Primary Financial Statements
Key messages for EFRAG DCL

Objective

1 The objective of this agenda paper is the discuss direction and key messages for EFRAG Draft Comment Letter on the IASB’s project *Primary Financial Statements* (the DCL).

Introduction

2 To facilitate the discussion, the EFRAG Secretariat proposes a number of key messages to be included in the DCL. These key messages have been based on the feedback received from EFRAG TEG and EFRAG TEG Working Groups (for details, see Agenda Paper 06-03).

3 The EFRAG Secretariat is planning to present to EFRAG TEG a Draft Comment Letter (DCL) in January 2020 for a recommendation to the EFRAG Board. The timing of EFRAG DCL is crucial so that the EFRAG Secretariat can have a basis for t the outreach activities to be started as soon as possible.

4 For time allocation purposes, in this agenda paper we have clearly identified the issues that we do and do not expect significant debate. It is our intention to focus the discussion in this session on the topics where we do expect debate.

General comments

5 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcomes the IASB’s Exposure Draft on Primary Financial Statements**. This project responds to a strong demand from users of financial statements to undertake a project on primary financial statements and there is a need to address the users' requests in a timely manner; and

(b) **EFRAG agrees with the IASB's proposal to update current requirements through the issuance of a new IFRS Standard**. EFRAG acknowledges that the IASB project on primary financial statements focused on a number of improvements to IAS 1. Nonetheless, such an approach will have the benefit of highlighting that the proposed changes are significant and will have a significant impact on the presentation of financial statements across different industries.

6 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat does not expect significant debate on the key messages highlighted above.

Questions for EFRAG TEG

7 Does EFRAG TEG agree with key messages suggested above?

Subtotals and categories in the statement of financial performance

8 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **In general, EFRAG supports the IASB's efforts to improve the structure and content of Primary Financial Statements.** EFRAG notes that there is currently diversity in practice in the type of subtotals used and their labels.

(b) **EFRAG supports the IASB's proposal to require and define 'operating profit or loss' and 'operating category'.** EFRAG highlights that 'operating profit or loss' is one of the most used subtotals and currently there is lack of consistency on its definition. In addition, EFRAG considers that the IASB's proposals are fairly flexible to accommodate the needs of different business models, including financial institutions and allow the use of additional subtotals within operating profit when deemed necessary. However, EFRAG considers that it would be useful to have:

(i) additional guidance on the notion of the "entity's main business activity" or "in the course of the entity's main business activity" as the allocation of income and expenses to the operating category significantly relies on these notions (e.g. related to the principal revenue-producing activities of the entity); and

(ii) flowcharts to clarify the classification of items between the categories.

(c) Even though an investing category is currently not used in practice, EFRAG assesses that having a separate investing category can provide useful information to users of financial statements. Thus, **EFRAG supports the requirement to present an investing category and related subtotal.** EFRAG highlights that when an entity invests in the course of its main activities, the income and expenses related to investments are presented within the operating profit. Thus, EFRAG is not expecting significantly material items to be included in the investing category. However, EFRAG:

(i) is concerned about presenting gains and losses on derivatives in the investing category under certain conditions (i.e. exceptions related to grossing up of gains and losses or the undue cost or effort), particularly when referring to financial institutions. This is because financial institutions might end up with an investing category just because of their hedging activities and it will be difficult to explain users why they have been presented as investments as typically risk management is related to operating and financing activities rather than investing. Finally, the IASB should make it clear whether such items would end up being presented in operating section because of the IASB proposal to require entities to present in operating profit income and expenses from investments if they are made in course of its main business activities;

(ii) considers that it would be useful to clarify whether paragraph 8 of IAS 1, which allows the use of different labelling, would apply to the new subtotals, in particular to operating profit or loss and share of profit of integral associates and joint ventures; and

(iii) considers that it would be useful to have guidance on whether entities can continue to apply current practice on aggregating income and expenses from risk management together with hedged line items, how to deal with discontinuation of hedging positions and whether results of risk mitigation will be categorised in the same way as hedge accounting.

