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Comment letter on EFRAG Draft Comment Letter on the IASB ED/2019/7 General Presentation and Disclosures

Dear Mr. Gauzès,

Thank you for the opportunity to comment on the EFRAG draft comment letter (DCL). Erste Group welcomes the IASB initiative to improve communication of the information in the financial statements with a focus on the statement of profit or loss. While agreeing with many of the proposals in the ED we also several objections. They are discussed in detail below in answers to questions to constituents raised in the EFRAG DCL. In this part of our comment letter we briefly describe the main concerns.

We question whether the mandatory 'Operating profit or loss' subtotal is sensible for entities like banks for which, due to the transfers from the financing and investing categories to the operating category, almost all income and expenses would belong to the operating category. Based on annual results of our bank between 2014 and 2019 the operating category subtotal constituted at least 97% of the pre-tax profit or loss.

The proposed requirements would force banks to present something which is labelled as 'operating' while they usually view their operating performance measure as a subtotal which is more upwards in the structure of their statements of profit or loss. Often it excludes volatile items such as impairment result from financial instruments, result from IAS 37 provisions, impairment on non-financial assets including goodwill or gains/losses from disposal of non-financial assets. In order to properly capture their operating performance, banks would have to consider introducing own developed subtotal(s) in the statement of profit or loss. However, this may not be straightforward as also noted in BC165 of the ED.

From this perspective, we would like to propose that the IASB considers dropping the mandatory requirements for structuring the statement of profit or loss if (substantially) all income and expenses, other than from coming from associates and joint ventures, relate to main business activities. Alternatively, the IASB could consider keeping this subtotal but dropping the requirement to use the attribute ‘operating’ in labelling this subtotal.

Further, we consider that the requirement for disclosing the income tax and the non-controlling interests effects for each reconciliation item between a management performance measure and the most comparable IFRS subtotal is overly burdensome. Providing such an information would require significant system costs, e.g. because the income tax expense calculation is based on local legislation rather than IFRS requirements. We doubt whether the need of users for this kind of information justifies the costs which the preparers would incur.

Also, we have doubts about the necessity to present operating expenses purely either ‘by nature’ or ‘by function’ method. We consider that the issue should be addressed for the cases where the concerns actually arise. They seem to relate to non-financial entities using the ‘cost of sales’ line item. The mixed presentation as such should not be prohibited, in our view. But if the mixed presentation was not allowed an additional guidance for distinguishing between the presentation methods would be helpful.

If you have any questions to our comments please do not hesitate to contact Martin Svitek martin.svitek@erstegroup.com or me.

Yours sincerely,

Manfred Schmid
Head of Group Accounting and Group Controlling

Question to constituents

32 For those in a regulated industry, would the IASB proposals in paragraph 48, for entities that invest in the course of the entity's main business activities, result in significant changes in practice that would be in conflict with regulation in your industry? Do you expect any additional challenges or significant costs?

Erste Group as a bank is subject to FINREP regulatory reporting requirements which are based on IFRS as set out by the EBA. However, already now Erste Group's statement of income as part of IFRS financial statements uses different structure of line items. As a result, even when the proposed requirements would further deviate the statutory from the regulatory IFRS we do not consider them to cause additional challenges or costs to our bank.

Question to constituents

33 Do you consider that separating returns from investments made in the course of an entity's main business activities from those that are not will be difficult to make in practice? Please explain.

We consider that all our investments are made in the course of our main banking business activities. This is the case both for investments in financial assets and investment properties. As a result, we do not need to make the separation and thus do not expect difficulties. From this perspective we propose to include banks in paragraph B27 among the examples of entities that invest in the course of their main business activities.

Question to constituents

42 Do you consider that it is difficult or costly to allocate income and expenses from financing activities and from cash and cash equivalents to those that do or do not relate to the provision of financing to customers? Please explain.

As a typical bank we consider that provision of funding to customers is our key activity. Thus, distinguishing between income and expenses from financing activities that relate to provision of financing to customers and that do not does not make sense for us. As a result, we would choose the accounting option of classifying all income and expenses from financing activities in the operating category as provided in paragraph 51(b). With this option we would not incur additional costs. (We further note that for our bank the question does not arise in respect income and expenses from cash and cash equivalents. Based on paragraph 52(a) they would have to be presented in the operating category since we invest in financial assets in the course of our main activities.)

