European Financial Reporting Advisory Group

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Primary Financial Statements Update

Objective

1 The objective of this session is to discuss with the EFRAG TEG the recent developments undertaken by the IASB on its research project *Primary Financial Statements*, including:

(a) presentation of share of profit or loss of integral associates and joint ventures ('JV');

(b) target improvements to the statement of cash flows; and

(c) presentation of management performance measures (MPMs).

Introduction

2 The IASB's *Primary Financial Statements* project is currently examining potential targeted improvements to the structure and content of the primary financial statements. The IASB is exploring whether it can develop new presentation requirements for the statement(s) of financial performance 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' performance and future prospects.

3 The IASB's discussion on the research project started in June 2015. EFRAG Secretariat has been providing updates to EFRAG TEG. The last update was provided by EFRAG Secretariat at the joint EFRAG CFSS-TEG meeting in November 2017. This update covers the IASB's meetings held in December 2017, January 2018, and February 2018.

4 It is worth noting that the IASB has been focusing its discussions on non-financial entities. The IASB will consider at a future meeting how its conclusions can be applied or adapted to more complex scenarios, including the financial statement of financial institutions such as banks

5 In Appendix 1, EFRAG Secretariat included a summary of the IASB tentative decisions since December 2017 and illustrative examples reflecting EFRAG Secretariat understanding of those decisions.

Presentation of the share of profit or loss of integral associates and JVs in the Statement of financial performance

6 In November 2017 the IASB discussed the presentation of the share of profit or loss of associates and JVs however it did not to reach a consensus.

7 In January 2018 the IASB continued its discussions, which focused on whether an entity should distinguish between 'integral' and 'non-integral' associates and JVs for presentation purposes and where these should be presented within the statement of financial performance.

Distinguishing between integral and non-integral associates and JVs

8 In the IASB agenda papers, the IASB staff noted that many users separate the results of investments in associates and JVs from the results of an entity's-controlled business activities when valuing an entity. These users considered that the activities of associates or JVs are always peripheral, and their results are of a different 'quality' (i.e. are a blend of different amounts and do not directly contribute to revenue).

9 Nonetheless, the IASB staff also noted that some users incorporate the results of at least some associates or JVs into their valuations. Whether the results of an associate or JV are included in the valuation depend on how closely aligned or integral the associate or JV business is to the reporting entity's business activities.

10 The IASB staff considered that separately presenting the results of integral associates and JVs could bring benefits for users as this would allow them to analyse these results separately from other non-integral equity-accounted investments. The IASB staff also argued that introducing a requirement in accounting standards to separate integral and non-integral associates and JVs would bring some order and consistency to how preparers provide this information.

11 In terms of definition of 'integral', the IASB staff suggested 3 approaches:

(a) *Approach 1*: treat all JVs as 'integral' and all associates as 'non-integral';

(b) *Approach 2*: use the IASB proposed definition of 'income/expenses from investments' (i.e. income/expenses from assets that generate a return individually and largely independently of other resources held by the entity') to make the split between 'integral' and 'non-integral' associates and JVs;

(c) *Approach 3*: develop a definition of 'integral' associate or JV (e.g. those whose activities are integrated into an entity's business activities and are thereby essential and fundamental in carrying out these activities).

Location for share of profit or loss of non-integral associates and JVs

12 The IASB staff suggested that the results from non-integral equity-accounted investments should be presented in the 'income/expenses from investments' category that they are proposing to introduce.

Location for share of profit or loss of integral associates and JVs

13 As to the location for presenting the results from integral associates and JVs, the IASB discussed three alternatives:

(a) above the 'income/expenses from investments' category, as part of an entity's business activities;

(b) above the 'income/expenses from investments' category, but placed immediately after the entity's business activities by creating an additional subtotal; or

(c) separately presenting the results from 'integral' and 'non-integral' associates and JVs within the 'income/expenses from investments' category.

14 The IASB staff recommended that all three approaches should be included in a due process document, in order to understand constituents' views of the respective merits of each.

IASB discussions and tentative decisions

15 In January 2018, the IASB tentatively decided:

(a) that entities should be required to present the results of 'integral' associates and JVs separately from those 'non-integral';

(b) to use the IASB proposed definition of ‘income/expenses from investments’ (November 2017 IASB meeting) as the basis for the split between integral and non-integral investments in associates or JVs (i.e. the results of associates and JVs that do not generate a return for the entity individually and largely independently from other resources held by the entity would be considered integral and excluded from the investing category);

(c) to include a non-exhaustive list of indicators that could be used in making this distinction;

(d) that the presentation in the statement(s) of financial performance of the share of profit or loss of ‘integral’ associates or JVs should be in a line item above the ‘income/expenses from investments’ category and require a new subtotal above that line item; and

(e) to discuss the alternative approaches considered by the IASB for presenting the share of the profit or loss of integral associates and JVs, both within and outside the ‘income/expenses from investments’ category, and the IASB’s reasons for rejecting those approaches.

