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STAFF PAPER

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Project	**Primary Financial Statements**		
Paper topic	Earnings before finance income/expenses and tax (EBIT)—approaches for describing capital structure		

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Purpose of paper

1. This Agenda Paper seeks the Board's views on the staff's proposal to require an EBIT (Earnings before finance income/expenses and tax) subtotal in the statement(s) of financial performance. The paper follows up on the discussion at the March 2017 Board meeting by asking for the Board's views on how we should describe the term capital structure (to be used in our definition of finance income/expenses). Agenda Paper 21B for this meeting develops the staff recommendations in this paper further.

2. This paper does not address whether an EBIT subtotal is relevant for financial institutions and other entities providing financing services. We would like the Board to focus on determining a suitable approach for a straightforward non-financial entity first. We will consider at a future meeting how this approach could be applied or adapted to more complex scenarios.

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Structure of paper

3. The paper is structured as follows:

   (a) summary of staff recommendations in this paper (paragraph 4);

   (b) background (paragraphs 5-6);

   (c) what is our objective in requiring an EBIT subtotal and why is it useful to investors? (paragraphs 7-11);

   (d) staff analysis of approaches to describing capital structure (used in description of finance income/expenses) (paragraphs 12-43);

   (e) staff recommendation (paragraph 44); and

   (f) appendix—how users use EBIT.

Summary of staff recommendations in this paper

4. The staff recommend a principles-based approach to describing capital structure. We recommend:

   (a) defining capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents; and

   (b) clarifying the current description of financing activities.

Background

5. At the March 2017 Board meeting[1], the staff recommended requiring the presentation of an EBIT subtotal in the statement(s) of financial performance. In order to have a comparable EBIT subtotal the staff proposed introducing the following requirements:

   (a) to define EBIT as profit before finance income/expenses and tax;

   (b) to define finance income/expenses as income/expenses related to an entity's capital structure; and

[1] Agenda Paper 21A for the March 2017 meeting covered our EBIT proposals for that meeting.

(c) that an entity's capital structure would include cash held, as well as short-term investments of excess cash.

6. At the March 2017 Board meeting, Board members tentatively agreed with the general direction of the staff' proposals in paragraph 5, ie introducing a comparable EBIT subtotal in the statement(s) of financial performance. However, Board members asked the staff to:

   (a) clarify our objective of proposing to require an EBIT subtotal, considering how EBIT is used by investors;

   (b) consider how to describe an entity's capital structure; and

   (c) consider whether additional guidance would be needed on the treatment of particular items of income and expenses (for example, the net interest on net defined benefit liabilities).

What is our objective in requiring an EBIT subtotal and why is it useful to investors?

What is our objective in requiring an EBIT subtotal?

7. Our objective in requiring an EBIT subtotal is:

   (a) to provide a comparable measure of performance further up the statement(s) of financial performance than profit before tax; and

   (b) to facilitate comparisons of entities with different capital structures.

8. We have received feedback that users would like additional required subtotals in the statement(s) of financial performance, especially ones that provide relatively comparable measures of performance. We think EBIT would be a useful subtotal for investors in the statement(s) of financial performance, in addition to profit before tax, because it is commonly used in practice to facilitate comparisons between entities with different capital structures (see paragraph 10).

9. We think that defining this subtotal using a 'bottom-up' approach (ie by specifying which items should be excluded from profit to obtain EBIT) might be easier for us to do and is more likely to result in a comparable measure than trying to define operating profit. Operating profit is a commonly used term for a subtotal used by many

companies across many jurisdictions, but it does not have a robust underpinning definition. There have been many efforts to define operating profit by the Board and other Standard-setters, but they have been unsuccessful. At the September 2016 World Standards-setters meeting, participants debated the characteristics of operating profit but they were unable to reach a consensus. During outreach, we have received support for defining and requiring an EBIT subtotal, rather than operating profit (eg in the July 2016 ASAF meeting and the November 2016 CMAC meeting).

Why is EBIT useful to investors?

