Primary Financial Statements – Research activities
Issues Paper

Objective

1 The objective of the session is to provide EFRAG TEG with a summary of:

(a) the updated EFRAG Secretariat analysis on the presentation of financial statements, based on a sample of European entities that report in accordance with IFRS Standards; and

(b) the EFRAG Secretariat assessment of how the IASB tentative decisions will impact current practice on presentation of financial statements.

2 This research will be subsequently used in EFRAG's early stage analysis and is meant to support EFRAG TEG members in their discussions in preparing for EFRAG's draft comment letter to the IASB.

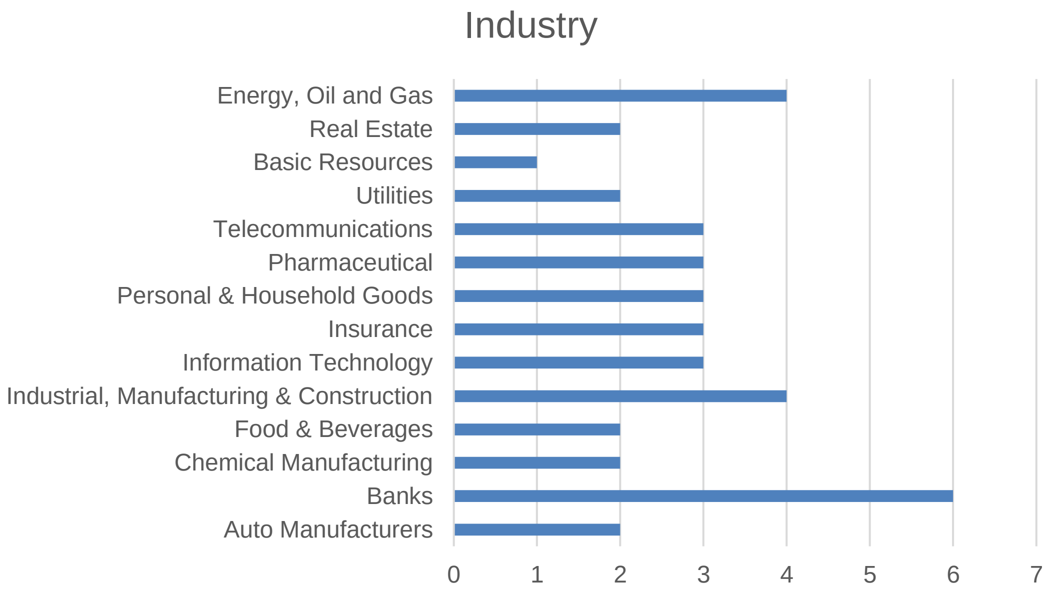
3 For this session, the EFRAG Secretariat provides an overview of its analysis on the statement of financial performance and statement of cash flows. In future sessions, the EFRAG Secretariat will provide EFRAG TEG members a more detailed analysis of the remaining topics that are in the scope described below (including disclosures), particularly when discussing in more detail EFRAG's early stage analysis and EFRAG's draft comment letter.

Entities analysed on the presentation of financial statements

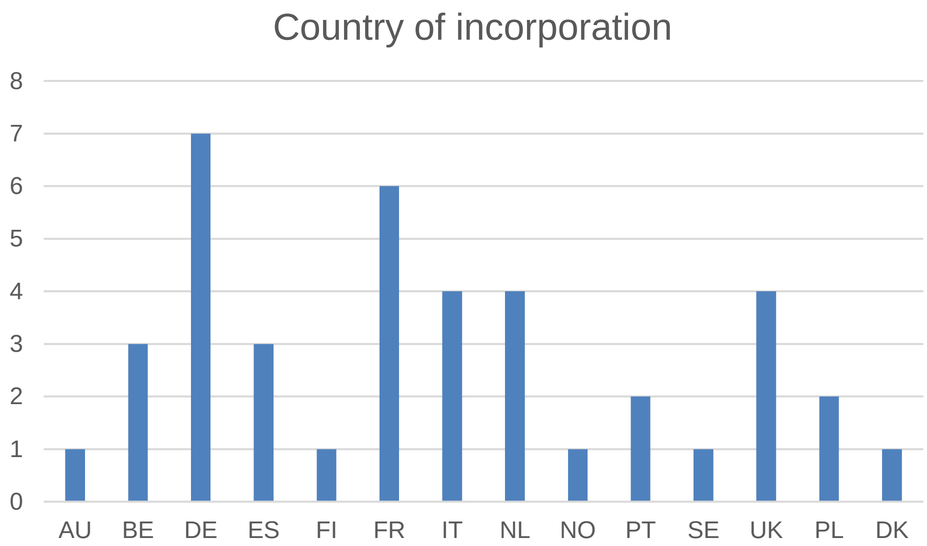
4 EFRAG Secretariat analysed the financial statements of 40 European listed entities included in the S&P Europe 350 Index and STOXX 600 in order to understand current practice on presentation and how the IASB's tentative decisions will impact current practice on presentation.