(d) **EFRAG supports the IASB's proposal to require and define "Profit or loss before financing and income tax" and the "financing category".** EFRAG highlights that the outcome of IASB's proposals is, to some extent, similar to the concept of Earnings Before Interest and Tax ('EBIT') and that there was a strong demand from users of financial statements to define and require the presentation of a subtotal equal or similar to EBIT. However, EFRAG considers that:

(i) it would be useful to clarify how interest revenue or interest expense from trade receivables with extend period payment should be presented if providing financing customers is not a main business activity of the company;

(ii) the presentation of a financing category provides limited added value when it only includes income and expenses on liabilities that do not arise from financing activities and such items are not significantly material (e.g. net interest expense /income on a net defined benefit liability/asset or unwinding of the discount on a decommissioning, restoration or similar liability);

(iii) the IASB should consider a link between the definition of financing category in the statement of financial performance to IAS 7, which is related to an entity's capital structure. This is because many users of financial statements seek to analyse the financial performance of an entity independently of how that entity is financed;

(iv) requiring entities to present the line item 'income and expenses from financing activities' as a minimum line item, may restrain current practice of providing such information under two different line items: 'income from financing activities' and 'expenses from financing activities'. EFRAG suggests that entities should have the option to present them separately when relevant;

(v) Entities have to present incremental expenses in the investing category while the IASB is silent on incremental expenses related to the financing category. EFRAG considers that it would be useful to have guidance on whether incremental expenses related to financing activities should also be in the financing activities;

(e) **Finally, EFRAG considers that the IASB should further consider the following**:

(i) in many jurisdictions, regulators have specific presentation requirements in addition to those required by the IFRS Standards (e.g. templates from regulators). EFRAG suggests the IASB to closely communicate with regulators on this topic (e.g. use of additional subtotals) to avoid the situation of entities having to prepare different financial statements to comply with IFRS and regulators' requirements;

(ii) whether in general, the presentation of the new subtotals would be subject to materiality considerations or whether entities would always be required to present them;

(iii) under the IASB proposals, cash and cash equivalents is used as a proxy for "excess cash" and related income and expenses should be classified as financing. However, in many specific cases the IASB requires the income and expenses from cash and cash equivalents (or part of it) to be allocated to operating profit, which makes the assessment complex and difficult. EFRAG suggests that the allocation of income and expenses from cash and cash equivalents could be done based on the definitions for each category (on the same basis as other line items), and consequently, be recognised as operating, investing or financing; and

(iv) both the statement of financial performance and the statement of cash flows will have three different categories with similar names (operating, investing and financing) even if they are not aligned. As a result, the presentation of share of profit of associates and joint ventures in the statement of financial performance and statement of cash flows is different. Therefore, EFRAG considers that it is important to have a clear conceptual basis for the new structure of the financial statements and clarity of the interaction between the statement of financial performance and interaction the statement of cash Flows, including some reasoning when there is no alignment.

9 In summary, EFRAG would welcome the IASB's efforts to improve the structure and content of primary financial statements but request further clarify in some areas.

10 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat does not expect significant debate on the key messages highlighted above.

Questions for EFRAG TEG

11 Does EFRAG TEG agree with key messages suggested above?

Management performance measures

12 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcomes the IASB efforts to provide guidance on Management Performance Measures, particularly when they are presented within the financial statements.** EFRAG recalls that many users consider Alternative Performance Measures (APMs) useful for assessing a company's business and performance and that users have called for more transparency and consistency on their use (e.g. APMs clearly identified, how they are calculated, comparatives to previous years and reconciliations with IFRS defined subtotals).

(b) **However, EFRAG is concerned with the IASB proposal to require entities to disclose information about management performance measures that are presented outside the financial statements, even when entities are not currently presenting them within the financial statements**. EFRAG considers that such an approach would raise a number of significant challenges. More specifically it would:

(i) raise questions on the IASB's mandate to require the disclosure of subtotals which are presented outside of the financial statements;

(ii) require the IASB to clearly define "public communications" and its scope (e.g. whether it would refer to entity's public communications over the year and which public communications would be in the scope);

(iii) require entities to present subtotals in the financial statements that are not aligned with the entity's accounting policies. Such a requirement would raise issues for auditors, give more prominence to non-IFRS defined subtotals or even elevate such subtotals to IFRS-defined terms;

(iv) raise questions on whether metrics required by regulators would be considered as MPMs and, therefore, required to be reconciled to the most comparable subtotal indicated by IFRS Standards;

(v) raise questions on whether changes in the use of MPMs or their calculation would constitute a change in an accounting policy and, consequently, whether entities may only change when it results in the financial statements providing reliable and more relevant information (management performance measures often change over time);

(vi) raise practical challenges related to the disclosures on the effect of tax and non-controlling of each line item included in reconciliation, particularly when considering that the IASB will require the presentation of adjusted earnings per share;

(c) **In addition, EFRAG considers that the IASB's proposals on MPMs would raise other wider issues**:

(i) would be in conflict with the IASB's proposals on role of primary financial statements and the notes (i.e. notes should provide additional information on the items presented in primary financial statements) as an entity would be required to provide disclosures on MPMs even if they are not presented on the face of the primary financial statements;

(ii) the guidance exempting some of performance measures from the requirement to provide reconciliation in the notes (e.g. gross profit), seems to be made on rules-based rather than on a principle-based approach; and

(iii) raise questions why there are no requirements for entities that use APMs within the financial statements but not in public communication (outside the financial statements).