EFRAG Secretariat analysis

16 EFRAG Secretariat notices that in June 2017 EFRAG CFSS and EFRAG TEG discussed the presentation of investments in associates and JVs and considered that the IASB should explore further the presentation of investments in associates and JVs as its presentation could depend on whether an investee is ‘embedded’ within the operations of the investor or is similar to an investment.

17 Therefore, the IASB’s discussions are aligned with the feedback received from EFRAG CFSS and EFRAG TEG. Nonetheless, EFRAG secretariat recalls that some EFRAG User Panel members have expressed preference for the share of profit of associates and JVs to be presented after the EBIT subtotal so that they could obtain a clean margin from an entities’ core operations.

18 EFRAG Secretariat acknowledges that associates and JVs can have a significant impact on the business of an entity and that users want information about dependency of a group on the associates and JVs. However, EFRAG Secretariat is concerned about the level of judgement that management will need to apply when making such a distinction and the potential impact on the accounting for associates and JVs under IAS 28 Investments in Associates and IFRS 11 *Joint Arrangements*.

19 For example, changes in the presentation requirements may generate measurement questions around the different types of associates and JVs. For example, questions on whether integral associates and JVs should be proportionally consolidated while non-integral should be measured under IFRS 9 *Financial Instruments*. It may also generate debate around the interaction between the notion of ‘integral’ and notions of ‘significant influence’ and ‘joint control’.

20 Finally, we note that the IASB’s discussions have been 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.

Questions for EFRAG TEG

21 Does EFRAG TEG agree with presenting the results of ‘integral’ associates and JVs separately from those ‘non-integral’?

22 Does EFRAG TEG agree with proposed definition for ‘integral’ associates and JVs?

23 Does EFRAG TEG agree that the presentation in the statement(s) of financial performance of the share of profit or loss of ‘integral’ associates or JVs should be

in a line item above the 'income/expenses from investments' category and require a new subtotal above that line item?

Presentation of cash flows associated with investments in associates and JVs in the statement of cash flows

24 According to paragraphs 37–38 of IAS 7, an investor should restrict its reporting in the statement of cash flows to the cash flows between itself and the investee (e.g. to dividends and advances).

25 In its February 2018 meeting, the IASB focused its discussion on investing types of cash flows between an entity and its associates or JV ('JVs') such as dividends received from, cash paid on acquisitions of, and loans made to associates and JVs.

26 In its discussion the IASB considered the proposed revised definition of 'investing activities' stipulating that: 'Investing activities are the acquisition and the disposal of long-term assets and other investments not included in cash equivalents, and the receipt of interest and dividends.'

27 Subsequently, the IASB considered whether it should present separately the cash flows that arise with 'integral' associates and JVs from those that arise with 'non-integral' associates and JVs and whether the split between 'integral' and 'non-integral' associates and JVs should be the same as for the statement(s) of financial performance.

28 Finally, it discussed different alternatives for the presentation of the cash flows that arise with 'integral' associates and JVs. In particular, whether they should be presented

(a) in the operating activities section: the cash flows from 'integral' associates and joint ventures would be presented as part of an entity's operating activities;

(b) in the investing activities section separately from the cash flows from 'non-integral' associates and JVs; or

(c) in a separate section, above the entity's 'investing activities' but placed immediately after the entity's operating activities.

IASB tentative decisions

29 The IASB tentatively decided to propose:

(a) separate presentation of the cash flows that arise between an entity and its 'integral' associates and JVs and the cash flows that arise between an entity and its 'non-integral' associates and JVs. The split between 'integral' and 'non-integral' associates and JVs would be the same for the statement of cash flows as for the statement(s) of financial performance.

(b) the separate presentation of the investing cash flows of 'integral' and 'non-integral' associates and JVs should be within the 'investing activities' section of the statement of cash flows.

EFRAG Secretariat analysis

30 EFRAG Secretariat acknowledges that the separation of cash flows between 'integral' and 'non-integral' associates and JVs could be beneficial for users as it would align the separate presentation of the share of profit or loss of those investees in the statement of financial performance, providing a link between income and expenses and their related cash flows.

31 Nonetheless, EFRAG Secretariat is concerned about the level of judgement that management will have to make when making the distinction.

Questions for EFRAG TEG

32 Does EFRAG TEG agree with the separate presentation of the cash flows arising between an entity and its 'integral' associates and JVs from the cash flows arising between an entity and its 'non-integral' associates and JVs?

Elimination of options for the classification of interest and dividends in the statement of cash flows

33 At its meeting in December 2016, the IASB tentatively decided to focus on targeted improvements to the statement of cash flows and explore the following:

(a) elimination of options for the classification of the cash flows from interest and dividends in the statement of cash flows;

(b) alignment of the operating section across the statement of cash flows and the statement(s) of financial performance; and

(c) requiring a consistent starting point for the indirect reconciliation of cash flows.

34 In November 2017, the IASB discussed and tentatively decided to clarify the current description of 'financing activities' in IAS 7 *Statement of Cash Flows* by indicating that 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 the payment of a finance charge.

Elimination of options for the classification of interest and dividends in the statement of cash flows

35 At its December 2017 meeting, the IASB discussed the elimination of options for the classification of interest and dividends (paid and received) for non-financial entities by prescribing a single classification for each of these items.