10. At the March 2017 Board meeting, we explained that EBIT provides users with additional insight about entities' financial performance, because it achieves comparability between entities with different capital structures and income tax situations by excluding the effect of the way an entity finances its business and the effect of tax. This is illustrated in the example below. Suppose that two entities A and B are identical, except that entity A is fully equity-financed whereas entity B is partly debt-financed. Entity A and B's profit will be different, though their EBIT will be the same:

	Entity A (fully equity-financed)	Entity B (partly debt-financed)
Revenue	10,000	10,000
Cost of goods sold	(4,000)	(4,000)
Gross profit	6,000	6,000
SG&A	(3,000)	(3,000)
EBIT	3,000	3,000
Finance income	0	10
Finance expenses	0	(1,010)
Profit before tax	3,000	2,000
Income tax	(900)	(600)
Profit	2,100	1,400

11. This characteristic of EBIT enables it to be used by investors in different types of analyses, such as:

    (a) Enterprise Discounted Cash Flows (DCF) models;

    (b) Multiples analysis; and

    (c) Ratio analysis.

The appendix provides more detail on these analyses.

Staff analysis of approaches to describing capital structure (used in description of finance income/expenses)

12. This section is set out as follows:

    (a) background (paragraph 13);

    (b) why have we used the term capital structure and what do we mean by it? (paragraphs 14-17);

    (c) approaches to describing capital structure (paragraphs 18-43);

        (i) Approach 1— Management's view;

        (ii) Approach 2— Strict definition; and

        (iii) Approach 3— Principles-based approach.

    (d) staff recommendation (paragraph 44).

Background

13. At the March 2017 Board meeting, we explained that many entities present EBIT or an EBIT-type operating profit calculated as profit before finance income/expenses and tax. We also noted that whilst we have not seen diversity in practice in the tax component, we have observed different entities classifying items differently in finance income/expenses. Therefore if we are to introduce a comparable EBIT subtotal, we will need to define finance income/expenses. As noted in paragraph 8, the EBIT subtotal is used by users of financial statements to compare the performance of entities independent of their capital structure. Accordingly, in March 2017 we proposed that we should define finance income/expenses in a way that helps this comparison (ie that finance income/expenses should be defined as income/expenses related to the entity's capital structure).

Why have we used the term capital structure and what do we mean by it?

14. At the March 2017 Board meeting, some Board members asked us to consider whether capital structure is an appropriate term to use, and, if so, justify our use of the term.

Our reasons for using the term

15. Capital structure is not defined in IFRS Standards. Some Board members queried why we are using a new term to define finance income/expenses, rather than a ‘financing’ notion (for example ‘financing activities’ is defined in IAS 7 *Statement of Cash Flows*). The staff think it is helpful to use a new term, at least initially, that is not restricted by the existing requirements for ‘financing activities’ in IAS 7 (however, we discuss how we might link capital structure to ‘financing activities’ in paragraphs 29-32).

16. The staff observe that some Board members may have concerns about introducing a new term—particularly one used widely in practice, which could have existing definitions or restrictions associated with it in some jurisdictions. For this reason, the staff suggest only that, for the moment, we consider the term capital structure to be a working title for the purposes of our discussions. An assessment of whether it is an appropriate term will be easier once we have discussed the different approaches for describing capital structure in the definition of finance income/expenses.

What do we mean by capital structure

17. The term ‘capital structure’ is widely used to refer to the way an entity finances its business. The capital structure of an entity is sometimes viewed narrowly as its equity and debt financing, with debt comprising some subset of the entity’s liabilities (possibly including related assets such as derivative assets). However, based on our research, capital structure is also often viewed as including excess cash and temporary investments of excess cash. This is because the way an entity manages such excess cash is interrelated with its decisions on debt and equity financing. For example, an entity might choose to invest excess cash temporarily rather than repay debt or return capital to shareholders, for example to retain liquidity or because there may be disadvantages in paying down debt at a particular time. In these cases, we think the

income on the temporary investments of excess cash should be recognised as finance income. As explained at the March 2017 Board meeting, the staff support this wider view of capital structure and based on our outreach during the project we think that such an approach is consistent with the views of many preparers and users[2]. However, we acknowledge that if we use the term capital structure we will need to consider how to describe this term.

Approaches to describing capital structure

18. The staff have identified three approaches that we could consider when describing capital structure:

    (a) **Approach 1—Management's view**: Management's view of what constitutes capital structure (with no or little guidance or constraints in IFRS Standards);

    (b) **Approach 2—Strict definition**: Prescribing what constitutes capital structure; and

    (c) **Approach 3—Principles-based approach**: Developing principles about what constitutes capital structure which management must follow in their determination of their entity's capital structure.