5 We note that the sample of 40 listed entities is not statistically representative of all European listed entities. For this sample, EFRAG Secretariat specifically selected a sample that would cover a wide range of industries, countries and sizes (market capitalisation).

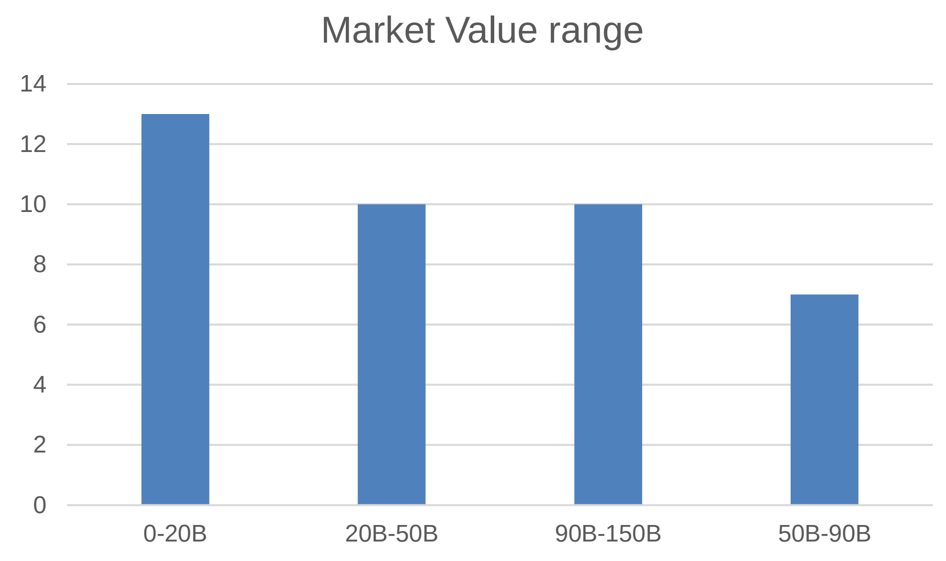
6 More specifically, EFRAG Secretariat analysed entities from 14 different industries. We selected a larger number of financial institutions to better understand the impact of the IASB's proposals focused on entities with financing and investing activities.



7 EFRAG Secretariat also analysed entities incorporated in 14 different European countries.



8 Finally, EFRAG Secretariat selected entities with different sizes in terms of market capitalisation to avoid focusing only on the biggest European listed entities.



Description of the analysis

9 EFRAG Secretariat focused its analysis on the key topics discussed by the IASB. More specifically, the scope of our analysis is:

(a) **Statement of financial performance:**

(i) *Presentation*

- level of disaggregation (number of line items and subtotals used);
- type of subtotals used;
- use of the presentation options for the analysis of expenses classified based on their nature or their function;
- use of the option to present a single statement of comprehensive income or two statements;
- presentation of share of the profit or loss of associates and joint ventures accounted for using the equity method; and
- presentation of non-recurring/unusual items on the primary financial statements.

(ii) *Disclosures*

- Disclosures of non-GAAP numbers, including reconciliations with subtotals defined in IFRS Standards; and
- Disclosures of unusual items.