36 Currently, paragraph 31 of IAS 7 requires an entity to disclose separately cash flows from interest and dividends (paid and received) and classify them as operating, investing or financing activities in a consistent manner from period to period.

37 IAS 7 notes that there is no consensus on the classification of cash flows for non-financial entities and allows cash flows from interest and dividends received and paid to be classified in a consistent manner from period to period as either operating, investing or financing activities. Typically, for non-financial institutions:

(a) interest paid may be classified as either operating or financing cash flows;

(b) interest received may be classified as either operating or investing cash flows;

(c) dividends paid may be classified as either operating or financing cash flows; and

(d) dividends received may be classified as either operating or a investing cash flows;

38 The IASB staff performed a limited review of 25 financial statements which showed the existence of diversity in practice in the classification of interest and dividends in the statement of cash flows. In some industries, the choice in classification appeared consistent among some entities, however, in many cases, entities in the same industry made different choices.

39 Furthermore, the IASB staff consulted with users and members of the Accounting Standards Advisory Forum (ASAF) and the feedback received showed that variation among entities is often not meaningful (i.e. does not reflect differences in business model) and only makes comparative analysis difficult. The consulted bodies expressed a desire for consistency in the presentation and in particular for interest paid, however, no consensus was reached as to whether interest paid should be presented as an operating or financing cash flow with majority leaning towards the financing cash flow option.

40 Additionally, the feedback statement on the UK Financial Reporting Council's Discussion Paper: *Improving the Statement of Cash Flows* reported that majority of respondents consider that all cash flows relating to financing liabilities (i.e. including interest payments) should be reported in the financing category of the statement of cash flows.

41 To address the concerns expressed by users, the IASB staff proposed prescribing a single classification of cash flows arising from interest and dividends for non-financial entities which will reduce diversity in practice and improve comparability for presentation of cash flows that do not appear to differ across entities.

42 The main drawback of this proposal is removing flexibility that may allow preparers to better reflect the way they manage the cash flows relating to their business activities which, however, was ranked less important by users with priority being given to reducing diversity in practice.

43 In addition, the IASB staff suggested that the IASB should:

(a) focus on the nature of interest paid and of interest and dividends received to determine whether these cash flows are operating in nature.

(b) clarify that:

(i) cash flows arising from interest incurred on financing activities should be classified as financing cash flows;

(ii) cash flows arising from interest paid that is capitalised as part of the cost of an asset should be classified as financing cash flows; and

(iii) dividends paid should be classified as financing cash flows.

(c) amend the definition of 'investing activities' in IAS 7 to clarify that interest/dividends received should be classified as investing cash flows.

IASB tentative decisions

44 At its meeting in December 2017, the IASB tentatively decided, for non-financial entities, to:

(a) remove from IAS 7 options for the classification of interest and dividends paid and of interest and dividends received and prescribe a single classification for each of these items;

(b) clarify that cash flows arising from:

(i) interest incurred (paid) on financing activities should be classified as financing cash flows;

(ii) interest paid that is capitalised as part of the cost of an asset should be classified as financing cash flows;

(iii) dividends paid should be classified as financing cash flows; and

(c) amend the definition of 'investing activities' in IAS 7 to clarify that interest and dividends received should be classified as investing cash flows.

EFRAG Secretariat analysis

45 EFRAG Secretariat supports the removal of options in IAS 7 for the classification of interest and dividends and the introduction of additional guidance for the definition of financing activities and classification of interest and dividends. In our view, this will bring consistency in presentation of similar line items and will better reflect the true nature of the respective cash flows.

46 We recall that EFRAG User Panel also highlighted the importance of removing presentation options whenever possible, including removing presentation options for dividends and interest in the statement of cash flows.

47 Nonetheless, EFRAG Secretariat considers that the IASB should test these principles against more complex situations (e.g. , such as the classification of interest that arises from trade payables, lease payable, factoring and reverse factoring).

Questions for EFRAG TEG

48 Does EFRAG TEG agree with the removal of IAS 7 options for the classification of interest and dividends paid and of interest and dividends received and prescribe a single classification for each of these items?

49 Does EFRAG TEG agree with the amendment of the definition of 'investing activities' in IAS 7 to clarify that the receipt of interest and dividends are investing cash flows?

Starting point for the statement of cash flows presented under the indirect method

50 Under the current IFRS requirements, the starting point to prepare the statement of cash flows under the indirect method is 'profit or loss'. At the same time, however, the illustrative examples accompanying IAS 7 use 'profit before tax' as the starting point for determining net cash flows from operating activities.

51 Research and outreach activities conducted by the IASB staff showed that there is diversity in practice on the starting point of the statement of cash flows when companies use the indirect method. Some common starting points are 'profit or loss'; 'profit attributable to shareholders', 'profit from continuing operations', 'profit before tax' or 'operating profit'.

52 The IASB staff proposed to have a consistent starting point for the indirect reconciliation of cash flows by either:

(a) amending IAS 7 to make it clearer that the starting point is the profit or loss subtotal and that no other subtotal can be used as a starting point; or

(b) requiring as a starting point a subtotal other than profit or loss.