The option of distinguishing between income and expenses from financing activities that relate to provision of financing to customers and other financing activities would be very artificial to apply to us. The borderline between the customer financing and other activities would not be clear. It would be very disproportionate since more than 90% of our balance sheet total consists of loans and debt securities which are typical financing instruments. The net interest income is our key revenue item at the very top of our statement of income. Separating a small part of interest expenses (allegedly unrelated to customer financing activities) would be very confusing, in our view.

Question to constituents

43 For those that provide financing to customers as a main business activity and are in a regulated industry, would the IASB's proposals in paragraph 51 of the ED be in conflict with regulation in your industry? Do you expect any additional challenges or significant costs?

In our view, the requirement in paragraph 51 for transferring of income and expenses from financing activities to the operating category is not in conflict with regulation, i.e. FINREP reporting. In the FINREP structure of the statement of profit or loss all items of interest income and interest expenses are included as part of 'Total operating income, net' subtotal.

Question to constituents

57 Do you consider income and expenses from cash and cash equivalents (i.e. short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value) as part of the entity's financing (paragraph 54 above) or investing activities (paragraph 55 above)? Please explain.

For banks income and expenses from cash and cash equivalent are naturally part of operating activities.

Question to constituents

63 How costly would it be to track whether exchange differences relate to the entity's main business activities, investing activities or financing activities? Please explain.

We consider any split of exchange differences in profit or loss as burdensome. This is especially true when entities steer the overall foreign currency position and use the system of position accounts whereby the gains and losses on foreign currency transactions are calculated on an aggregated level.

In the specific case of our bank this concern will be mitigated by the fact that the items resulting in income and expenses outside the operating category constitute just a small fraction of our overall activities (see also our answer to question in paragraph 190 of the DCL). Furthermore, they do not give rise to foreign exchange differences because associates and joint ventures are non-monetary items and pension liabilities are not denominated in foreign currencies. As a result, all our foreign exchange differences seem to relate to the operating category.

Question to constituents

76 Do you consider income and expenses that reflect the effect of the time value of money on liabilities that do not arise from financing activities (as in paragraph B47 of the ED) as part of the entity's financing or operating activities? Please explain.

We consider that all the time value of money effects should be treated equally, i.e. for qualifying entities they should be transferred to the operating category. This should also include interest income and expenses on other liabilities such as unwinding of discount on pension liabilities and provisions (as further exemplified in paragraph B37 of the ED). Currently we include also these items in the net interest income. Also the regulatory IFRS FINREP reporting as set out by the EBA applies this approach.

Question to constituents

93 Do you consider that the IASB needs to expand the new paragraph 20D of IFRS 12, for example to include additional indicators, to reduce the level of judgement involved when making a distinction between integral and non-integral entities? Please explain.

We consider that additional examples for the distinction between integral and non-integral associates could be helpful.

However, considering that in our business the investments in associates and joint venture account for less than 0.1% of our overall assets we are of the opinion that we would not need to develop a complex internal guidance for the distinction. And such a policy could be developed even within the proposed requirements.

Question to constituents

94 Considering that the IASB is proposing the subtotal 'profit before financing and income tax', which includes the result of associates and joint-ventures on a net basis, do you consider that it would be useful to separately present or disclose the income tax related to associates and joint-ventures accounted for under the equity method?

As a bank which would apply the option of presenting all income and expenses from financing activities (and from cash and cash equivalents) in the operating category we would not present the subtotal 'profit before financing and income'. Thus, this the question does not relate to us directly and we do not express our opinion.

Question to constituents

121 Do you consider that it is useful to have disclosures by nature in single note when an entity presents its expenses within operating profit or loss by function (i.e. when an entity assesses that presentation by function provides the most useful information)? Do you anticipate that such information will be costly to provide? Please explain.

We will not apply the 'by function' presentation since banks typically present their expenses using 'the nature of expense method'. Thus this the question does not relate to us directly and we do not assess the costs.

Question to constituents

122 Do you consider that it is useful to have in the statement of profit or loss:

(a) a strict presentation either by nature or by function (no mix);

(b) a general presentation by nature or by function together with limited additional requirements as suggested in the ED by the IASB; or

(c) a mix presentation basis (no restrictions). Please specify why.