(b) ***Statement of cash flows***

(i) *Presentation*

- starting point for the indirect method;
- presentation of interest and dividends in the statement of cash flows;
- presentation of cash flows that arise from associates and joint ventures;

(c) ***Statement of financial position***

(i) *Presentation*

- Level of disaggregation (number of line items and subtotals used)
- Use of the category ‘others’.

Questions for EFRAG TEG

10 Does EFRAG TEG has any comments or suggestions on the scope and sample selected?

Key findings for non-financial entities

Statement of financial performance: General

11 In general, the structure and content of the financial statements of the non-financial entities analysed varied significantly. For example, some entities separately presented information about operating, financing and investing activities, while others would simply present all the activities above profit before tax.

12 Considering the IASB’s tentative decisions on the structure and content of financial statements, the EFRAG Secretariat assesses that in general the IASB’s proposals would lead to a significant change to current practice on presentation of financial statements.

Statement of financial performance: level of disaggregation - number of line items

13 The EFRAG Secretariat noted that for non-financial entities the level of disaggregation varied significantly from 8 to 24 line items. We also observed that for financial institutions the level of disaggregation tends to be higher. We observed that on average non-financial entities presented 14 line items which were distributed in the following way:

(a) Up to 10 line items: 13%

(b) From 11 to 15 lines items: 65%

(c) More than 15 line items: 23%

14 The IASB has tentatively decided to require new additional subtotals and categories[1]. Therefore, to comply with such requirements, many entities will need to provide a higher level of disaggregation, particularly in regard to line items related to the investing and financing categories.

Statement of financial performance: level of disaggregation - subtotals used

15 The EFRAG Secretariat noted that most of entities (60%) had at least 4 subtotals:

(a) Gross profit;

(b) Operating profit;

(c) Profit before tax (required by IAS 1); and

(d) Profit for the year (required by IAS 1).

16 We also noted that 54% of the entities also used subtotals within other subtotals. For example, some entities presented ‘total operating costs’, ‘total operating income’ and then ‘total operating profit’.

17 The entities analysed use many different subtotals on the face of the statement of financial performance. These include:

[1] Operating profit, operating profit or loss and share of profit or loss of integral associates and joint ventures, profit or loss before financing and income tax, investing category, financing category and income and expenses related to these two categories.

(a) **Gross profit**: all the entities that presented their analysis of expenses by function presented this subtotal.

(b) **Operating profit**: this subtotal was used by the majority (65%) of entities. The subtotal operating profit typically excluded line items related to share of profit from equity accounted investments, exceptional items, finance costs, investment costs and taxes. However, the calculation varied between entities as, for example, some entities included results from associates and joint ventures in operating profit while others excluded them, and similarly with income and expenses from investment activities. Finally, in many cases this subtotal was similar to earnings before interest and tax (EBIT) as it only excluded finance costs and share of profit from equity accounted investments.

(c) **Profit before interest and tax or EBIT:** Only 19% of the entities made explicit reference to EBIT. This subtotal excluded items such as 'net financial expenses', 'unwinding of discount of provisions', 'share of profit from equity accounted investments' and 'taxes'. Their calculation also varied between entities as for example some entities included results from associates and joint-ventures in EBIT while others excluded them. Finally, as referred above, in many cases "operating profit" was a term similar to 'EBIT'.

(d) **Finance results:** Many entities (45%) presented a separate subtotal related to 'finance results'. However, there is no definition within IFRS Standards of what should be included in finance costs. Financing activities are currently defined only in IAS 7 as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

(e) **Profit before tax:** all entities used this subtotal

(f) **Profit for the year:** all entities used this subtotal as required by IAS 1.

18 Many other less common subtotals were presented, such as:

(a) Gross operating profit;

(b) Total revenues and total costs;

(c) Total operating cost and total operating income;

(d) Profit on sales;

(e) Income (expenses) from investments;

(f) Income from property management; and

(g) EBITDA.