53 With respect to the latter, the subtotals other than profit or loss could be:

(a) the 'profit before financing and income tax' subtotal (EBIT); or

(b) the 'profit before investing, financing and income tax' subtotal (similar to operating profit).

54 The expected benefits of using any of these two subtotals would enable users to better understand the link between cash flows from operating activities and the new subtotals introduced for the statement(s) of financial performance and could also potentially simplify the indirect reconciliation of cash flows by removing some reconciling items.

IASB tentative decisions

55 In December 2017, the IASB tentatively decided to require a consistent subtotal as the starting point for the indirect reconciliation of cash flows from operating activities. This subtotal should be ‘profit before investing, financing and income tax’.

EFRAG Secretariat analysis

56 EFRAG Secretariat supports the IASB tentative decision to require a consistent starting point for the indirect reconciliation of cash flows from operating activities.

57 Using the subtotal ‘profit before investing, financing and income tax’ as a starting point is likely to eliminate any inconsistencies in the current reporting practise as well as reduce the adjustments to be made for some items of investing or financing nature. It is also in line with EFRAG User Panel members comments that if the IASB changed the content and structure of the statement of financial performance to include, for example EBIT, then the IASB would have to consider the potential impact of those changes on the statement of cash flows, particularly when using the indirect method of presentation

58 However, EFRAG Secretariat considers that it would be simpler to clarify that the reconciliation should start with ‘profit or loss’. This is because management will have to apply considerable judgement when calculating ‘profit before investing, financing and income tax’, a new measure that heavily depends on the new and untested definitions of investing and financing income and expenses.

Questions for EFRAG TEG

59 Does EFRAG TEG consider useful to have ‘profit before investing, financing and income tax’ as the starting point for the indirect reconciliation of cash flows?

Aligning the operating section across the statement of cash flows and the statement(s) of financial performance

60 At its meeting in December 2017, the IASB discussed whether it should align the operating section across the statement of cash flows and the statement(s) of financial performance.

61 EFRAG Secretariat noted that users have called for consistency between an entity’s operating profit and cash flows from operating activities as this helps them understand the entity’s cash conversion cycle.

62 The IASB staff expressed the view that the IASB should not seek to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance for the following reasons:

(a) the IASB has had difficulties in the past in trying to define operating profit as stakeholders have different views about what income/expenses should be included in operating profit. As a result, no consensus has been reached so far.

(b) at its November 2017 meeting, the IASB decided to introduce a new subtotal (ie ‘profit before investing, financing and income tax’ subtotal), however, labelling the subtotal ‘operating’ was not agreed upon.

(c) the statement of cash flows and statement(s) of financial performance have different purposes and alignment would never be entirely possible and will not necessarily aid understanding of either statement.

63 In addition, the IASB discussed whether it should make some additional targeted improvements to IAS 7 which would require a broader project with respect to:

(a) reporting cash flows to acquire property, plant and equipment within operating activities (or as a separate standalone category) if this provides clearer information to investors about the split between an entity's operating activities versus non-operating activities, rather than between operating and investing activities; or

(b) requiring a separate section for the reporting of income tax.

IASB tentative decisions

64 At its December 2017 meeting the IASB tentatively decided to not to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance.

65 The IASB also tentatively decided not to make any other further improvements to the statement of cash flows, besides the improvements mentioned in paragraphs 44, 55 and 64 above.

EFRAG Secretariat analysis

66 EFRAG Secretariat acknowledges that aligning the operating section across the statement of cash flows and the statement(s) of financial performance will not necessarily improve users' understanding about an entity's cash conversion cycle. Those two primary financial statements have different purposes and reflect an entity's operations on different basis which makes their alignment not entirely possible.

67 Nonetheless, EFRAG Secretariat recalls that the majority of the respondents to the FRC Discussion Paper *Improving the Statement of Cash Flows* considered that a reconciliation of operating activities should be presented in all cases. That is, entities should be required to present a reconciliation between operating income and cash flows from operating activities event when a direct method of cash flow statement is presented. Similarly, EFRAG User panel considered that a reconciliation of operating activities is fundamental as it links the statement of cash flows to other primary financial statements.

68 Finally, if a user wants to reconcile 'operating income' or 'profit before investing, financing and income tax' with 'operating cash flows', it would be useful to have an illustrative examples showing the typical reconciling items likely to be created by the IASB's decision not to align the two statements.

Questions for EFRAG TEG

69 Does EFRAG TEG agree that the IASB should not align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance?

Presentation of management performance measures ('MPM')

Description of the issue

70 In December 2016, the IASB decided to explore providing guidance on the use of performance measures, including separate presentation of non-recurring, unusual or infrequently occurring items.

71 This is because many of the performance measures are not specified in IFRS Standards even if commonly presented by entities as subtotals in the statements of financial performance. Such measures are sometimes referred to as non-IFRS or alternative performance measures and include gross profit, operating profit, earnings before interest and taxation ('EBIT'), and the modified forms of commonly used measures e.g. adjusted operating profit or adjusted profit.

72 In addition, some entities only provide their key performance measures outside the financial statements. This means that these performance measures are not audited and, in many cases, difficult to reconcile to the financial statements.

