STAFF PAPER

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Project	**Primary Financial Statements**
Paper topic	Management performance measures and subtotals similar to gross profit

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Purpose of the paper

1. The purpose of this paper is to discuss whether subtotals similar to gross profit that meet the definition of management performance measures (MPMs) should be exempt from the disclosure requirements for MPMs.

2. By 'subtotals similar to gross profit' we mean subtotals, such as net interest income and net rental income that:

   (a) are similar to gross profit—in that they typically represent the difference between (a type of) revenue and directly related expenses incurred in generating that revenue.

   (b) are presented by entities using the 'nature of expense' method for their primary analysis of operating expenses. Such subtotals do not strictly meet the Board's definition of gross profit as 'revenue minus cost of sales' because 'cost of sales' is a functional line item.

Summary of staff recommendations

3. The staff recommend the Board:

   (a) add ‘subtotals similar to gross profit’ to the list of subtotals that are not MPMs;

   (b) describe such subtotals as ‘typically representing the difference between (a type of) revenue and directly related expenses incurred in generating that revenue’; and

   (c) provide a non-exhaustive list of examples of subtotals ‘similar to gross profit’ and subtotals that are not considered ‘similar to gross profit’.

Structure of the paper

4. This paper is structured as follows:

   (a) Background (paragraphs 5–11)

   (b) What is the issue? (paragraphs 12–14)

   (c) Possible approaches (paragraphs 15–23)

   (d) Staff recommendation (paragraph 24)

   (e) Appendix—research on additional subtotals presented in accordance with paragraph 85 of IAS 1 *Presentation of Financial Statements* in the statement(s) of financial performance

Background

Management performance measures

5. The Board has tentatively defined an MPM as:

   > A subtotal of income and expenses that is used in public communications with users of financial statements, outside financial statements, and which, in management’s view

complements IFRS-defined totals or subtotals in communicating an entity's performance.

6. The Board has tentatively decided MPMs are subject to disclosure requirements as described in paragraph 24 of the appendix to the cover note—including:
   (a) a reconciliation between the MPM and the most directly comparable subtotal or total defined by IFRS Standards (see paragraph 7);
   (b) the income tax effect and non-controlling interests (NCI) effect for each item reconciling the MPM to the most directly comparable total or subtotal defined by IFRS Standards; and
   (c) narrative disclosures—including an explanation of how the MPM has been calculated and how the MPM provides useful information about an entity's financial performance.

7. The Board has tentatively decided the following totals and subtotals are not considered MPMs and are therefore exempt from the MPM disclosures:[1]
   (a) the subtotals required by paragraph 81A of IAS 1—including the proposed new required subtotals developed as part of this project;
   (b) profit before tax and profit from continuing operations;
   (c) gross profit—defined as revenue minus cost of sales; and
   (d) operating profit before depreciation and amortisation.

8. The totals and subtotals in paragraph 7 can be used as the most directly comparable subtotal or total defined by IFRS Standards for the purpose of the MPM reconciliation described in paragraph 6(a).

9. The Board exempted the measures in paragraphs 7(b)–7(d) from the MPM disclosures because it considered that the MPM disclosures for those subtotals would not be useful to users. For example, the Board included 'operating profit before depreciation

[1] This applies regardless of whether such measures are presented in the statement(s) of financial performance or in the notes.

and amortisation' in this list to avoid requiring the disclosure of the income tax and NCI effect for depreciation and amortisation.

Subtotals in the statement(s) of financial performance

10. Paragraph 85 of IAS 1 requires an entity to present additional subtotals—in addition to those listed in paragraph 81A of IAS 1—in the statement(s) of financial performance when such presentation is relevant to an understanding of the entity's financial performance. Paragraph 85A of IAS 1 includes requirements such additional subtotals must meet—including that they must be comprised of line items made up of amounts recognised and measured in accordance with IFRS Standards.

Interaction between MPMs and subtotals required by paragraph 85 of IAS 1

11. Applying the tentative Board decisions, there is an overlap between MPMs and subtotals required by paragraph 85 of IAS 1:
    (a) MPMs are presented as a subtotal in the statement(s) of financial performance only if they:
        (i) meet the requirements in paragraphs 85 and 85A of IAS 1. For example, some MPMs may not meet those requirements because they are not recognised and measured in accordance with IFRS Standards; and
        (ii) fit into the new structure of line items and subtotals of the statement(s) of financial performance—MPMs do not fit in the new structure if they disrupt the analysis of operating expenses by nature or by function, or if they adjust for items that are included in multiple sections (operating, investing and financing) of the statement(s) of financial performance. In addition, the Board has tentatively decided to prohibit the use of columns for the presentation of MPMs.[2]

[2] As a result of the restrictions on the presentation of MPMs described in paragraph 11(a), the staff expect that few MPMs will qualify for presentation in the statement(s) of financial performance.

