IFRS

STAFF PAPER

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Project	Primary Financial Statements		
Paper topic	Descriptions of subtotals		
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Purpose of this paper

1. This Agenda Paper discusses whether the term:
   (a) 'operating profit' should be used to describe either the 'business profit from consolidated entities' subtotal or the 'profit before income/expenses from investments, finance income/expenses and income tax' subtotal; and
   (b) 'EBIT' should be used to describe the 'profit before finance income/expense and income tax' subtotal.

2. IAS 1 *Presentation of Financial Statements* gives entities permission to amend the labels of financial statements and the line items and subtotals presented in the primary financial statements (see paragraphs 5, 10, 57(b) and 86 of IAS 1). Consequently, entities will be able to amend any descriptions of the new subtotals the Board is proposing. We however think it is important to discuss the description of the new subtotals for two reasons:
   (a) it is likely that most entities will use the titles and descriptions the Board uses; and
   (b) the titles the Board uses to describe subtotals cannot be used to describe anything else in the financial statements, for example a management performance measure (MPM).

Summary of staff recommendations

3. The staff recommend that:

   (a) the subtotal previously described as ‘business profit from consolidated entities’ should be described as ‘operating profit or loss’;

   (b) the subtotal previously described as ‘profit before income/expenses from investments, finance income/expenses and income tax’ should be described as ‘operating profit or loss and share of profit or loss of integral associates and joint ventures’;

   (c) the subtotal previously described as ‘profit before finance income/expense and income tax’ should be described as ‘profit or loss before financing and income tax’; and

   (d) entities should be prohibited from using the term ‘EBIT’ to describe the subtotal ‘profit or loss before financing and income tax’.

Overview

4. The paper is structured as follows:

   (a) Background (paragraphs 5-7)

   (b) Issue 1—Operating profit (paragraphs 8-29):

      (i) Should we describe one of the proposed subtotals as operating profit? (paragraphs 15-17)

      (ii) Which subtotal should be described as operating profit? (paragraphs 18-27)

      (iii) Should we change the description of the ‘profit before income/expenses from investments, finance income/expense and income tax’ subtotal? (paragraphs 28-29)

   (c) Issue 2—EBIT (paragraphs 30-46):

      (i) Should we use the term ‘EBIT’ to describe the ‘profit before finance income/expense and income tax’ subtotal? (paragraphs 32-34)

(ii) Can the term EBIT be used to describe other measures of performance? (paragraphs 35- 39)

(iii) What description should we use for the 'profit before finance income/expenses and income tax' subtotal? (paragraphs 40-46)

(d) Appendix: illustrations of proposals

Background

5. The Board tentatively decided to require three new IFRS-defined subtotals in the statement(s) of financial performance.

6. We are currently describing:

(a) two of the subtotals generally based on the income/expenses they exclude, ie:

(i) profit before finance income/expenses and income tax; and

(ii) profit before income/expenses from investments, finance income/expenses and income tax.

(b) the third subtotal as 'business profit from consolidated entities'.

7. In November 2017 (AP 21A), the Board discussed using the term 'operating profit' to describe one of the subtotals. However, the Board tentatively decided not to use this term for the subtotal it was then considering. Some Board members suggested it was difficult to reach a decision about the use of the term 'operating profit' because, at that time, the Board had not reached a tentative decision regarding the presentation of the share of profit or loss of associates and joint ventures.

Issue 1—Operating profit

8. Prior to 2003, IAS 1 required entities to present the results of operating activities in the statement of profit or loss. However, when IAS 1 was revised in 2003, that requirement was removed. The reason given was that 'Operating activities' are

not defined in IAS 1, and the Board decided not to require disclosure of an undefined item.[1]

9. The Basis for Conclusions on IAS 1 includes the following discussion about entities that decide to present an operating profit subtotal (emphasis added):

> BC56 The Board recognises that an entity may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would **normally be regarded as 'operating'**. In the Board's view it would be misleading and would impair the comparability of financial statements **if items of an operating nature were excluded from the results of operating activities**, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation or amortisation expenses.

10. One of the first tasks the Board gave staff on this project was to explore whether to define operating profit. A definition of operating profit was considered important because operating profit is one of the most widely used measures of performance. Recent staff research found that, of 85 entities analysed, 58 included a measure of operating profit (or a similar label such as 'profit from operating activities' or 'profit from operations') in their statement(s) of financial performance. However, there is a diversity in practice in what entities include in this measure, in particular in:

    (a) whether the share of profit or loss from joint ventures and associates is considered a part of the operating profit (see paragraphs 22-23); and

    (b) whether interest on defined benefit plans is considered a part of the operating profit or included within the finance costs.