73 Finally, in accordance to the feedback received by the IASB staff, most users of financial statements support giving entities some flexibility in presenting performance measures, provided that those measures are not misleading. Such performance measures can provide additional information about, and a better understanding of the financial performance and the management's view of what is important to the entity, as well as insight into how the business is managed.

Previous discussions on MPM

74 In March 2017 and June 2017**,** the IASB discussed whether it should require an entity to present an MPM in the financial statements if that MPM is presented in the annual report and meets the requirements in paragraphs 85-85B of IAS 1.

75 The IASB also discussed whether it should add presentation and disclosure requirements to increase MPM's transparency, including:

(a) information on management-defined constraints that would be required to be applied consistently over time;

(b) separately presenting infrequently occurring items from frequently occurring items for the items excluded from the MPM subtotal and disclosing a historical summary of items excluded from the MPM subtotal;

(c) clear description of why the MPM subtotal provides management's view of performance, including an explanation of why items have been excluded from the MPM subtotal.

76 Finally, the IASB discussed whether it should impose constraints on the use of MPM subtotal, in addition to those in paragraphs 85-85B of IAS 1, including:

(a) prohibiting exclusion of items solely on the basis they are considered outside of management control;

(b) introducing management-defined constraints;

(c) prohibiting exclusion of infrequently occurring items;

(d) prohibiting exclusion of items when it contradicts the Board's view of operating performance, e.g. items necessary to generate revenue such as share-based payment expenses;

77 The IASB members had concerns that 'elevating' the MPM to an IFRS measure by requiring it in the statement of financial performance, would result in this measure may no longer be subject to requirements for non-GAAP measures imposed by the regulators.

78 The IASB was generally supportive of the proposals to introduce management-defined measure providing management's view of performance in the statement of financial performance, however, did not take any decision.

Objective of and suitable locations for MPMs

79 In December 2017, the IASB discussed the objective of introducing an MPM into the financial statements and possible locations for the presentation and disclosure of that measure. For the further discussion, the IASB assumed that:

(a) an IFRS-defined measure is as a measure 'defined or specified in IFRS Standards';

(b) an MPM is a sum of financial measures of an entity's financial performance. Therefore, an MPM would not be based on:

(i) a non-financial measure e.g. market share, staff turnover, number of units sold per employee; or

(ii) forward-looking information e.g. management's expectations about future sales.

80 In the agenda papers, the IASB staff proposed:

(a) that the objective should be to encourage management to present its key performance measures inside the financial statements where they would be subject to greater transparency and audit;

(b) to require presenting an MPM as a subtotal in the statements of financial performance unless it does not fit in the structure for the statements; or otherwise

(c) to require providing an MPM in a separate reconciliation directly following the statements of financial performance i.e. directly after the other comprehensive income section.

81 The discussion also concerned whether to require entities to provide information about infrequently occurring items, useful to assess the persistence or sustainability of an entity's financial performance. At the meeting, the IASB considered the feedback received on the IASB Discussion Paper *Principles of Disclosures* which indicated that respondents were generally supportive of having principle-based guidance for the presentation of infrequent/unusual items.

82 Finally, the IASB discussed the location of the MPM. More specifically, the IASB discussed its presentation as a subtotal in the statements of financial performance and, in addition, considered the following alternatives:

(a) using a columnar approach in the statements of financial performance (i.e. separate column) which would give more prominence to the presented information and address the users' needs;

(b) in a separate reconciliation accompanying the statements of financial performance, which would be less restrictive compared to the columnar approach but still be presented prominently in the statement of financial performance; and

(c) in the notes – which would be least restrictive, however, the MPM would be less prominently presented and could be more difficult to find.

<u>IASB tentative decisions on the objective of and suitable locations for MPM</u>

83 The IASB tentatively decided that entities should be required to identify an MPM and present that measure as a subtotal in the statement of financial performance, if both the following conditions are met:

(a) it satisfies the requirements in IAS 1 for subtotals, as follows:

(i) it comprises line items made up of amounts recognised and measured in accordance with IFRS Standards;

(ii) it is presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

(iii) it is consistent from period to period;

(b) it fits in the IASB's proposed structure for the statement(s) of financial performance:

(i) presentation of expenses by function or by nature;

(ii) profit before financing, investing and tax subtotal;

(iii) income/expenses from investments category;

(iv) profit before financing and tax subtotal; and

(v) finance income/expenses category.

84 Such an MPM should not be, however, displayed with more prominence than the subtotals and totals required in IFRS Standards.

85 Otherwise, entities should provide the MPM in a separate reconciliation of that measure with a measure that is defined in IFRS Standards.

Requirements for MPM

86 In January 2018, the IASB continued its discussion on the requirement to introduce of MPMs into the financial statements and reconcile those MPMs with measures 'defined or specified in IFRS Standards'. More specifically, the IASB discussed which MPM should be introduced into the financial statements. For example, the IASB discussed whether all MPMs used by management outside the financial statements should be presented in the financial statements or whether the IASB should focus only on those within the entity's annual report.