(d) **EFRAG suggests the IASB to review the scope of its proposals on MPMs to limit its requirements to MPMs that are presented, at the entity's option, within the financial statements.**

(e) EFRAG highlights that applying retrospective application requirements to management performance measures, leads to the risk of the use of hindsight. This may diminish the relevance and reliability of financial statements

13 Considering the mixed feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat expects significant debate on the key messages highlighted above.

Questions for EFRAG TEG

14 Does EFRAG TEG agree with key messages suggested above?

Integral and non-integral associates and joint ventures

15 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcomes the IASB's proposal to make a distinction between integral and non-integral associates and joint ventures**. EFRAG considers that providing such distinction will help users of financial statements identifying associates and joint ventures that are closely related to the entity's main business activities.

(b) **Nonetheless, EFRAG acknowledges that there are mixed views in this area and that the IASB's proposal to change the presentation requirements may rise other wider issues** as it may:

(i) 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*';

(ii) involve significant judgement (which in turn may lead to structuring opportunities) in the identification of integral and non-integral associates and joint ventures; Therefore, the definition of integral and non-integral will be crucial and

(iii) raise questions on the need for a different treatment of associates and joint ventures in the statement of financial performance and statement of cash flows*.*

16 Considering the mixed feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat expects significant debate on the key messages highlighted above.

Questions for EFRAG TEG

17 Does EFRAG TEG agree with key messages suggested above?

Disaggregation principles and general requirements

18 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcomes the IASB's efforts to improve disaggregation as a complement to the additional subtotals**, particularly when dealing with group of line items that have dissimilar characteristics and if the further disaggregation leads to the disclosure of material information.

(b) EFRAG considers that having the principles and general requirements on aggregation and disaggregation of information in the financial statements in a single place within the new standard will bring clarity and improve consistent application, especially when dealing with large residual balances and 'other' balances;

(c) EFRAG supports the IASB decision to not introduce quantitative threshold for disaggregation of group of items. EFRAG is of the view that a principle-based rather than a rule-based guidance should be developed to address the over-aggregation of line items.

19 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat does not expect significant debate on the key messages highlighted above.

Questions for EFRAG TEG

20 Does EFRAG TEG agree with key messages suggested above?

Analysis of expenses

21 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcomes the IASB proposal to continue to require entities to present an analysis of expenses using either by-function or by-nature method, based on whichever provides the most useful information to users of financial statements**;

(b) **EFRAG considers that the list of factors proposed by the IASB could be helpful to entities to determine whether a by-function or by-nature methodology provides the most useful information to users**;

(c) **However, EFRAG expresses concerns on the IASB's proposal to not allow analysis of expenses using a mixture of the nature of expense method and the function of expense method**. EFRAG highlights that:

(i) currently it is quite common that entities use a mixed (by-function and by-nature) presentation as an appropriate way to show performance. In addition, under the IASB proposals, entities would still be required to present line items by nature even if they present their analysis of expenses by function;

(ii) a strict by-function presentation will prevent entities from presenting unusual items (e.g. impairments) on the face of the financial statements as such presentation is on a by-nature basis;

(d) **EFRAG welcomes the IASB proposal to require entities that present an analysis of expenses using the function of expense method on the face of the financial statements to also provide in the notes an analysis of its total operating expenses using the nature of expense method**.

22 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat does not expect significant debate on the key messages highlighted above.

Questions for EFRAG TEG

23 Does EFRAG TEG agree with key messages suggested above?

Unusual items

24 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG welcome the IASB's proposal to require entities to disclose unusual income and expenses in a single place**. EFRAG acknowledges that information about unusual items is relevant for users of financial statements and that currently there is diversity in practice on how entities provide such information.