19. The staff have analysed these three approaches in turn below. We accept that no approach to describing capital structure will suit all users and some will wish to amend the information provided using their own view or model (and therefore we will want to ensure they are provided with the disaggregated information to do so). For this reason, the staff envisage that under each approach we would require the following:

    (a) line items that present both finance income and finance expenses separately in the statement(s) of financial performance (IAS 1 *Presentation of Financial Statements* currently requires a line item for finance cost/expenses but not finance income[3]);

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[2] for example, see Morgan Stanley, 'ModelWare (ver. 1.0): A Road Map for Investors', 2004, p. 50

[3] Paragraph 82(b) of IAS 1

(b) disaggregation of finance income and finance expenses either on the face of the statement(s) of financial performance or in the notes; and

(c) an explanation/table detailing what constitutes capital structure.

20. Additional notes:

(a) If the Board decides to allow or require the share of the profit or loss of associates/joint ventures to be presented below EBIT (see agenda paper 21E), we should consider whether we can still call our subtotal an EBIT subtotal or whether we should use another term, like 'business profit' to better represent the fact that for entities with investments in associates/joint ventures this subtotal is 'earnings before finance income/expenses, tax and share of results of associates/joint ventures'.

(b) We are only addressing the presentation and classification of amounts in the statement(s) of financial performance. Our proposals do not affect any recognition and measurement requirements, nor the determination of which items are presented in other comprehensive income (OCI), or recycled from OCI.

Alternative approach

21. At the March 2017 Board meeting, we briefly discussed an approach whereby the split above and below EBIT could be determined by the Board based on how some users use the information in the primary financial statements when valuing the business (ie whether they look at the flows from an item or value an item separately). The benefit of such an approach would be that we could avoid conceptual difficulties of trying to define or clarify terms such as 'capital structure' and 'financing activities'. Under this approach, the Board could identify those assets and liabilities that most users value separately[4] (for example, bank loans, investment property etc) and require a subtotal above the income/expenses arising from those items. Although, it is unlikely that we would be able to find a subtotal that draws the line in exactly the right place for most users, there will be some items that nearly all users value separately. If we exclude the income and expenses from those items from our subtotal,

[4] See appendix, paragraphs A2-A4.

it would prevent users having to do so before using that subtotal as a starting point for forecasting future free cash flows to value the entity's operations.

22. The staff have not developed this approach further in this paper for the following reasons:

    (a) it would not be consistent with our objective to provide a subtotal that facilitates comparisons of entities with different capital structures; and

    (b) we think it would be difficult to obtain sufficient information to identify the items that most users value separately and so we doubt that this approach would be feasible.

Approach 1—Management view

Description

23. Under this approach, management would determine what constitutes capital structure for their entity. The Board may wish to provide a high-level definition of capital structure (for example equity, debt, cash and temporary investments of excess cash) or it may wish to remain silent.

24. Currently most entities already determine a weighted average cost of capital (WACC), for example as a starting point for determining a discount rate for impairment testing under IAS 36 *Impairment of Assets*. In order for an entity to determine its WACC, it unavoidably needs an internal process to determine what constitutes both debt and equity. The debt and equity determined using this internal process could be included in the management view of capital structure. If the Board supports Approach 1, it could also provide additional discipline by requiring that an entity determines WACC and capital structure consistently.

Staff view of Approach 1

25. Information about what an entity manages as its capital structure and additional transparency about an entity's WACC calculation may provide useful information to users. However, our objective of introducing an EBIT subtotal is to try to provide a comparable subtotal for users. Management would have different views on what constitutes capital structure, and hence what is included in finance income/expenses. Therefore, the staff do not think Approach 1 would be consistent with this objective

and would be unlikely to result in significant improvements to current practice. Therefore, the staff have not developed this approach further.

Approach 2—Strict definition

Description

26. Under this approach the Board would prescribe what should be included in capital structure. For example, the Board could require that the following list of items comprises capital structure:

    (a) equity instruments issued by the entity;

    (b) bank loans;

    (c) bonds and commercial paper issued in capital markets;

    (d) lease liabilities;