87 The IASB also discussed:

(a) location of the reconciliation between the MPM and an IFRS-defined measure, including whether it should be part of the primary financial statements or in the notes;

(b) constraints on the MPM in a separate reconciliation;

(c) interactions with the proposed amendments with IFRS 8 *Operating Segments* requirements, including whether a reconciliation should be combined into the operating segments information;

(d) additional disclosure requirements on MPM, including their description, calculation, historical data and changes to the measure; and

(e) interaction with existing regulatory requirements for non-IFRS measures.

<u>IASB tentative decisions on requirements for MPM</u>

88 In January 2018, the IASB tentatively decided that:

(a) all entities should specify their key performance measure(s) in the financial statements;

(b) if any of these measures are not specified or defined in IFRS Standards, an entity should identify such measures as MPMs;

(c) the key performance measures identified in the financial statements should include, as a minimum, the key performance measures communicated in the annual report

These decisions were subject to the staff further clarifying when a measure is 'specified or defined in IFRS Standards' and which types of measures would be considered 'key performance measures'

(d) if an MPM does not fit in the statement of financial performance, a separate reconciliation between the MPM and the most appropriate measure specified or defined in IFRS Standards should be disclosed in the notes;

(e) there should be no specific constraints on MPMs provided in a separate reconciliation;

(f) the following disclosures should be required for each MPM (including an MPM presented as a subtotal in the statement(s) of financial performance):

(i) a description of why the MPM provides management's view of performance, including an explanation of how the MPM has been calculated and why.

(ii) sufficient explanation, if there is a change in how the MPM is calculated during the year, to help users understand the reasons for and effect of the change. The IASB decided not to require a five-year historical summary showing, for each year, the calculation of the MPM.

(g) the reconciliation between the MPM and the most appropriate measure specified or defined in IFRS Standards should be provided separately from the operating segment information disclosed in accordance with IFRS 8 *Operating Segments*. However, entities would not be prohibited from also including MPM within the operating segment information. Furthermore, the following disclosures would be required in such cases:

(i) an explanation of how the MPM differs from the total of the measures of profit or loss for the reportable segments; and

(ii) if none of the MPM fits into the operating segment information, an explanation of why this is the case.

(h) not to specify in IFRS Standards that the MPM are not measures specified or defined in IFRS Standards.

89 The IASB asked the IASB staff to further clarify when a measure is 'specified or defined in IFRS Standards' and which types of measures would be considered 'key performance measures'.

Clarifying the meaning of a 'key performance measure' and measures 'specified or defined in IFRS Standards'

90 In February 2018 the IASB continued its discussion on when a measure is 'specified or defined in IFRS Standards' and which types of measures would be considered 'key performance measures' that are captured by the MPM requirements (i.e. the scope of MPMs that would be captured).

91 Entities may report key non-financial measures or key financial measures of an entity's financial position or cash flows. Other measures calculated using, as inputs, amounts from the statements of financial performance, such as ratios, growth rates and measures of single items of income and expense, such as adjusted revenue, might also be identified as key performance measures by some entities. Moreover, basic, diluted and adjusted EPS measures might be seen as key performance measures of an entity. However, the IASB Staff considered that it be important to limit the MPM requirements to management's key financial measures of profit or comprehensive income to avoid introducing excessive disclosure, and to focus on the most common performance measures reported by management.

92 Therefore, the IASB staff proposed to limit the MPM requirements to management's 'key financial measures' of profit or comprehensive income communicated in the entity's annual report.

93 At the preceding meetings, for identifying MPSs and for the separate reconciliation, the IASB staff proposed to introduce the term "defined or specified by IFRS Standards". To narrow and clarify the scope, in February 2018 the IASB staff proposed to replace that term with "subtotal or total that is required in IFRS Standards for the statement(s) of financial performance".

<u>IASB tentative decisions</u>

94 At the meeting the IASB asked the staff to develop a simplified approach to MPM for a future meeting. No decisions were made.

EFRAG Secretariat analysis

95 In previous meeting, EFRAG CFSS and TEG discussed the possibility of having guidance for a 'management operating performance measure' ('MOPM') as alternative of having 'operating profit' defined by the IASB. Subsequently, the IASB widened its approach to focus on 'Management Performance Measures' more in general (e.g. core operating profit, EBITDA).

96 EFRAG CFSS and TEG members acknowledged that MPM are often used in practice and that additional guidance could bring more transparency and consistency on their use. However, members expressed concerns about requiring the use of MPM and elevating them into IFRS-defined terms.

97 EFRAG Secretariat notes that currently, according to its research on a sample of European listed companies, the most common management performance measures are 'gross profit', 'operating profit' and 'EBIT'. If the IASB improves its structure and includes the new subtotals under discussion, entities will be required to present:

(a) profit before investing, financing and taxes (proxy of 'operating profit');

(b) profit before financing and taxes ('EBIT');

(c) profit before tax subtotal; and

(d) profit or loss.

98 Consequently, this structure will reduce the pressure of having additional MPMs as the most common performance measures would already be addressed.