11. Many of our stakeholders have suggested that we should define operating profit. For example, CMAC and GPF members encouraged the Board to require in the

[1] See BC55 of Basis for Conclusions on IAS 1.

statement of profit or loss subtotals, such as operating profit and EBIT. [2] Some ASAF members encouraged the Board to explore describing the subtotal above the 'income/expenses from investments' category as 'operating profit'.[3]

12. The Board has tentatively decided not to attempt to positively define an operating profit subtotal. Although many stakeholders including users supported the idea, the Board's initial research suggested that it would be difficult to develop a definition that would work well without defining what items are not included in the operating profit.

13. Therefore, the Board focussed on defining categories of income/expense and the proposed subtotals, working up from the profit or loss for the period, and tentatively decided to require entities to present three new subtotals:

    (a) profit before finance income/expenses and tax;

    (b) profit before income/expenses from investments, finance income/expenses and tax; and

    (c) business profit from consolidated entities.

14. In the course of developing these categories, the Board discussed, and decided against, describing one of them as operating. However, as the Board has further developed its proposals and added a proposal for the business profit from consolidated entities subtotal, we think it would now be useful to reconsider whether we should describe one of the proposed subtotals as operating profit or loss and, if so, which one.

Should we describe one of the proposed subtotals as operating profit or loss?

15. Incorporating 'operating profit or loss' into IFRS terminology and assigning it to an IFRS-defined subtotal would mean that one of the most commonly used descriptions for a measure of financial performance could only be used to present a measure that is defined in IFRS Standards and is comparable across entities. In other words, entities would not be allowed to use the description 'operating profit

[2] Refer to June 2016 Joint CMAC-GPF meeting.

[3] Refer to December 2017 ASAF meeting.

or loss' for entity specific measures that may not be comparable across entities, for example MPMs. Such measures could then only be described using terms such as 'adjusted operating profit'.

16. There are also disadvantages to describing one of the proposed subtotals as operating profit:

(a) the subtotal selected may include items of income or expense that some stakeholders do not consider to be a part of operating profit, or vice versa.[4]

(b) this approach is not responsive to those stakeholders who would have liked the Board to positively define operating profit and not as a residual.

17. Overall, the staff think the advantages of using the term 'operating profit' to describe a comparable measure of financial performance defined by the Board outweigh the disadvantages.

Question 1
Does the Board agree to use the term 'operating profit' to describe one of the proposed subtotals in the statement(s) of financial performance?

Which subtotal should be described as operating profit?

18. In the staff's view, two of the proposed subtotals, 'business profit from consolidated entities' and 'profit before income/expenses from investments, finance income/expenses and income tax' come close to the common notion of an operating profit. However, we believe that allowing entities to describe either one of them as 'operating profit' would be confusing and not result in the comparability we want to achieve.

19. As the only difference between the two subtotals is the share of profit or loss from integral associates and joint ventures, the question we need to answer is whether

[4] See paragraph 51 of September 2017 AP 21A.

operating profit should include the share of profit or loss from integral associates and joint ventures.

20. The staff did not consider describing the subtotal 'profit before finance income/expenses and income tax' as operating profit. This subtotal includes income earned independently of the main activities of the entity which we think cannot be faithfully described as a measure of operating performance.

What is the current practice?

21. In our review of financial statements of 85 entities across a range of industries and geographies, we identified 42 entities that present both:

    (a) operating profit; and

    (b) the share of profit or loss from joint ventures and associates.

22. Of those 42 entities;

    (a) thirty-one (74%) present the share of profit or loss of associates and joint ventures below operating profit;

    (b) ten (24%) present the share of profit or loss of associates and joint ventures within operating profit; and

    (c) one (2%) presents 'operating profit before entity-accounted entities' and 'operating profit after equity-accounted entities'.

23. We did not observe any industry or geography trends in this analysis.

Staff analysis

24. Many users seek to analyse the results of investments in associates and joint ventures separately from the results of an entity's operating activities. This is because:[5]

    (a) the activities of associates and joint ventures are not controlled by the entity; and

    (b) the results of associates and joint ventures are of a different 'quality' because:

[5] See paragraph 14 of January 2018 AP 21B

(i) the results of associates and joint ventures are a blend of different amounts (ie, business, investing, financing and tax amounts of the investee);

(ii) associates and joint ventures make no contribution to revenue, so revenue-based margins that include the results from associates and joint ventures are distorted.

25. In addition, the staff's analysis of current practice (paragraph 23) suggests that most, but not all, preparers do not consider the share of profit or loss from joint ventures and associates to be a part of their operating profit.

