we note that its calculation is likely to significantly change and entities would have to find another term to express a management performance measure related to operating profit.

20 From our research, we also noticed that a few non-financial companies make explicit reference to EBIT (i.e. **profit before financing and income tax**). operating profit have subsequent line items limited to profit from equity accounted investments, exceptional items, finance costs and taxes.

21 Finally, we also noticed that most companies did not use subtotals to distinguish between financing and investing activities. That is, entities did not present a subtotal such as **operating profit and share of profit from integral A&JV** to separately present income and expenses from investing activities.

22 Considering this, EFRAG Secretariat expects that the introduction of the subtotals **operating profit and share of profit from integral A&JV** and **profit before financing and income tax** would represent a significant change to current practice and may require one-off costs to change the reporting systems.

23 Nonetheless, EFRAG Secretariat acknowledges that investors frequently ask the IASB to provide guidance on presentation of commonly used subtotals such as EBIT and EBITDA (the IASB has not addressed the latter) and that the subtotal **profit before financing and income tax**[2] would represent a proxy for EBIT.

24 The EFRAG Secretariat also considers that, as for the investing category, the IASB should provide a list of some items that would typically be treated as investing. For example, interest income on trade receivables and foreign exchange gains or losses that arise from financing activities.

<u>Entities that provide financing to customers (traditional bank)</u>

25 Early in 2018, EFRAG Secretariat undertook limited research activities focused on the statements of financial performance of 12 listed banks included in the S&P Europe 350 Index.

26 From our research, we noticed that the subtotal 'operating profit' or equivalent subtotals (e.g. operating income) were used by many banks. However, none of the companies made explicit reference to **Profit before financing and income tax** or 'EBIT'. In addition, none of the companies presented a separate subtotal named '**finance result'** or '**investment result'**.

27 We also observed that operating profit normally included interest income, fee and commission income, trading income, dividend income, gains or losses on financial assets and liabilities, personnel and other administrative or operating expenses. In many cases, this subtotal excluded line items such as impairment charges (e.g. loans), 'share of profit in associates and JVs', 'negative goodwill', 'changes in value of goodwill', 'gains and losses on non-financial assets and investments', 'gains or losses on derecognised of non-financial assets and subsidiaries' and 'profit or loss on non-current assets and disposal of groups classified as held for sale'.

28 Considering this, the EFRAG Secretariat does not expect that the introduction of the subtotal '**operating profit'** would be a significant change in practice or costly for traditional banks. However, we note that its calculation is likely to significantly change and entities would have to find another term to express a management performance measure related to operating profit.

29 In addition, the EFRAG Secretariat expects that the introduction of subtotal **operating profit and share of profit from integral A&JV** would represent a significant change to current practice for a traditional bank. It is noteworthy that, at this stage, we have not heard any request from investors for such a subtotal for traditional banks.

<u>Entities that have 'income/expenses from investments' as part of their main business activity and entities that have investment and financing income and expenses as part of their main business activity</u>

30 The IASB has also discussed how its approach should be applied to entities that have 'income/expenses from investments' as part of their main business activity (e.g. investment property companies) and entities that have investment and

[2] Profit before financing and income tax is not exactly the same as EBIT as, for example, interest related to investments are included above and unwinding of the discount on liabilities that do not arise from financing liabilities are included below that subtotal.

financing income and expenses as part of their main business activity (e.g. conglomerates[3]).

31 At this stage, the EFRAG Secretariat has not yet concluded its research on presentation practices for conglomerates and entities with investing activities (investment property). The EFRAG Secretariat is planning to bring such an analysis in a future meeting.

32 Nonetheless, EFRAG Secretariat notes that the IASB's approach may result in application difficulties on which subtotals to present for entities that have multiple businesses, including which are the main businesses, and where the distinction between financing and investment income may become difficult to draw. These difficulties could lead to inconsistent presentation.

**Questions for EFRAG TEG-CFSS**

33 On the presentation of subtotals in the statement of profit or loss, does EFRAG TEG/CFSS expect that the IASB's tentative decisions:

a) result in better economic decision-making by investors?

b) result in change in current practice?

c) be costly to implement?

34 Please consider the effect analysis matrix in Appendix 1.

**Management performance measures (MPMs)**

35 At its meeting in April 2018, the IASB tentatively decided to require all entities to identify measures of profit or comprehensive income that, in the view of their management, communicates to users the financial performance of the entity. If such a measure is a subtotal or total required by paragraph 81A of IAS 1 *Presentation of Financial Statements*[4] then the entity shall:

(a) identify this measure; and

(b) explain why it best communicates management's view of the entity's financial performance; further disclosure requirements would not apply.

36 Otherwise, if such a measure would complement the subtotals or totals required by paragraph 81A of IAS 1, then such a measure is an MPM and the following additional requirement would apply, including:

(a) disclosing in the notes a reconciliation between that measure and the most directly comparable subtotal or total required by paragraph 81A of IAS 1; and

(b) providing an explanation of how the measure provides relevant information about an entity's financial performance.

37 The IASB asked staff to come back with a proposed description or definition of EBITDA with a view to adding EBITDA to the list of measures that are not considered to be management performance measures.

*EFRAG Secretariat analysis*

38 The EFRAG Secretariat notes that general principles and guidance on the use of MPMs could bring more transparency and consistency on their use. For example, EFRAG Secretariat considers that it is important to clearly identify an MPM (including the basis on which it is developed) and to reconcile it with the subtotals or totals required in IFRS Standards.

[3] Number of different and distinct business activities grouped together in a single reporting entity.

[4] Profit or loss, total other comprehensive income, and comprehensive income for the period.