(b) **EFRAG also welcomes the IASB's proposed guidance to help entities identifying unusual income and expenses.**

(c) However, EFRAG is concerned that:

(i) an expense may be classified as unusual even if it occurred many times in the past, thus occurred frequently (i.e. not infrequently). This may confuse users when analysing historical trends (i.e. restructuring expenses could be considered as an unusual item even if it had occurred in the last 5 years);

(ii) the IASB has not considered the possibility of providing follow up information about items classified as unusual. Such information is relevant for users of financial statements for stewardship reasons;

(iii) there may be a tendency for preparers to continue to focus on unusual expenses and not on unusual income; Thus, the IASB would have to ensure that presenting only unusual expenses and not unusual gains or losses of the same nature and occurring during the same period may violate the principles related to unusual items;

(iv) as mentioned above, an entity that presents an analysis of its presentation by function presentation, may not be able to present unusual items on the face of the statement of financial performance as they are typically described by its nature;

(v) from the IASB's proposals, it is not clear whether the presentation of items of income and expense as 'extraordinary items' in the income statement and the notes will continue to be forbidden

(d) EFRAG highlights that applying retrospective application requirements to unusual items there is the risk of the use of hindsight as entities on the effective date will be in a better position to assess whether an item is unusual than it would have been assessed at the time that the event occurred. This may diminish the relevance and reliability of financial statements.

25 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat does not expect significant debate on the key messages highlighted above.

Questions for EFRAG TEG

26 Does EFRAG TEG agree with key messages suggested above?

Statement of cash flows

27 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat suggests the following key messages:

(a) **EFRAG supports the IASB proposal to require entities to use the same starting point for the reconciliation of operating cash flows in the statement of cash flows using the indirect method** as currently there is diversity in practice.

(b) **EFRAG also supports the IASB proposal to use the operating profit or loss subtotal as the starting point for reconciliation.** EFRAG considers that there are pros and cons for using either *profit after tax* or *operating profit or loss*. However, considering that the definition of the operating category in the statement of financial performance is not aligned with the definition of operating activities in the statement of cash flows, such reconciliation becomes even more relevant as it will provide a link between the two statements. In addition, EFRAG assesses that it will reduce the number of necessary adjustments to the line items that have an investing or financing nature.

(c) **EFRAG supports the removal of options in IAS 7 Statement of cash flows for the classification of interest and dividends and the introduction of additional guidance for the definition of financing activities.** EFRAG expects that this will bring more consistency in presentation of similar line items and will better reflect the true nature of the respective cash flows.

(d) Nonetheless, EFRAG suggests the IASB to have a separate project on IAS 7 with the objective of having a comprehensive review of the existing challenges, particularly in regard to some financial institutions (e.g. banks and life insurers) where the statement of cash flows is considered not useful. Therefore, EFRAG suggests the IASB to:

(i) make further research work on having a statement of cash flows that is structured differently for financial institutions to ensure that it provides relevant information to users and mentioned EFRAG's Discussion Paper issued in 2015 *The Statement of Cash Flows: issues for Financial Institutions* (here)

(ii) consider the issues raised in the FRC discussion paper *Improving the Statement of Cash Flows* (here)

28 Considering the mixed feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat expects some debate on the key messages highlighted above.

Questions for EFRAG TEG

29 Does EFRAG TEG agree with key messages suggested above?

Other comments

30 EFRAG observes that there is still room to improve primary financial statements. In particular, EFRAG considers that the IASB should consider in the future potential improvements to the statement of changes in equity, statement of cash flows and statement of financial position.

IASB proposals on the presentation of other comprehensive income

31 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG suggests the following key messages:

(a) **EFRAG does not consider the IASB's proposal a significant improvement as it simply modifies the labelling of OCI line items.** EFRAG considers that it will be difficult to significantly improve the understandability of OCI without addressing the distinction between profit or loss and OCI and the role of recycling;

(b) **EFRAG highlights that relevant information about OCI is also provided in the statement of financial position (e.g. separate components of equity), thus any future discussions on OCI should also consider the statement of financial position and its interaction with the statement of financial performance**;

(c) EFRAG highlights that the IASB is silent in regard to the use of new categories within the other comprehensive income even though there are transactions and events where the income and expenses have to be allocated to both the statement of profit or loss and other comprehensive income (e.g. hedging activities). For presentation purposes, an entity is required to allocate the income and expenses to the different categories in the statement of profit or loss, however it is silent on the statement of other comprehensive income, particularly in regard to items that may be recycled in the future (to which section of the statement of profit or loss it should be recycled).