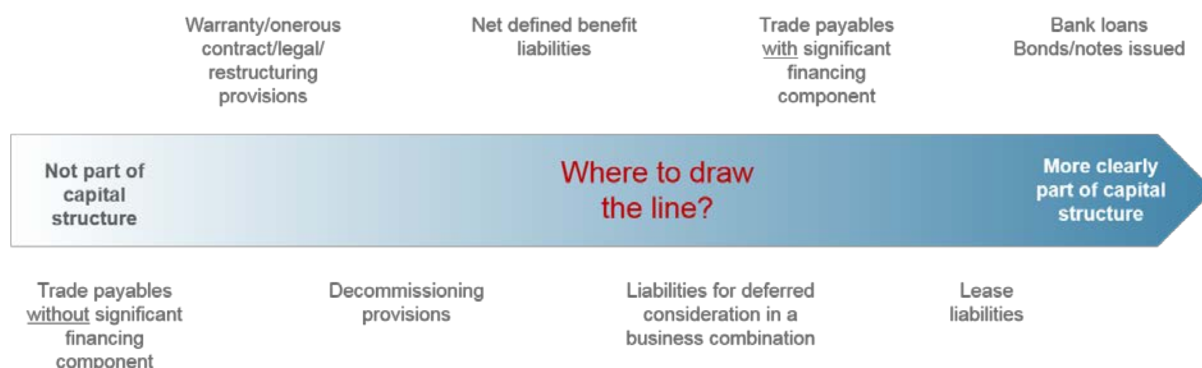
    (e) preference shares classified as liabilities;

    (f) accrued interest payable;

    (g) derivatives relating to items of capital structure;

    (h) cash and cash deposits; and

    (i) listed securities.



Staff view of Approach 2

27. A strict definition of finance income/expenses and capital structure would be consistent with our objective of introducing a comparable EBIT subtotal. However, the Board has had difficulties in the past trying to find a commonly agreed definition

of 'debt' or 'net debt', for example when developing the 2016 Amendments to IAS 7. Furthermore, if we define capital structure by providing a list of different assets or liabilities it may be difficult to ensure that the list is complete and would be applied consistently by entities. We may also need to adapt Approach 2 for different industries. The staff observe that if we develop clear principles (discussed in approach 3 below) we could achieve a similar, comparable outcome to Approach 2, whilst retaining a predominantly principles-based approach. Therefore, the staff have not developed Approach 2 further.

Approach 3—Principles-based approach (staff's preferred approach)

Description

28. Under this approach, the Board would develop principles about what should constitute capital structure for management to apply. We think that capital structure would include all equity instruments issued by the entity and so we do not think we need further principles for which equity instruments would be in capital structure. However, we would want to develop principles to determine which assets and liabilities would be in capital structure.

29. Paragraph 6 of IAS 7 defines financing activities as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. We think defining capital structure in relation to liabilities (and assets) arising from financing activities is a good starting point for developing principles over capital structure and is consistent with the Board's past decisions. Furthermore, the staff think it may cause difficulties if we deliberately decouple 'financing activities' which is defined in terms of equity and borrowings, from 'capital structure'.

30. Nevertheless, the IAS 7 definition of financing activities is broad and is subject to different interpretations by entities, primarily because the term 'borrowings' in the description is not defined.[5] Furthermore, because 'financing activities' is defined in terms of equity and borrowings, the staff does not think assets and liabilities arising from financing activities would include temporary investments of excess cash. As

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[5] Paragraph 5 of IAS 23 *Borrowing Costs* defines 'borrowing costs'. However, this definition is unclear because it provides a circular definition as follows (emphasis added): **Borrowing costs are** interest and other costs that an entity incurs **in connection with the borrowing of funds.**

explained in paragraph 17, the staff think the way an entity manages excess cash is interrelated with its decisions on capital structure (ie excess cash is 'negative' capital structure). Therefore, the staff think we should include cash and temporary investments of excess cash in capital structure (we will refer to both together as 'excess cash' in the rest of this paper).

31. Consequently, we think that if we follow a principles-based approach to defining capital we would need to:

(a) consider ways to ensure that 'financing activities' is interpreted consistently (discussed in paragraph 32); and

(b) include a principle for 'excess cash' (discussed in paragraphs 33-35).

Ways to ensure consistent interpretation of financing activities

32. The staff think we could consider one or more of the following methods to ensure that 'financing activities' is interpreted more consistently across entities:

(a) consider ways to clarify the current description of financing activities in IAS 7. At its March 2013 meeting,[6] the Interpretations Committee discussed how the definitions of operating, investing and financing cash flows in IAS 7 might be made clearer and could lead to a more consistent application. The Board could use the staff analysis presented to the Interpretations Committee as a starting point to clarify the definition of financing activities (considered further in Agenda Paper 21B).

(b) include a presumption that all liabilities arise from financing activities, unless specific criteria are met or the entity can justify otherwise.[7] Note, we think most assets do not arise from financing activities. Exceptions might include derivative assets relating to liabilities arising from financing activities.