39 However, we are concerned with the interaction of the proposed requirements with the requirements of paragraph 85 of IAS 1 as requiring a reconciliation in the disclosures of such subtotals presented already presented in the face (where there would be a reconciliation with other IFRS subtotals) would add unnecessary burden to the preparation of statements of profit and comprehensive income,

**Questions for EFRAG TEG-CFSS**

40 On disclosures of management performance measures, does EFRAG TEG/CFSS expect that the IASB's tentative decisions:

a) result in better economic decision-making by investors?

b) result in change in current practice?

c) be costly to implement?

41 Please consider the effect analysis matrix in Appendix 1.

## Disaggregation and infrequent items

*Disaggregation of expenses in operating profit by function or by nature*

42 For disaggregation of expenses in the operating profit by function and by nature, the IASB tentatively decided to add to the requirements in IAS 1 a list of factors for entities to consider when deciding whether a by-nature or by-function methodology provides more useful information about financial performance. The list was discussed at the June EFRAG TEG meeting and includes the following factors:

(a) which method provides the best information about the key components or drivers of profitability;

(b) which method most closely matches how management report internally to the board or key decision makers and the way the business is run;

(c) peer industry practice; and

(d) when the allocation of expenses to functions would be arbitrary, then a 'by nature' method should be favoured.

43 Additionally, the IASB tentatively decided that when an entity uses the nature of expense methodology to present an analysis of expenses recognised in profit or loss, the entity is not required to provide additional information using the function of expense method. Conversely, when an entity provides a primary analysis of expenses using a by-function methodology, the entity should be required to disclose in a single note additional information on the nature of expenses. This information, however, should be provided at an entity level and not as a breakdown of each functional line presented.

*Disaggregation principles and factors to consider*

44 To improve the level of disaggregation of line items in the primary financial statements and in the notes, the IASB tentatively decided to explore how different characteristics could be used to aggregate or disaggregate financial information. However, the IASB decided not to consolidate the characteristics mentioned in IAS 1 and other IFRS Standards into a single list and that any further guidance developed in this respect would not override specific aggregation and disaggregation requirements in individual IFRS Standards.

45 The IASB rejected the IASB Staff's proposal to introduce thresholds or rebuttable presumptions for aggregating or disaggregating financial information and asked the IASB staff to explore whether principle-based guidance could be developed to encourage further disaggregation of large residual balances and 'other' balances.

46 Additionally, the IASB tentatively decided to include a principle for determining the location of financial information in the primary financial statements or the notes that is based on the role of the primary financial statements and the role of the notes suggested in Discussion Paper *Disclosure Initiative - Principles of Disclosure*. That principle would not override the specific requirements of IAS 1 for the presentation of minimum line items and subtotals in the primary financial statements. An entity should also apply that principle when a Standard allows entities to determine whether to provide financial information in the primary financial statements or in the notes.

*Disclosure of unusual or infrequent items*

47 Users of financial statements consider that information on non-recurring, unusual, or infrequent transactions allows them to assess the impact of such events and transactions on future performance. Many entities provide measures that exclude unusual or infrequent items, however, practice varies significantly and the reasons and methods for identifying such transactions is often not clear.

48 In September 2018, the IASB decided to address the concerns and tentatively decided to:

(a) require separate disclosure of information about unusual or infrequent items in the notes to the financial statements and to require attributing those items to line items in the statement(s) of financial performance;

(b) develop principle-based guidance to help entities identify unusual or infrequent items.

49 When developing the guidance, the IASB will base on the proposals for the definitions of *unusual* and *infrequently occurring* from the Discussion Paper *Disclosure Initiative – Principles of Disclosure*, i.e.:

(a) *Unusual*: Highly abnormal and only incidentally related to the ordinary and typical activities of an entity, given the environment in which the entity operates;

(b) *Infrequently occurring*: Not reasonably expected to recur in the foreseeable future given the environment in which an entity operates.

*EFRAG Secretariat analysis*

50 EFRAG Secretariat observes that the current practice for a lot of entities is to use a mixed approach (by nature and by function) to report their operating expenses which might be particularly useful for some industries.

51 EFRAG Secretariat supports the IASB efforts to improve the level of disaggregation of line items in the primary financial statements and in the notes as a way to stimulate further disaggregation of large residual balances.

52 The EFRAG Secretariat supports the IASB's decision to address users' requests for information about unusual and infrequent items. We note that practice varies, and that entities label such items in various ways, e.g. 'non–recurring', 'exceptional', 'special', or 'one-time'. There is no clear demarcation between items excluded for other reasons and unusual/infrequent items and some entities even combine such items into a single line item or group of 'other' items without describing the nature of the items included.

53 However, in our opinion, providing guidance on how to identify unusual or infrequent items on a consistent and comparable basis may prove to be challenging.

# Appendix 1 – Effects analysis matrix

| Key proposals | economic decision-making by investors | change in practice | costs of implementation |
|---|---|---|---|
| Subtotals | Better/No impact/Worse/Don't know | Change/no change/not applicable | Costly/not costly/Not applicable |
| Operating profit | | | |
| Operating profit and share of integral JVs and associates | | | |
| Profit before financing and income tax | | | |
| Management performance measures | | | |
| Inclusion of management performance measures in the financial statements | | | |
| Reconciliation to closest IFRS-defined subtotal | | | |
| Tax and NCI for each adjustment | | | |
| Explanation of why measure is useful and how it has been calculated | | | |
| Disaggregation | | | |
| Disaggregation of expenses in business profit by function or by nature | | | |
| Disclosure of unusual or infrequent items | | | |
| Disaggregation principles and factors to consider | | | |

IFRS