99 EFRAG Secretariat considers that general principles on the use of MPM could be useful, particularly when these measures are included in the primary financial statements and notes. For example, EFRAG Secretariat considers that it is important to clearly identify an MPM and reconciled it with the subtotals or totals required in IFRS Standards.

100 However, EFRAG is concerned about requiring the presentation of an MPM in the financial statements if that MPM is used in the annual report, particularly when the MPM is not aligned, or even against, the accounting policies of an entity (e.g. an entity applies IFRS 17 *Insurance Contract* but identifies key performance measures in accordance with IFRS 4 *Insurance Contracts)*. Furthermore, EFRAG Secretariat is concerned about identifying such MPM as 'key performance measures' as users might focus on these performance measures which may be not in compliance with IFRS Standards.

101 EFRAG Secretariat also notes that performance measures used by management within the management commentary may change from one year to another, according to their needs. For example, in one year a company may be affected significantly by foreign currency exposure

102 and decide to focus on measures that remove the effects of foreign currency (e.g. organic growth). The following year, the same company may acquire a number of businesses and decide to focus on measures that remove the effects of business combinations. Therefore, EFRAG Secretariat considers that it will be difficult to require presenting of such measures in the financial statements. In addition, setting the scope of MPM may be extremely difficult due to the variety of performance measures used by companies.

103 EFRAG Secretariat is concerned about the overly prescriptive approach of the IASB discussions and the use of different but similar terms that may confuse users (e.g. alternative performance measures, MPM, key performance measures, key financial measures, measures that are specified or defined in IFRS Standards, subtotals or totals that are required in IFRS Standards), particularly when considering The

European Securities and Markets Authority (ESMA) guidelines *Alternative Performance measures* that already uses terms such as 'measures defined or specified by the applicable financial reporting framework' and defines APMs.

104 Moreover, EFRAG Secretariat notes that an MPM can encompass a line item. For example, an entity may use in its management report 'group revenue' that reflects proportionate consolidation of associates and JV. If the IASB continues its discussions on MPM, it will also have to take into account such items.

105 EFRAG Secretariat also considers that one of the most challenging area will be related to non-recurring or infrequent items. This is because entities may want to present a MPM named 'recurring operating profit' before the new subtotal 'profit before investing, financing and taxes'. Such an MPM could exclude items such as costs with restructurings and impairments of property, plant and equipment (when entity presents its expenses by nature). EFRAG Secretariat is concerned that this may lead to mislabelled items (as management tends to remove negative aspects only) and questions how such guidance would interact with paragraph 87 of IAS 1 on extraordinary items.

106 Finally, EFRAG Secretariat considered that increasing complexity in presentation and assessment of financial performance, resulting from the proposed IASB's approach, may affect the use of automation of the analysis of financial statements and robotics in preparation of financial statements.

107 Particularly, in accordance with current IASB's approach, MPMs may be presented in different parts of the financial statement i.e. on the face of the statement of financial performance or in the reconciliation statement. Consequently, the cost for users to assess the financial performance and to find the particular MPM, or its reconciliation and explanation, may by unduly increased. The same applies to automated preparation of financial statements and the obligatory filing of electronic financial statements, expected to be introduced in Europe.

108 As noted in paragraph 98 above, we think that if an MPM would actually not be required by the modified statement's structure, then a good place to present it would rather be the reconciliation statement.

Questions for EFRAG TEG

109 Do TEG members have comments on the IASB's approach to MPM?

Appendix 1: Summary of the IASB tentative decisions and illustrative examples

Introduction

1 In this appendix we provide a summary of the IASB tentative decisions on Primary Financial Statements for the period December 2017 to February 2018 and some illustrative examples developed by EFRAG Secretariat

Summary of the IASB tentative decisions

Summary of the IASB tentative decisions: December 2017 to February 2018	
Statement(s) of financial performance - Management performance measure	**December 2017** The IASB tentatively decided that entities should be required to identify an MPM and: (a) present that measure as a subtotal in the statement(s) of financial performance, if it fits in the IASB proposed structure for the statement(s) and satisfies the requirements in IAS 1 for subtotals; (b) otherwise provide the MPM in a separate reconciliation of that measure with a measure that is defined in IFRS Standards.
	January 2018 The IASB tentatively decided that: (a) all entities should specify their ‘key performance measures’ in the financial statements; (b) if any of these measures are not specified or defined in IFRS Standards, an entity should identify such measures as MPMs; (c) the ‘key performance measures’ identified in the financial statements should include, as a minimum, the ‘key performance measures’ communicated in the annual report; This decision subject to the staff further clarifying when a measure is ‘specified or defined in IFRS Standards’ and which types of measures would be considered ‘key performance measures’ (d) if an MPM does not fit in the statement of financial performance, a separate reconciliation between the MPM and the most appropriate measure specified or defined in IFRS Standards should be disclosed in the notes; (e) there should be no specific constraints on MPMs provided in a separate reconciliation; (f) the following disclosures should be required for each MPM (including an MPM presented as a subtotal in the statement of financial performance): i. a description of why the MPM provides management’s view of performance, including an explanation of how the MPM has been calculated and why. ii. sufficient explanation, if there is a change in how the MPM is calculated during the year, to help users understand the reasons for and effect of the change.