19 The EFRAG Secretariat assesses that the IASB's proposals on new subtotals and categories will significantly impact current practice on the presentation of subtotals:

(a) **Operating profit**: currently there is no definition of operating profit in IFRS Standards, and therefore it is a subtotal defined by management. The IASB tentatively decided to provide guidance on the calculation of operating profit, which means that entities will have to revise one of their most common performance measures.

(b) **EBIT**: currently there is no definition of EBIT in IFRS Standards, and therefore it is a subtotal defined by management. The IASB tentatively decided to provide guidance on the calculation of 'profit before finance and tax', thus some entities will have to revise their calculation of the subtotal 'EBIT'.

(c) **Finance results:** currently there is no definition within IFRS Standards of what should be included in finance costs. The IASB tentatively decided to define a financing category, thus entities will have to revise their presentation of of the subtotal 'finance results'.

(d) **Investing category:** from the sample analysed, only one entity presented a separate category for investment activities. Therefore, most entities analysed will need to revise their structure to separately present income and expenses from investments.

(e) **Financing category:** from the sample analysed, 71% presented a financing category, even if some of these entities included the share of profit of associates and joint ventures in this category. There were also some entities that presented a single category for financing and investing. Therefore, the introduction of a financing category will impact many entities that currently include all income and expenses together above profit before tax and those that have a single category for financing and investments.

(f) **Use of different subtotals:** entities will have to reconsider whether they will be able to continue to use some of their subtotals (e.g. EBITDA).

Statement of financial performance: presentation of expenses by nature and by function

20 Our research revealed the following:

(a) The most common classification used by entities (45%) was to present their analysis of expenses using the function of expenses. Of the remaining entities, 35% used a classification of expenses based on their nature and 13% used a combined approach by mixing the nature and function presentation. For 6% of the entities it was difficult to conclude.

(b) We noted a trend within some industries:

(i) *Auto manufacturers*: Preference for presentation by function;

(ii) *Industrial, Manufacturing and construction*: preference for presentation by function;

(iii) *Information technology*: preference for presentation by function;

(iv) *Pharmaceutical*: preference for presentation by function;

(v) *Telecommunication Services*: preference for presentation by nature; and

(vi) *Utilities:* preference for presentation by nature.

(c) Entities that presented a combined approach by mixing the nature and function presentation used classifications such as ‘distribution expenses’ and ’administrative expenses’ together with items such as restructuring, provisions, amortisation, depreciation and impairments.

21 The EFRAG Secretariat assesses that the IASB’s proposals to require an entity to present an analysis of expenses included in operating profit or loss using a classification based on either their nature or function (no mix) would impact a limited number of entities that use a combined approach by mixing the nature and function presentation. In addition, all entities will have to reassess whether their presentation provides the most useful information to users of financial statements in accordance with the guidance proposed by the IASB.

Statement of financial performance: Single statement or two statements

22 The majority of the entities in the sample used two statements to present their performance, thereby contributing to comparability across countries and industries. However, we note that outreach activities have suggested that investors often do not use or understand the other comprehensive income part of the statement of financial performance.

Statement of financial performance: Unusual items

23 The majority of entities (61%) did not include an explicit reference to unusual line items on the face of the statement of financial performance.

24 For the entities that made explicit reference to unusual items on the face of the statement of financial performance, we noted that:

(a) They disclosed the total amount in a separate note;

(b) different terms were used to refer to unusual line items – two entities used the term ‘extraordinary contributions’. Other entities referred to them as ‘non-underlying items’, ‘items affecting comparability’ or ‘special items’ (EFRAG Secretariat will further analyse their disclosures in the future to better understand the nature of these items);

(c) five entities included these amounts in operating profit, three entities excluded them from operating profit; two entities presented unusual items after profit before taxes. One entity had the effect of non-recurring items in each relevant subtotal;

(d) the nature of the line items presented as unusual included:

(i) restructuring costs;

(ii) non-recurring net finance income(cost)

(iii) impairment of assets;

(iv) reversal of impairment on financial assets; and

(v) litigations related expenses.