(b) subtotals presented in accordance with paragraph 85 of IAS 1 other than those listed in paragraph 7 are MPMs if they meet the definition of an MPM, ie they:

(i) are used in public communications with users of financial statements, outside financial statements, to communicate the entity's performance; and

(ii) in management's view complement IFRS-defined totals or subtotals in communicating an entity's performance.

What is the issue?

12. When subtotals presented in the statement(s) of financial performance, other than those listed in paragraph 7, in accordance with paragraph 85 of IAS 1 meet the definition of an MPM, they are subject to the MPM disclosure requirements (see paragraph 6). For (some of) those subtotals, it could be argued that the MPM disclosures may not be useful because:

(a) for *all* subtotals, the line items in the statement(s) of financial performance provide a reconciliation to a subtotal or total defined by IFRS Standards.

(b) for *some* subtotals, such as subtotals similar to gross profit (as described in paragraph 2) like net interest income, there is no obvious 'most directly comparable subtotal or total defined by IFRS Standards' to reconcile to. Such subtotals could be reconciled to operating profit, but then the reconciling items would include items that users are unlikely to adjust for in calculating adjusted net profit or adjusted EPS measures, for example selling, general and administrative expenses. Users may therefore not be interested in the income tax and NCI effect for such items.

(c) for *some* subtotals, such as subtotals similar to gross profit, the purpose of the subtotal is straightforward and clear, so the narrative disclosures in paragraph 6(c) may not be useful and may result in boilerplate information.

13. Our analysis in the Appendix shows that the situation described in paragraph 12:

(a) is expected to be rare for non-financial entities—assuming current practice continues. This is because in current practice:

   (i) many entities present gross profit as an additional subtotal applying paragraph 85 of IAS 1. The Board has tentatively decided gross profit is not an MPM (see paragraph 7(c)).

   (ii) entities do not present other subtotals similar to gross profit.

(b) may be common for financial entities[3]—for example in current practice some banks and real estate investment companies present additional subtotals applying paragraph 85 of IAS 1, other than gross profit, that they also use in investor communications outside the financial statements.

14. In our view, the Board needs to consider amending its proposals to address this issue, at the very least for financial entities.

Possible approaches

15. We have considered the following approaches:

(a) Approach A—stating that subtotals presented in the statement(s) of financial performance in accordance with paragraph 85 of IAS 1 are not MPMs (paragraphs 16–17);

(b) Approach B—adding ‘subtotals similar to gross profit’ to the list of subtotals that are not MPMs (paragraphs 18–20); and

(c) Approach C—adding specific subtotals to the list of subtotals that are not MPMs (paragraphs 21–23).

Approach A—IAS 1.85 subtotals are not MPMs

16. Applying Approach A any subtotal that meets the conditions described in paragraph 11(a) and is presented in the statement(s) of financial performance would not be treated as an MPM. The advantage of Approach A is that it simplifies the relationship,

[3] As defined in paragraph 16 of the appendix to the cover note.

described in paragraph 11, between MPMs and subtotals presented in the statement(s) of financial performance.

17. The disadvantages of Approach A are that:

    (a) it may scope out measures from the MPM disclosures for which the MPM disclosures would be useful. While a reconciliation may be unnecessary for subtotals presented in the statement(s) of financial performance (see paragraph 12(a)), other MPM disclosures including the tax and NCI effect may still provide useful information for some subtotals. For example, an entity could present an 'operating profit before amortisation of intangible assets acquired in business combinations and impairment of goodwill' subtotal in the statement(s) of financial performance when it presents its primary analysis of expenses by nature. The disclosures described in paragraphs 6(b) and 6(c) may be useful for such measures.

    (b) it may encourage entities to include measures as subtotals in the statement(s) of financial performance to avoid the MPM disclosures. This would put pressure on the requirements that restrict which subtotals can be presented in the statement(s) of financial performance (see paragraph 8(b)).

    (c) while this approach simplifies the requirements for MPMs and subtotals, we note that it would not entirely replace the requirements in paragraph 7 (the list of subtotals that are not MPMs) because paragraph 7 applies to measures presented in the statement(s) of financial performance *or in the notes*. For example, the requirements in paragraph 7 are still needed to ensure that entities that disclose 'operating profit before depreciation and amortisation' only in the notes would not be required to provide MPM disclosures for that measure.

Approach B—adding 'subtotals similar to gross profit' to the list of subtotals that are not MPMs

18. Approach B would involve adding 'subtotals similar to gross profit' to the list of subtotals that are not MPMs (see paragraph 7). The aim of this approach is to narrow the relief from the MPM disclosures to the population of subtotals for which such

disclosures are not useful (see paragraphs 12(b) and 12(c)). The Board could provide a description of ‘subtotals similar to gross profit’ as ‘typically representing the difference between (a type of) revenue and directly related expenses incurred in generating that revenue’.