(c) link financing activities to financial instruments. Ie only financial assets and financial liabilities as defined by IAS 32 *Financial Instruments:*

[6] See Agenda Paper 7 for the March 2013 IFRS Interpretations Committee meeting.

[7] When we consider financial institutions it might be more appropriate to have the opposite presumption, ie presume that all liabilities relate to operating activities, unless the entity can justify otherwise.

Presentation should be considered assets and liabilities arising from financing activities.

(d) prescribe that certain assets and liabilities arise from financing activities where there is likely to be diversity in practice.

Principle to cover temporary investments of excess cash ('excess cash')

33. We think the following might be ways of describing a principle to cover 'excess cash':

    (a) cash and cash equivalents (IAS 7 defines cash equivalents as 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);

    (b) cash, cash equivalents and other liquid investments (ie other investments that are readily convertible to a known amount of cash)[8]; or

    (c) allowing greater management judgement by providing a more flexible description, for example cash and other assets that are available to service liabilities arising from financing activities.

34. It is likely that some of the principles in paragraph 33 would be subject to different interpretations by entities, particularly paragraph 33(c). If we want greater consistency in how the principle is applied to achieve a more comparable EBIT subtotal, we could prescribe the treatment of some assets as investments of excess cash.

35. The above principles do not address the fact that some cash might not be available to settle liabilities because it is either needed in operations or restricted. However, we think that these portions of cash would be difficult to identify.

Alignment of 'financing' with the cash flow statement

36. If we define capital structure as equity, assets and liabilities arising from financing activities, and cash and cash equivalents, we may want to align the concept of 'financing' between the statement of cash flows and statement(s) of financial performance. However, if we allow a broader definition of 'excess cash' than cash and cash equivalents, we could have items of finance income in the statement(s) of

[8] Based on the explanation of short-term highly liquid investments in paragraph 7 of IAS 7.

financial performance where the related cash flows would currently be classified as investing activities in the statement of cash flows.

Advantages and disadvantages of Approach 3

37. The staff have identified the following as the key arguments for and advantages of Approach 3:

    (a) it would provide users with a relatively comparable starting point for analysis, whilst recognising that it is not possible to prescribe the treatment for all different assets and liabilities that may arise in practice, across all types of entity.

    (b) a principles-based approach would probably be easier to apply/adapt to more complex cases, such as financial institutions and conglomerates, than a strict definition (although the staff recognises that this needs to be investigated further and presented to the Board). All entities are already required to classify cash flows as financing activities in accordance with IAS 7 (although some are of the view that such a distinction is not meaningful for some entities such as financial institutions).

    (c) ASAF, CMAC and GPF members were generally supportive of the Board developing principles-based guidance for the presentation of subtotals in the statement(s) of financial performance, rather than prescriptive requirements.

    (d) a principle of identifying assets and liabilities arising from financing activities would be consistent with IAS 7, including the recent 2016 amendments to IAS 7. This approach may also lead to closer alignment of the concept of 'financing' between the statements of cash flows and financial performance.

38. The staff have identified the following as the key arguments against and disadvantages of Approach 3:

    (a) the interpretation of 'assets and liabilities arising from financing activities' and 'excess cash' would still require the use of some management judgement. Therefore, whilst there would be greater comparability between entities than under Approach 1, Approach 3 would still not lead to a

comparable EBIT subtotal unless we develop these principles further as suggested in paragraphs 32 and 33(a)-(b).

(b) if we provide additional requirements about what constitutes financing activities (see paragraph 32) this could have consequences for the requirements for the statement of cash flows in IAS 7. However, at the same time this could also lead to improvements in comparability between entities applying IAS 7. We will be discussing the elimination of some options for classification in the statement of cash flows at a future Board meeting and clarifying what we mean by financing activities may help us to do this. Similarly providing guidance on what constitutes borrowings could have implications for how entities interpret borrowing costs in accordance with IAS 23 *Borrowing Costs*. This is because borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds.

Staff view of Approach 3

39. Approach 3 is the staff's preferred approach for the reasons given in paragraph 37.

40. However, as noted in paragraph 31(a), if we adopt a principles-based approach that defines capital structure in terms of financing activities, we would need to consider ways to ensure that 'financing activities' is interpreted consistently if we want to have a comparable EBIT subtotal.