25 The EFRAG Secretariat assesses that the IASB’s proposals and definition of unusual income and expenses will require entities to reconsider the line items presented on the face as extraordinary, non-recurring, unusual, etc. In addition, entities will have to reconsider whether their subtotals that exclude line items such as restructuring costs, litigation expenses and impairments (e.g. profit before income tax and extraordinary contribution) will fit within the new structure proposed by the IASB.

Statement of financial performance: results of associates and joint ventures

26 The presentation of results of associates and joint ventures varied. In most cases (84%), the presentation of results of associates and joint ventures was within profit before tax. In such cases, 19% of those entities included them in operating profit/ EBIT and 52% after operating profit /EBIT. Entities which did not have an operating category in their statement of financial performance included the share of profit(loss) from associates and joint ventures between the gross profit and profit before income taxes.

27 Only one entity in our sample of 31 non-financial entities presented a statement of financial performance with clearly separate operating, financing and investing categories. This entity included the share of profit(loss) from equity-accounted investments in the investing category.

28 There were 8 entities that presented a separate line item for the results of equity-accounted investments between two other subtotals, however, no particular subtotal was created to show the results in performance before and after this had been taken into account.

29 The EFRAG Secretariat assesses that the IASB’s proposals on integral and non-integral will significantly affect all entities that currently present share of profit of associates and joint ventures as currently none of the entities analysed made a distinction between integral and non-integral.

Statement of cash flows

30 When analysing the statement of cash flows we noted that:

(a) the **starting point** for determining net cash flow from operating activities when the indirect method is used varied. The majority of the entities (65%) used 'profit after tax'. The remaining entities used 'profit before tax' or operating profit;

(b) the presentation of **interest received** and **dividends received** in the statement of cash flows varied. The majority of the entities (65%) presented interest received from debt investments, dividends received from equity investments and dividends received from joint ventures or associates in operating activities, while the others used investing activities;

(c) nearly half of the entities (48%) presented interest paid as in the operating category of the statement of cash flows; and

(d) all entities presented **dividends paid** within the financing activities.

31 In regard to how the IASB's proposals will change current practice, the EFRAG Secretariat assesses that the IASB's proposals will impact some but not all sections of the statement of cash flows.

(a) **starting point for determining the net cash flows from operating activities**: the IASB's tentative decision to start with the subtotal operating profit is a significant change to current practice. Thus, most entities will have to revise their statement of cash flows to start with operating profit when using the indirect method;

(b) **dividends paid**: the IASB's tentative decision to classify all dividends paid within financing activities will not change current practice as all entities analysed presented dividends paid within the financing activities section;

(c) **Interest paid:** the IASB's tentative decision to classify all interest paid within financing activities will affect many non-financial entities (48%) that current classify interest paid within operating section;

(d) **Interest received:** the IASB's tentative decision to classify all interest received within the investing category will significantly change current practice as the half of non-financial entities (48%) classified interest received as operating rather than investing; and

(e) **dividends received:** the IASB's tentative decision to classify all dividends received within the investing category will affect many non-financial entities (32%) that current classify dividends received within operating section.

Questions for EFRAG TEG

32 Does EFRAG TEG agrees with the EFRAG Secretariat initial assessment of how the IASB's tentative decisions will impact current practice on presentation of financial statements for non-financial entities?

Key findings for financial institutions

Statement of financial performance: General

33 In general, although financial institutions usually provide a higher level of disaggregation (many subtotals and line items), the structure of the financial statements varies significantly. For example, some financial institutions separately present 'total income' and 'total expense', while others present income and expenses together under the same subtotal. Some focus on identifying what is operational income and expenses, while others do not.

34 Considering the IASB's tentative decisions on the structure and content of financial statements, the EFRAG Secretariat assesses that in general the IASB's proposals would lead to a significant change to current practice on presentation of financial statements. Detailed explanations can be found below.

Statement of financial performance: level of disaggregation - number of line items

35 Financial institutions tend to provide a higher level of disaggregation than non-financial entities. For example, we observed that financial institutions presented on average 22 line items while non-financial entities presented on average 14 lines items. Further, the number of line items were distributed in the following way:

(a) Up to 10 line items: 0%

(b) From 11 to 15 lines items: 11%

(c) More than 15 line items: 89%

36 The IASB has tentatively decided to require new additional subtotals and categories. Therefore, to comply with such requirements, the EFRAG Secretariat assesses that many financial institutions will need to revise their current line items (e.g. revise presentation of line items such as unwinding of discount on pension liabilities and provisions).