Summary of the IASB tentative decisions: December 2017 to February 2018	
	iii. the IASB decided not to require a five-year historical summary showing, for each year, the calculation of the MPM. (g) the reconciliation between the MPM and the most appropriate measure specified or defined in IFRS Standards should be provided separately from the operating segment information disclosed in accordance with IFRS 8. However, entities would not be prohibited from also including MPM within the operating segment information. Furthermore, the following disclosures would be required in such cases: iv. an explanation of how the MPM differs from the total of the measures of profit or loss for the reportable segments; and v. if none of the MPM fits into the operating segment information, an explanation of why this is the case. (h) not to specify in IFRS Standards that the MPM are not measures specified or defined in IFRS Standards. The IASB tentatively decided to further clarify when a measure is 'specified or defined in IFRS Standards' and which types of measures would be considered 'key performance measures'.
	February 2018 At the meeting the Board asked the staff to develop a simplified approach to management performance measures for a future meeting. No decisions were made.
Presentation of the share of the profit or loss of 'integral' associates and JVs	**December 2017** The IASB tentatively decided that: (a) entities should be required to present the results of 'integral' associates and JVs separately from those of 'non-integral' associates and JVs. (b) the project's first due-process document should: i. use the Board's proposed definition of 'income/expenses from investments' (from the November 2017 Board meeting) as the basis for the split between integral and non-integral investments in associates or JVs, and include a non-exhaustive list of indicators that could be used in making this distinction. ii. propose the presentation in the statement(s) of financial performance of the share of profit or loss of integral associates or JVs as a line item above the 'income/expenses from investments' category and require a new subtotal above that line item. iii. discuss the alternative approaches considered by the Board for presenting the share of the profit or loss of integral associates and JVs, both within and outside the 'income/expenses from investments' category, and the Board's reasons for rejecting those approaches.
Statement of cash flows	**December 2017** At its meeting in December 2017, the Board tentatively decided, for non-financial entities, to:

Summary of the IASB tentative decisions: December 2017 to February 2018	
	(a) remove from IAS 7 options for the classification of interest and dividends paid and of interest and dividends received and prescribe a single classification for each of these items. (b) clarify that cash flows arising from: iv. interest incurred on financing activities should be classified as financing cash flows; v. interest paid that is capitalised as part of the cost of an asset should be classified as financing cash flows; vi. dividends paid should be classified as financing cash flows; (c) amend the definition of 'investing activities' in IAS 7 to clarify that interest and dividends received should be classified as investing cash flows. (d) the IASB tentatively decided to require a consistent subtotal as the starting point for the indirect reconciliation of cash flows from operating activities. This subtotal should be 'profit before investing, financing and income tax' (e) the IASB tentatively agreed to not to align the operating section of the statement of cash flows with a corresponding section in the statement(s) of financial performance. (f) he IASB also tentatively decided not to make any other further improvements to the statement of cash flows.
	February 2018 The IASB tentatively decided to propose: (a) separate presentation of (i) the cash flows that arise between an entity and its 'integral' associates and JVs and (ii) the cash flows that arise between an entity and its 'non-integral' associates and JVs. The split between 'integral' and 'non-integral' associates and JVs would be the same for the statement of cash flows as for the statement(s) of financial performance. (b) the separate presentation of the investing cash flows of 'integral' and 'non-integral' associates and JVs should be within the 'investing activities' section of the statement of cash flows.

Illustrative example on the statement(s) of financial performance

3 EFRAG Secretariat developed one simplified illustrative example on the presentation of the statement of financial performance reflecting its understanding of the IASB's tentative decisions.

IE 1 - Statement of financial performance

Revenue	x
Costs of sales	x
Depreciation	x
Administrative and selling expenses	x
Management performance measure (e.g. 'core operating profit')	**X**
Restructuring expenses	x
Share of profit of integral associates and JVs	x
Profit before investments, financing and income tax	**X**
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 non-integral associates and JVs	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**

Illustrative example on the statement of cash flows

4 EFRAG Secretariat one illustrative example of the presentation of the statement of financial performance reflecting its understanding of the IASB tentative decisions.

Statement of cash flows

Cash flows from operating activities	
Profit before investing, financing and income tax	x
Income/expense adjustments for:	
Share of profit from integral joint venture	x
Depreciation	x
Movements in working capital	
Increase in trade and other receivables	x
Decrease in inventories	x
Decrease in trade payables	x
Cash generated from operations	x
Income taxes paid	x
Net cash flows from operating activities	
Cash flows from investing activities	
Acquisition of integral associate	x
Acquisition on non-integral associate	x
Purchase of property, plant and equipment	x
Proceeds from sale of equipment	x
Interest received	x
Dividends received from integral joint venture	x
Dividends received from non-integral joint venture	x
Net cash flows from investing activities	
Cash flows from financing activities	
Proceeds from issue of share capital	x
Proceeds from long-term borrowings	x
Payment of lease liabilities	x
Dividends pais	x
Interest paid	x
Net cash from financing activities	x
Next increase cash and cash equivalents	x
Opening balance	x
Closing Balance	x