As a bank we generally use the 'by nature' presentation. However, certain aspects of 'the function of expense method' may be found in our statement income. Some examples are discussed below. So far, based on IAS 1 requirements, we have not been confronted with the need to identify which line items potentially use the 'by function' logic.

We wonder whether it is really necessary to ask for purity of the methods. We consider that the issue should be addressed for the cases where the concerns actually arise and the mixed presentation as such should not be prohibited. The ED explains in paragraph BC110 that both methods have merits for forecasting components of operating expenses and calculation of performance metrics and margins. It further says: "*Users have raised concerns that useful information can be lost because entities choose which method to use and because, in practice, many entities use a mixture of both methods.*"

We believe that this issue is relevant mainly for non-financial entities using the 'cost of sales' line item where a large part of major expenses such as depreciation, amortisation, personnel expenses is hidden. We are not aware that profit or loss statements of banks have been challenged by users in this regard. The pure 'by nature' presentation requirement would force banks to reconsider the structure in the areas where it is not necessary, in our view.

But if the mixed presentation was not allowed we consider that an additional guidance should be provided. We mention two examples in this respect. The EFRAG DCL says that the administrative expenses line item is presented 'by function'. Also, in the Illustrative Examples part of the ED 'General and administrative expenses' are a typical item which can be found in the statements of financial performance using 'the function of expense method'. At our bank we use 'Other administrative expenses' line item in the statement of income. It does not seem to use much of the 'by function' logic. It comprises items such as costs for office space, trainings, travel, personnel leasing, cars, cash transportation, IT, advertising, marketing, legal, consulting or audit (personnel expenses and depreciation/amortisation are excluded). These are expenses which are not related to a specific IFRS standard and are accounted for applying the general accrual principle. As a result, they seem to be similar in their accounting nature. Thus, it would be helpful to clarify that certain items which are typical of the 'by function' approach may also fit the 'by nature' logic.

Another example is that if restructuring provisions relate to expected personnel and other administrative expenses we present them in the respective income statement line items (unlike expenses from other IAS 37 provisions). It could be clarified whether in such cases the 'by function' or 'by nature' presentation is applied.

Our bank participated at the IASB/EFRAG fieldwork for the proposals in the 2019 Exposure Draft. In the discussion the IASB mentioned that an underlying idea for the requirement of purity of the approach was that if certain line items use specific labels such as 'personnel expense' it is important for users that additional expenses of this kind are not hidden under other P&L line items. We consider this to be a helpful clue on how to think about line items to be presented in the 'by nature' approach. Examples in the additional guidance might also be developed around this notion.

Question to constituents

185 What is your assessment of the overall costs and benefits of the IASB's proposal on the calculation of the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation as required by paragraph 106(b)?

We are not able to estimate the actual costs at this stage. But we would like to highlight that disclosing these effects will be overly burdensome. At our bank we do not run systems for tracking such effects for the reconciling items. In our systems income tax expenses are calculated in a tax ledger. This calculation is driven by local tax legislation and in many cases local GAAP and thus is disconnected from IFRS. Calculation of the NCI effects is not disconnected from IFRS as it is performed in the consolidation system, but would still require new system setups.

We do not understand why this information is necessary when the tax and NCI effects are presented in the statement of profit or loss only at the level of the overall profit or loss. Why should be tracking of these effects pushed upwards in the structure of the statement of profit or loss? (When saying this we note that our management performance measures – used currently or considered for future as a result of the proposed changes – would be subtotals of line items in the statement of profit or loss recognised and measured applying IFRS, i.e. in the structure of the statement they would be well above the overall profit or loss.)

The simplified approach provided in the ED for calculating the income tax effects on the basis of a reasonable pro rata allocation or another more appropriate method would not provide much relief, in our view. The pro rata allocation of the current and deferred income tax effects can hardly be reasonable. The reason is that the tax effects for individual items can be significantly different to the overall income tax effect. To prove the reasonability the individual items effects would need to be tracked anyway.