19. The advantage of Approach B is that it is more targeted than Approach A, focusing on a set of subtotals for which the issues in paragraphs 12(b) and 12(c) are likely to arise. Approach B is therefore less likely to have unintended consequences—that is, a loss of useful information for users—than Approach A.

20. The disadvantage of Approach B is that entities may interpret the notion of ‘subtotals similar to gross profit’ differently. There is a risk that entities may argue that any subtotals above operating profit are ‘similar to gross profit’ to avoid MPM disclosures, even when such disclosures are useful (see example in paragraph 17(a)).

Approach C—adding specific subtotals to the list of subtotals that are not MPMs

21. This approach would consist of adding specified subtotals to the list of subtotals that are not MPMs (see paragraph 7). For example, the following measures could be included in that list (see paragraphs A5–A8 of the Appendix):

(a) net interest income;

(b) net fee and commission income;

(c) insurance service result;

(d) net financial result (investment income minus insurance finance expenses); and

(e) net rental income.

22. The advantages of Approach C are:

(a) it focuses on common subtotals for which the MPM disclosures are unlikely to be useful (see paragraphs 12(b) and 12(c))—including net interest income; and

(b) it clearly identifies the subtotals the requirement applies to.

23. The disadvantages of Approach C are that:

(a) it is a rules-based approach:

(i) the list of subtotals may not capture all subtotals for which MPM disclosures are not useful. For example, entities may present variants of the subtotals listed in paragraph 21 (for example see findings for banks in paragraph A7); and

(ii) the list may need to be updated periodically to reflect new business models or reporting practices.

(b) it could be argued the list in paragraph 7 should only include subtotals that the Board has defined or described. We could describe these subtotals, for example net interest income could be described as interest revenue minus interest expense. However, such an approach may give rise to questions about what should be included in the interest expense line item, which is something the Board is not addressing as part of this project.

Staff recommendation

24. We recommend Approach B because:

(a) unlike Approach A, it is a targeted approach which means the risk of unintended consequences is likely to be lower.

(b) unlike Approach C, it is a principles-based approach.

25. We think we can manage the issue in paragraph 20 by:

(a) stating that not all subtotals above operating profit are similar to gross profit;

(b) providing a non-exhaustive list of examples of 'subtotals similar to gross profit' such as net interest income, insurance service result and net rental income; and

(c) providing a list of examples of subtotals that are not considered 'similar to gross profit', such as 'operating profit before amortisation of intangible assets acquired in business combinations and impairment of goodwill'.

Question for the Board
Does the Board agree with the staff recommendation to: (a) add ‘subtotals similar to gross profit’ to the list of subtotals that are not MPMs; (b) describe such subtotals as ‘typically representing the difference between (a type of) revenue and directly related expenses incurred in generating that revenue’; and (c) provide a non-exhaustive list of examples of subtotals ‘similar to gross profit’ and subtotals that are not considered ‘similar to gross profit’?

Appendix—research on additional subtotals presented in accordance with paragraph 85 of IAS 1 in the statement(s) of financial performance

A1. We have analysed which additional subtotals entities present in the statement(s) of financial performance in accordance with paragraph 85 and 85A of IAS 1 for a sample of 100 entities (see column 'Companies presenting IAS 1.85 subtotals' in tables below). We have only considered subtotals that entities may continue to present in the statement(s) of financial performance applying the Board's tentative decisions and that could meet the definition of an MPM—meaning we excluded from our analysis:

(a) subtotals that would no longer fit in the statement(s) of financial performance applying the Board's tentative decisions, such as 'recurring operating profit' or 'operating profit including share of *operating profit* of associates and joint ventures' (that is, operating profit as if proportional consolidation had been applied);

(b) subtotals that are likely to be replaced by the Board's defined subtotals in the statement(s) of financial performance when applying the Board's tentative decisions, such as measures labelled 'operating profit'; and

(c) subtotals that are an aggregation of mostly income *or* mostly expenses, such as 'total operating expenses', which would not meet the definition of an MPM as a 'subtotal of income *and* expenses'.

A2. In addition, we analysed which of those subtotals may meet the definition of an MPM in the last two columns of the tables below:

(a) 'companies using IAS 1.85 subtotals in annual report outside F/S' represents the number of companies that use the subtotals presented in the statement(s) of financial performance in the annual report outside the financial statements; and

(b) 'companies using IAS 1.85 subtotals *prominently* in annual report outside F/S' represents a subset of (a), that is, companies that present such subtotals in a list of key performance indicators discussed on the first few pages of the annual report.

A3. We expect the number of subtotals that meet the definition of an MPM will be in the range between the number of those in A2(a) and A2(b).