41. We do not support:

(a) including a presumption that all liabilities arise from financing activities (paragraph 32(b)) or only financial assets and financial liabilities arise from financing activities (paragraph 32(c)) because such a presumption would result in these assets and liabilities being treated as borrowings based on the current definition of financing activities (paragraph 29). However, the staff do not think that all of these assets and liabilities involve the 'borrowing' of cash/funds; and

(b) prescribing that particular items arise from financing activities (paragraph 32(d)), without clarifying what we mean by 'financing activities' or

‘borrowings’ because this would result in an approach that is almost identical to Approach 2.

42. Therefore the staff have not developed the methods described in paragraphs 32(b)-(d) further. Instead, we recommend clarifying the current description of financing activities (paragraph 32(a)). Agenda Paper 21B discusses how this might be achieved.

43. We recommend using ‘cash and cash equivalents’ as defined in IAS 7 as a proxy for an excess cash notion. Such an approach would result in comparability and help to achieve alignment with IAS 7. We think it would be difficult to incorporate judgement about what management considers to be excess cash if we want a comparable subtotal.

Staff recommendation

44. The staff recommend a principles-based approach to describing capital structure (Approach 3). We recommend:

    (a) defining capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents; and

    (b) clarifying the current description of financing activities.

    (The staff have developed this recommendation further in Agenda Paper 21B.)

Question for the Board
Does the Board provisionally agree with the staff recommendations in paragraph 44 (subject to discussions on Agenda Paper 21B)?

Appendix—How users use EBIT

A1. This appendix explains how users use EBIT in:

(a) Enterprise Discounted Cash Flows (DCF) models;

(b) Multiples analysis; and

(c) Ratio analysis.

Enterprise Discounted Cash Flow models

A2. Finance handbooks such as Koller et al. (2010)[9] recommend an Enterprise DCF model for valuation of entities (except for valuing banks), variations on which are used in practice. Investors using this model first forecast cash flows available to all capital providers (investors, lenders and other creditors) of an entity, ie its 'free cash flows'. Investors then discount the free cash flows using the weighted average cost of capital (WACC), thereby obtaining an entity's 'enterprise value'. Subsequently, the value of any non-equity financial claims is subtracted from the enterprise value to obtain the value of the entity's equity.

A3. Investors often use EBIT as a starting point for forecasting an entity's free cash flows, because free cash flows need to exclude the effect of the way an entity finances its business.

A4. Investors may value some assets separately and add them to the value obtained by discounting free cash flows to get to an entity's enterprise value. For example, an entity's share in some associates or joint ventures, equity investments in other non-controlled entities or investment properties could be valued separately.

Multiples analysis

A5. Investors also use multiples as a valuation method, or they use multiples to test the plausibility of the results obtained through DCF models. In contrast with DCF models, multiples are used to compare companies relative to their peers rather than

[9] Koller, T., Goedhart, M. and Wessels, D. (2010). *Valuation: Measuring and Managing the Value of Companies*. Hoboken, NJ: John Wiley & Sons.

to obtain an absolute valuation. Multiples are considered a less sophisticated valuation method than DCF models, but are often used because of their simplicity.

A6. The numerator and denominator of a multiple need to be consistently defined, ie they must relate to the same group of claimants. Two types of multiples can be distinguished[10]:

(a) enterprise multiples—enterprise value (EV, calculated by adding the value of non-equity claims to an entity's market capitalisation) divided by a metric that also relates to the entire enterprise, ie a metric that excludes any transactions with capital providers. Examples are: EV/Sales, EV/EBIT, EV/EBITA and EV/EBITDA.

(b) equity multiples—equity market value divided by a metric that is attributable to the entity's shareholders. Examples are: price/earnings (P/E) and price/book (P/B).

A7. Investors use EBIT as the denominator or as a starting point for calculating the denominator (after adjustments, eg for depreciation, amortisation and non-recurring items) for enterprise multiples. Although the P/E multiple is more widely used[11], enterprise multiples are preferred for comparing entities with different capital structures[12].

Ratio analysis

A8. Investors also use EBIT (with or without adjustments) as an input for calculating various ratios for comparative purposes between peer entities and over time. For example, interest coverage (EBIT/interest, or also EBITA/interest or EBITDA/interest) indicates an entity's ability to pay interest on its outstanding financial obligations.

[10] See UBS (2017). *Fundamental Equity Analytics, How to analyse and talk the language of multiples* and Citi Investment Research & Analysis (2015). *The Fundamentals: Equity Valuation*.

[11] Cascino et al. (2013), *The use of information by capital providers, EFRAG-ICAS Academic literature review*.

[12] UBS (2017), Citi Investment Research & Analysis (2015), Koller (2010).