37 In addition, the EFRAG Secretariat has not seen line items related to the unwinding of the discount of some liabilities being separately presented in the face of the financial statements. Therefore, financial institutions may need to reassess whether such line items are material to require separate presentation.

Statement of financial performance: Level of disaggregation - subtotals used

38 Financial institutions tend to use more subtotals than non-financial entities (on average, financial institutions used 8 subtotals while non-financial entities used 5 subtotals). Financial institutions presented many different subtotals such as:

(a) **operating income, operating expenses and/or operating profit**: the majority of the financial institutions (56%) used a subtotal related to operating profit. These subtotals 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 'share of profit in associates and joint ventures', impairment charges (e.g. loans), 'goodwill', 'net gain on non-current assets' and 'net less on held for sale group entity;

(b) **subtotals similar to gross profit** (i.e. represent the difference between a type of revenue and directly related expenses incurred in generating that revenue):

(i) net interest income (typically used by banks);

(ii) net fee income (typically used by banks);

(iii) premiums earned (typically used by insurance entities); and

(iv) net insurance benefits and claims (typically used by insurance entities)

(c) **total income and total expenses**: the majority of the financial institutions (67%) used subtotals that were an aggregation of mostly income or mostly expenses, such as 'total income' or 'total expenses'.

(d) **profit before tax**: All financial institutions used this subtotal as required by IAS 1.

(e) **profit or loss**: All financial institutions used this subtotal as required by IAS 1. Some financial institutions used different terms such as 'net income' or 'net result' to present their profit for the period.

39 Financial institutions used many other subtotals on the face of the statement of financial performance, including subtotals within subtotals (e.g. subtotals related to impairments or subtotals that excluded non-recurring items).

40 None of the financial institutions made explicit reference to 'profit before interest and tax' or 'EBIT'. In addition, none of the financial institutions presented a separate subtotal or category named 'finance result' or 'investment result'.

41 The IASB has tentatively decided to require new additional subtotals and categories. Therefore, to comply with such requirements, the EFRAG Secretariat assesses that many financial institutions will need to revise their current subtotals to understand whether they will comply with the new required structure (e.g. those that present the information by separately presenting 'total income' and 'total expenses').

42 In particular, currently there is no definition of operating profit, therefore it is a subtotal defined by management. The IASB tentatively decided to provide guidance on the calculation of operating profit, therefore financial institutions will have to revise one of their most common performance measures.

Statement of financial performance: presentation by nature and by function

43 Some financial institutions (44%) presented their analysis of expenses using the classification based on their nature while the remaining financial institutions (56%) used a classification based on a combined approach by mixing the nature (e.g. depreciation and amortisation expense) and function presentation (e.g. administrative expenses).

44 The EFRAG Secretariat assesses that the IASB's proposals to require an entity to present an analysis of expenses included in operating profit or loss using a classification based on either their nature or function (no mix) will affect many financial institutions that use a combined approach by mixing the nature and function presentation as they typically mention 'general and administrative expenses', 'other administrative expenses' and 'acquisition and administrative expenses'.

Statement of financial performance: Single statement or two statements

45 All the financial institutions in the sample used two statements to present their performance, thereby contributing to comparability.

Statement of financial performance: Unusual items

46 Financial Institutions did not include an explicit reference to the term non-recurring, exceptional, non-core items or extraordinary on the face of the statement of financial performance.

47 However, line items and subtotals that could be considered as non-recurring were presented separately. For example:

(a) Subtotals such as 'net operating income before change in expected credit losses and other credit impairment charges'; and

(b) Expense line items such as impairments, net gain on non-current assets, goodwill, net loss on the sale of a group and cost of risk that were presented separately between subtotals.