Reverse factoring

32 Currently there is no specific reference in IFRS to reverse factoring, however there are accounting standards requirements that are relevant in determining the appropriate accounting policies (IFRS 9, IAS 1, IAS 7). Applying these standards requires significant judgement, particularly, as reverse factoring arrangements can differ significantly.

33 Therefore, EFRAG would welcome specific reference whether this type of liability should be presented as a trade payable or as a financial debt/borrowing (from bank) in the statement of financial position. Similarly, EFRAG would welcome guidance on whether payments related to reverse factoring is best presented as an operational cash flow or a financing cash flow in the cash flow statement.

Statement of financial position

34 EFRAG assesses that the IASB should consider requiring, through minimum line items or subtotals, disaggregation of equity on the face of the statement of financial position to clearly identify and differentiate different subclasses of equity (e.g. ordinary shares and financial instruments that could be settled by issuing ordinary shares – implementation guidance). In addition, EFRAG considers that it would also be useful to have a definition of debt and related disclosures.

The statement of changes in equity

35 EFRAG considers there is a need to improve the statement of changes in equity to increase comparability and understandability for users of the financial statements, particularly on information related to separate components of equity related to other comprehensive income. EFRAG considers that the IASB should look for improvements to the statement of changes in equity, particularly when considering that the IASB is not likely to address this issue within the FICE project.

Income tax

36 The IASB discussions have not focused on the income tax element of the financial statements when currently there are jurisdictions that use different compulsory contributions to state revenues, such as levies or extraordinary contributions.

37 Considering the feedback received from EFRAG TEG and EFRAG TEG Working groups, the EFRAG Secretariat expects some debate on the key messages highlighted above.

EBITDA

38 EFRAG highlights that there is a strong demand from users of financial statements for the IASB to define EBITDA (earnings before interest, tax, depreciation and amortisation), one of the most common performance measures used by users of financial statements. In addition, EFRAG highlights that users of financial statements challenged the IASB proposal to exempt from the MPM's disclosure requirements the subtotal 'operating profit or loss before depreciation and amortisation' as EBITDA typically excludes impairments from assets that are amortised or depreciated.

Proposed amendments to other standards (IAS 33 Earnings per Share; IAS 34 Interim Financial Reporting; IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and IFRS 7 Financial Instruments: Disclosures)

39 In regard to the proposed amendments to IAS 34, EFRAG has some concerns about requiring a reconciliation of the MPM to the most directly comparable subtotal or total specified in IFRS Standards, including the effect of tax and non-controlling interests (NCI) separately for each of the differences between the MPM and the IFRS measure at interim financial statements. This is because, MPM reconciliations, including tax effect and NCI effect can be costly, particularly when preparing interim financial statements at consolidated level (e.g. tax includes income tax of different subsidiaries and not transactions)[1].

Questions for EFRAG TEG

40 Does EFRAG TEG agree with key messages suggested above?

Early Stage Analysis

41 EFRAG Secretariat plans to publish, together with the DCL, an early stage analysis (the ESA) of the expected impact of the IASB's proposals. We propose to align ESA with the structure of the DCL and provide the references to the particular parts of ESA in the notes to constituents of each section of the DCL. The analysis itself will form an additional appendix to the DCL.

42 In November 2019, the EFRAG Secretariat presented an overview of its research that covered the financial statements of 40 European listed entities included in the S&P Europe 350 Index and STOXX 600. The research was intended to explain current practices regarding primary financial statements and the possible impact of

[1] The EFRAG Secretariat has not identified concerns on other amendments.

the IASB's tentative decisions on presentation and disclosure of financial information (for details, see November EFRAG TEG Agenda Paper 11-03).

43 In the near future, in order to enhance that analysis and provide additional input to the DCL, the EFRAG Secretariat plans to extend the scope of the research and additionally cover the existing practices related to two area affected by the IASB proposals: (a) MPM disclosures and (b) presenting and disclosing information about unusual items.

Outreach activities

44 From March to May 2020, during the ED consultation period, the EFRAG Secretariat also plans to conduct outreach activities in order to assess the expected costs of, and benefits from, implementing the proposals. The outreach activity is planned to take a form of survey.

Questions for EFRAG TEG

45 Does EFRAG TEG have suggestions on the EFRAG Secretariat plans regarding ESA?

46 Does EFRAG TEG have suggestions on the EFRAG Secretariat outreach activities during the ED consultation period?