We do not consider the reasoning why disclosures of the tax and NCI effects are required in paragraph BC177 of the ED as convincing. The paragraph mentions feedback from users that *"…one of the benefits of management performance measures to users is the detailed information that can be used to calculate a related earnings per share figure. To calculate such an earnings per share figure, users need information about the earnings adjustments attributable to the parent and the tax effects of those adjustments.*" Further it says: "*The Board decided to propose this disclosure at the level of individual adjustments made in calculating a management performance measure … because it gives users information needed to select which adjustments they want to consider in arriving at an adjusted earnings per share measure used in their analysis.*"

Currently our bank does not provide any earnings per share measure in relation to the MPM 'Operating result' used by the bank. And users do not ask the bank for this kind of information. We wonder why users should be provided not only with this information but also with the information enabling them to further adjust the earnings per share measure in their analysis on line-by-line basis. If analysts felt the need to calculate their own EPS ratio they would need to hope that the line items they want to adjust appear in a MPM reconciliation. They would maybe find the information they need in the financial statements of entities heavily using MPMs, while they would not find the information in the financial statements of those entities not using MPMs. Thus, such self-calculated EPS would hardly be comparable which would limit usefulness of the information.

In our view, this would be an information from the category of 'nice to have' to the users which would not justify the burden to the preparers.

Question to constituents

186 What is your assessment on number of MPMs that will need to be disclosed by entities under the IASB's proposals? Please indicate which MPMs you have identified.

If the structure of the statements profit or loss did not change we would identify two currently used performance measures 'Operating result' and 'Operating income' as MPMs that need to be disclosed. However, as discussed in the answer to question in paragraph 190 of the DCL, the mandatory 'Operating profit or loss' subtotal will lead to reconsideration of the currently used MPMs and new MPMs may have to be introduced. At this stage it is too early to conclude about the number of MPM since this will be assessed in the light of final requirements.

Question to constituents

187 What is your assessment on the relevance of the MPMs identified (is it too much? too little? which additional ones?)

We consider that the existing performance measures 'Operating result' and 'Operating income' would provide the most relevant information. From this perspective if new MPMs have to be introduced and they replace the currently used measures in order to reduce the noise brought by the mandatory 'Operating profit or loss' subtotal this we will consider as a suboptimal situation.

Question to constituents

188 Do you agree with the scope of the IASB's proposals? If not, which alternative (Alternative 1 or Alternative 2 above) would you prefer so that financial statements remain relevant?

We consider that the definition of the MPMs in respect of subtotals of income and expense used in public communication may be too broad and it is not clear how public communication should be understood. In our view, it would be sufficient if the public communication was restricted to communication released jointly with the annual or interim report (Alternative 2). Such performance measures attract similar attention of users due to being issued at the same time and their relationships to IFRS subtotal used in the statement of profit or loss should be clear from the disclosures.

Question to constituents

189 Do you agree with EFRAG's suggestion to apply the MPM requirements also to the non-GAAP performance measures, presented within financial statements, that may not satisfy the proposed criteria of MPMs (e.g. adjusted revenues and ratios)?

We do not agree with enhancing the same MPM disclosure requirements to other non-GAAP performance measures. Ratios such as ROA, ROE, cost/income ratio are by nature not directly reconcilable to the IFRS subtotals. Thus the need to reconcile them would lead to new set of requirements. On the other hand, it may be useful to provide the qualitative disclosures in paragraph 106(a) of the ED in respect of other non-GAAP performance measures which would be in scope of Alternative 2 of the previous question.

Question to constituents

190 The ED is introducing more structure in the presentation requirements, including a requirement to present on the face of the income statement a new subtotal named "operating profit or loss", which will become an IFRS defined measure. Entities that currently use a performing measure labelled "operating profit or loss" on the face or in the notes will be forced to either (i) change the label for their performing measure and continue to use both the old measure and the new IFRS defined "operating profit", or to (ii) discontinue the pre-existing performance measure, replacing its use with the new IFRS defined "operating profit or loss".

In the context described above, do you believe that the IASB's proposals on the structure and content of the statement of profit or loss will lead to an increased number of MPMs?

The proposals for the structure of the statement of profit or loss are of a particular concern to us. Introduction of the mandatory 'Operating profit or loss' subtotal is sensible for entities with significant income and expenses in other categories (i.e. financing and investing) of the statement of profit or loss.