26. Finally, including the results of integral associates or joint ventures in operating profit might create an incentive to classify profit-making associates and joint ventures as integral. This would put pressure on the indicators[6] that the Board developed to help preparers determine whether an associate or joint venture is integral.

27. Consequently, the staff think that the subtotal that excludes the share of profit or loss of associates and joint ventures (ie the 'business profit from consolidated entities' subtotal) should be described as operating profit.

Question 2
Does the Board agree to describe the 'business profit from consolidated entities' subtotal as operating profit?

Should we change the description of the 'profit before income/expenses from investments, finance income/expenses and income tax' subtotal?

28. The staff think that the description 'profit before income/expenses from investments, finance income/expenses and income tax' does not work well because some users may associate the description of this subtotal with operating profit. Consequently, it may be confusing to see both a subtotal described as operating profit as well as a subtotal described as profit before income/expenses from investments, finance income/expenses and income tax.

[6] Refer to IASB Update September 2018.

29. Since the only difference between this subtotal and the operating profit subtotal (if the Board agrees with the staff recommendation in previous section to describe business profit from consolidated entities as operating profit) is the share of profit or loss from integral associates and joint ventures, we think that a clearer description for this subtotal could be 'operating profit **and** share of profit or loss of integral associates and joint ventures'. This description has three potential benefits:

(a) the proposed description reflects how the subtotal is related to operating profit;

(b) the proposed description is more concise and clearer than 'profit before income/expenses from investments, finance income/expenses and income tax' which makes the subtotal easier to understand and use; and

(c) the link to operating profit may reduce the concerns of those preparers who would like to include their share of profit or loss of integral associates and joint ventures in operating profit.

Question 3
Does the Board agree with the staff recommendation that the 'profit before income/expenses from investments, finance income/expenses and income tax' subtotal should be described as 'operating profit and share of profit or loss of integral associates and joint ventures'?

Issue 2—EBIT

30. The Board identified EBIT as one of the most commonly used subtotals[7] and decided to define a subtotal that would represent a measure of profit before the effect of financing and tax. That measure is the proposed 'profit before finance income/expenses and income tax' subtotal.

[7] The staff have recently analysed the financial statements of 85 entities and found that 12 of those entities include an EBIT-type measure of performance (using a number of same or similar descriptions) in their statement(s) of financial performance

31. The Board has not yet discussed whether to describe profit before finance income/expenses and income tax as EBIT (the issue was raised in September 2017 AP 21 but was not discussed during the Board meeting) and we address this now.

Should we use 'EBIT' to describe the 'profit before finance income/expenses and income tax' subtotal?

32. As with operating profit, using EBIT to describe the 'profit before finance income/expenses and income tax' subtotal would mean that one of the most commonly used descriptions for a measure of financial performance could only be used to present a measure that is defined by IFRS Standards and is comparable across entities. In other words, entities would not be allowed to use the description 'EBIT' for entity specific measures, for example MPMs. Such measures could for example be described as 'adjusted EBIT'.

33. However, unlike with operating profit, the staff think that the disadvantages of using the term EBIT outweigh the advantages because:

    (a) EBIT means earnings before interest and tax, and the term 'earnings' is generally not used in IFRS terminology (except in IAS 33 *Earnings per Share*), and

    (b) the description 'earnings before interest and tax' does not faithfully represent the Board's definition of items excluded from the 'profit before finance income/expenses and income tax'. We think the description would be misleading if used to describe the proposed subtotal because it implies all interest is excluded from the subtotal, and the subtotal only excludes interest and tax. This is not how the Board has defined the proposed subtotal. For example:

        (i) most interest income, except for interest on cash and cash equivalents, would be included above the subtotal.

        (ii) the Board has tentatively decided that some entities with more than one business activity would present interest expense relating to their business activities above this subtotal.[8]

(iii) the subtotal excludes all expenses from financing activities, including exchange rate differences and transaction costs.

34. The staff therefore recommend that the Board prohibits the use of the term 'EBIT' to describe the subtotal 'profit before finance income/expenses and income tax'.

Question 4
Does the Board agree that entities should be prohibited from using the term 'EBIT' to describe the subtotal 'profit or loss before finance income/expense and income tax?

Can 'EBIT' be used to describe other measures of performance?

35. If the Board agrees to prohibit the use of EBIT to describe the defined subtotals, entities could use this description elsewhere, for example, to describe MPMs.