Non-financial entities

A4. The following table summarises the findings by industry:

Number of companies in sample		Companies presenting IAS 1.85 subtotals		Companies using IAS 1.85 subtotals in annual report outside F/S	Companies using IAS 1.85 subtotals *prominently* in annual report outside F/S
Healthcare	10	Gross profit	9	6	2
Industrials	10	Gross profit	5	5	0
		Operating profit before D&A	1	1	1
		Operating profit before A	1	1	0
Materials	10	Gross profit	6	2	2
Consumer staple	10	Gross profit	4	2	1
Consumer discretionary	10	Gross profit	6	3	1
		Operating profit before D&A and provision expense	1	1	1
Energy	10	Gross profit	4	2	0
IT	10	Gross profit	6	4	2
Telecom	5	Gross profit	2	1	1
Utilities	5	Gross profit	2	1	1

Financial entities

A5. 'Financial entities' as defined in this project (see paragraph 16 of the appendix to the cover note) include entities such as banks, real estate investment companies, insurers and conglomerates with a financing arm. [4] The following table summarises the findings for the first two types of financial entity:

Number of companies in sample		Companies presenting IAS 1.85 subtotals		Companies using IAS 1.85 subtotals in annual report outside F/S	Companies using IAS 1.85 subtotals *prominently* in annual report outside F/S
Real estate investment entities (see para. A6)	10	Net rental income	3	3	1
		Gross profit	2	0	0
		Gross profit for each activity	2	2	1
		Profit on disposal of investment properties	3	2	1
		Other subtotals	3	1	0
Banks (see para. A7)	10	Net interest income	8	7	2
		Net fee and commission income	4	4	2
		Operating income	3	3	2
		Operating income before credit losses	8	7	6
		Operating profit before credit losses	3	3	2
		Net interest income after credit losses	1	1	0

[4] The few conglomerates included in our sample present similar subtotals as non-financial entities. Such conglomerates have been included in the table for non-financial entities, classified using the conglomerates' primary industry classification.

Real estate investment companies

A6. We found that real estate investment companies in our sample present the following types of subtotals above operating profit:

(a) net rental income—usually defined as gross rental income plus service fees earned minus direct property operating expenses;[5]

(b) gross profit;

(c) separate subtotals similar to gross profit for each business activity or segment, such as ‘net income from retirement living; and

(d) profit or loss on sale of investment property—calculated as sales proceeds minus the carrying amount of the investment property.

Banks

A7. We found that banks in our sample present the following types of subtotals above operating profit (see simplified examples below):

(a) net interest income.

(b) net interest income after credit losses.

(c) net fee and commission income.

(d) a subtotal calculated as the sum of net interest income, net fee and commission income, gains and losses on various financial instruments, other income and credit losses (see example 2). Some entities in the sample label this subtotal ‘operating income’.

(e) operating income as described in (d) before credit losses (see examples 1 and 2). Some entities in the sample label this subtotal ‘revenue’.

(f) operating profit (that is, operating income as described in (d) minus operating expenses such as employee benefits) before credit losses (see example 1).

[5] For example the European Public Real Estate Association has guidance on the definition of net rental income.

Banks—Example 1	
Interest income	1000
Interest expenses	(900)
Net interest income	100
Fee and commission income	500
Fee and commission expenses	(400)
Net fee and commission income	100
[gains/losses on various financial instruments and other income]	150
Operating income before loan impairment losses	350
[operating expenses such as employee benefits]	200
Operating profit before loan impairment losses	150
Loan impairment losses	(50)
Operating profit	100
Share of profit of associates and joint ventures	30
Profit or loss	**130**

Banks—Example 2	
Interest income	1000
Interest expenses	(900)
Net interest income	100
Fee and commission income	500
Fee and commission expenses	(400)
Net fee and commission income	100
[gains/losses on various financial instruments and other income]	150
Operating income before loan impairment losses	350
Loan impairment losses	(50)
Operating income	300
[operating expenses such as employee benefits]	200
Operating profit	100
Share of profit of associates and joint ventures	30
Profit or loss	**130**

Insurers

A8. We have not analysed subtotals presented by insurers, because we expect the structure and content of insurers' statement(s) of financial performance will change when IFRS 17 *Insurance Contracts* is implemented. The Effects Analysis accompanying IFRS 17 includes an example of the statement(s) of financial performance showing two subtotals—'insurance service result' and 'net financial result' (see example below). [6] If presented, these subtotals would be presented above operating profit applying the Board's tentative decisions.

Insurance revenue	550
Incurred claims and other expenses	(520)
Insurance service result	30
Investment income	250
Insurance finance expenses	(191)
Net financial result	59
Profit or loss (or operating profit)	**89**

[6] See page 83 of the IFRS 17 Effects Analysis.