48 The IASB has tentatively decided to require new additional subtotals and categories. Therefore, to comply with such requirements, the EFRAG Secretariat assesses that many financial institutions will need to revise their current subtotals and line items, particularly those related to non-recurring items. For example, financial institutions that are currently excluding non-recurring items (e.g. impairments) from their operating profit would have to revise their presentation.

Statement of financial performance: Results of associates and joint ventures

49 The presentation of results of associates and joint ventures varied. However, the presentation of results of associates and joint ventures was often shown after operating profit or at the bottom close to the subtotal profit before tax.

50 The IASB has tentatively decided to separately present integral and non-integral associates and joint ventures. Therefore, to comply with such requirements, the EFRAG Secretariat assesses that all financial institutions that present share of profit of associates and joint ventures will need to revise their current subtotals and line items, particularly those related to integral and non-integral, a distinction that currently is not being made.

51 An example is included below on how the presentation would change:

Interest income	x
Interest expense	x
Net interest income	**x**
Fee and commission income	x
Fee and commission expense	x
Net fee and commission income	**x**
Net trading income	x
Net investment income	x
Credit impairment losses	x
Employee benefits expense	x
Depreciation and amortisation expenses	x
Operating profit	**X**
Share of results of integral associates and joint ventures	x
Operating profit and share of profit or loss of integral associates and joint ventures	**X**
Share of results of non-integral associates and joint ventures	x
Unwinding of discount on pension liabilties and provisions	x
Profit before tax	**X**
Income tax expense	x
Profit for the year	**X**

Statement of cash flows

52 All of the financial institutions analysed used the indirect method in their statement of cash flows. However, they had different starting points for their presentation of cash flows. The majority of the financial institutions used either 'profit before tax' (44%) or 'profit or loss' (44%) as a starting point. Only 11% started with 'operating profit'.

53 Concerning the classification of interest, many financial institutions presented **interest paid** and **interest received** within 'operating activities'. However, such classification was not always clearly presented on the face of the statement of cash flows when financial institutions used the indirect method. In some cases, this information is separately presented in a subtotal within the operating cash flows section or at the bottom. There were also cases where interest paid was classified as financing. For example, interest paid related to intra-group borrowings or net cash impact of interest margin relating to hedging derivatives on financing debt.

54 In regard to **dividends paid,** when presented they were typically classified as financing activities.

55 In regard to **dividends received** from equity instruments, when presented they were typically classified as operating activities. However, there was one case where cash flows from dividends received from equity instruments were classified as investing activities.one financial institution classified dividends received from associates and joint ventures in operating activities.

56 Finally, most of the references to associates and joint ventures were related to acquisition and disposals of associates and joint ventures, which were classified as investing activities.

57 In regard to how the IASB's proposals will change current practice, the EFRAG Secretariat assesses that:

(a) **starting point for determining the net cash flows from operating activities**: the IASB's tentative decision to start with the subtotal operating profit is a significant change to current practice. Thus, most financial institutions will have revise their statement of cash flows to start with operating profit;

(b) **dividends paid**, the IASB's tentative decision to classify all dividends paid within financing activities will not change current practice as all financial institutions analysed presented dividends paid within the financing activities section; and

(c) **Interest paid, interest received and dividends received:** the impact on the statement of cash flows will depend on how financial institutions will classify related income/expenses in P&L. Applying the proposals for classification in the statement(s) of financial performance for financial entities, it is likely that many financial entities will present most, or all, of their interest income, interest expenses and/or dividend income in the operating profit section of the statement(s) of financial performance. The EFRAG Secretariat assesses that in such cases, there would not be a significant change in practice. The financial institutions that have classified interest paid as financing (e.g. interest paid related to intra-group borrowings or net cash impact of interest margin relating to hedging derivatives on financing debt) or interest received as investing, will have to revise their classifications in the statement of financial performance as the classification in the statement of cash flows will depend on classification of related income/expenses in the statement of financial performance.

Questions for EFRAG TEG

58 Does EFRAG TEG agree with the EFRAG Secretariat initial assessment of how the IASB tentative decisions will impact current practice on presentation of primary financial statements for financial institutions?