For our bank this subtotal would be very formal since almost all income and expenses would belong to the operating category. Based on annual results of the bank between 2014 and 2019 the difference between the pre-tax result and the proposed Operating profit or loss subtotal was between 0.6% to 3.4%. The Operating profit or loss would only exclude results from associates and joint ventures and unwinding of discount on pension liabilities and provisions. Moreover, if also the unwinding belonged to the operating category (as asked by EFRAG in the question in paragraph 76 of the DCL, and we agree with this) the two measures would be even closer.

In our view, the operating P&L would not bring much added value for the statement of profit or loss of typical banks. It would be an artificial subtotal which formally improves comparability without contributing to relevance of the information.

The proposed requirements would force banks to present something which is labelled as 'operating'. However, financial institutions seem to view the operating performance well above the total profit or loss in the structure of the statement of profit or loss.[1] This is also evidenced

[1] Operating result as defined by Erste Group is the net amount of operating income and operating expenses.
Operating income includes net interest income, net fee and commission income, dividend income, net trading result, result from financial instruments at FVPL, income on investment properties and result from equity method investments. Operating expenses consist of personnel, other administrative and depreciation/amortisation expenses.
The operating result excludes gains/losses on financial assets and liabilities not measured at FVPL, impairment result from financial instruments, result from IAS 37 provisions, impairment on non-financial assets including goodwill, gains/losses from disposal of non-financial assets, levies on banking activities, recovery and resolution fund contributions.
Operating result captures net income from core activities. Negative operating result would mean that the bank does not have a viable business model. Operating result could also be understood as presenting income and expenses which are a relatively stable source of performance. (When saying this, the individual items of the net trading result and gains/losses on FVPL instruments may be volatile, but there are large offsetting effects between the fair value option liabilities (FVPL gains/losses) and related derivatives (net trading result)). Outside the operating performance are volatile items of IFRS 9 and IAS 36 impairment gains/losses, IAS 37 provisions income and expenses, selling gains/losses on assets measured at cost but also tax and similar expenses (income tax, levies, recovery and resolution fund).

by the early stage analysis published by EFRAG in its draft comment letter. In paragraph 271(a) discussing operating income, operating expenses and/or operating profit subtotals presented by financial institutions, the draft comment letter says: "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 loss on held for sale group entity."

In order to properly capture the operating performance in the statement of profit or loss from the management perspective, we would have to consider introducing own developed subtotal(s). These would be also communicated externally and thus would meet the definition management performance measure(s). In this place we would either use the current MPM 'Operating result' (with some modifications such as excluding the net result from equity method investments and unwinding of discount on pension liabilities and provision if, as proposed, they are outside the operating category) or think about developing new MPM(s).

However, adding such subtotals which also are MPMs would not be straightforward because as noted in BC165 of the ED: "*…the Board expects that few management performance measures would meet the requirements for presentation as a subtotal in the statement(s) of financial performance*." We note that based on the current IAS 1 requirements we are not in need to use such additional subtotals in the statement of profit or loss and we do not even use them.

From this perspective, we would like to propose that the IASB considers dropping the mandatory requirements for structuring the statement of profit or loss if (substantially) all income and expenses, other than such coming from associates and joint ventures, relate to main business activities. Alternatively, the IASB could consider keeping this subtotal but dropping the requirement to use the attribute 'operating' in labelling this subtotal. For example, a label 'Profit or loss before associates and joint ventures and income tax' could be used in this place or entities could use other appropriate labels.

The income and expenses from associates and joint ventures would still be provided on face of the statement in separate line items including the split into integral and non-integral. They would follow after the operating section (which would not use its subtotal or would use the alternative subtotal). In this way users, should they be interested, could readily derive the formal 'Operating profit or loss' subtotal or would see it with a different label.

Question to constituents

250 Do you agree that the IASB should consider providing more guidance for the presentation of revenues and costs when they are allocated to different business activities on the face of the statement of profit or loss, including consistency with IFRS 8 and disclosure on judgement applied in the allocation process?

Even when Erste Group is not involved in other than typical banking business activities we support providing the guidance. It would help entities which face this issue since the proposed requirements in the ED are not clear in this regard.