36. The Board's tentative decisions on MPMs require that MPMs should be labelled in a clear and understandable way so as not to mislead users. The Board also clarified that MPMs provide additional information that complements the subtotals required by paragraph 81A of IAS 1, rather than provide a better view of financial performance.

37. By requiring the labels to be not misleading, the staff think that it follows that the label should faithfully represent what is included in the measure. Therefore, we think that the term EBIT can only be used to describe an MPM when the MPM is a 'true' EBIT, ie it is equivalent to profit or loss, plus all interest and income tax items. If items such as restructuring and relocation expenses are added back we do not think such a subtotal would be faithfully represented by the EBIT label. Our research suggests that alternative performance measures often adjust for items considered to be infrequent, and as such could not be faithfully described as EBIT.

38. Nevertheless, entities could use modified forms of EBIT to describe their MPMs, such as 'adjusted EBIT', if such a description faithfully represents the MPM.

[8] Refer to IASB Update September 2018.

39. The staff therefore propose to clarify that a label can only be used to describe an MPM when the label faithfully represents the measure, meaning that an EBIT label can only be used to describe a measure that has been calculated as profit or loss plus all interest income/expenses and income tax expense.

Question 5
Does the Board agree to clarify that a label can only be used to describe an MPM when the label faithfully represents the measure, and that therefore an EBIT label can only be used to describe a measure that has been calculated as profit or loss plus all interest income/expense and income tax income/expense?

What description should we use for ‘profit before finance income/expenses and income tax’?

40. The description ‘profit before finance income/expense and income tax’, although attempting to capture income and expenses that are excluded from the subtotal, has some of the same disadvantages associated with using the EBIT label for the subtotal. In order words, it does not describe the subtotal faithfully. For example, the subtotal is likely to include income from most financial assets (as a reminder, the investing category would include most of the income from financial assets of a non-financial entity).

41. As per the Board’s proposals, income and expenses excluded from the profit before finance income/expense and income tax subtotal are:

    (a) interest income from cash and cash equivalents calculated using the effective interest method;

    (b) other income from cash, cash equivalents and financing activities;

    (c) expenses from financing activities; and

    (d) finance income and expenses not arising from financing activities, for example unwinding of discount (the descriptions of proposed minimum line items will be discussed at future Board meeting).

42. Because the current description does not faithfully represent items excluded from the subtotal, the staff think we should use a different description for this subtotal. There are two approaches we can consider:

(a) Approach A: direct approach—describe what the subtotal includes, for example profit or loss from operating and investing activities;

(b) Approach B: residual approach—describe what the subtotal excludes, for example, profit or loss before financing and income tax.

43. The staff think both approaches provide a better description of which income/expenses are included or excluded from the subtotal than the current description of profit before finance income/expenses and income.

44. However, we acknowledge that Approach B may not provide a faithful description of the subtotal in some circumstances because the subtotal also excludes finance income and expenses which do not arise from financing activities (for example, the unwind of a discount on a pension asset/lability or a long-term provision).

45. The staff think Approach A faithfully describes the subtotal. However, entities that have material share of profit or loss from integral joint ventures and associates would need to describe the subtotal as ‘profit from operating and investing activities, and share of profit or loss from integral joint ventures and associates’ or similarly. This might be considered too long description. Also, we think description in the Approach A is more difficult to understand than Approach B. This is because we think that it may not be clear that interest expense and income taxes are the most significant items excluded from the ‘profit or loss from operating and investing activities’.

46. Overall, the staff think that understandability of Approach B outweigh its disadvantage. The staff thinks that, in practice, entities that have significant finance income and expenses that do not arise from financing activities could amend the description of the subtotal to reflect this, consistent with the general approach in IAS 1 to allow amending the description in order to provide the most relevant information (discussed in paragraph 2).

Question 6
Does the Board agree with the staff recommendation that the ‘profit before finance income/expenses and income tax’ subtotal should be described as ‘profit or loss before financing and income tax’?

Appendix: Illustrations of proposals

Current descriptions of the proposed subtotals **Statement of Financial Performance**	
Revenue	X
Cost of sales	X
Gross profit	**X**
SG&A expense	X
Business profit from consolidated entities	X
Share of profit from integral associates and joint ventures	X
Profit before income/expense from investments, finance income/expenses and income tax	X
Share of profit of other associates and joint ventures	X
Change in fair value of financial assets	X
Dividends received on equity investments	X
Profit before finance income/expenses and income tax	X
Interest income from cash and cash equivalents calculated using the effective interest method	X
Other income from cash and cash equivalents and financing activities	X
Expenses from financing activities	X
Net interest cost on net defined benefit liability	X
Profit before tax	X
Income tax expense	X
Profit for the period from continuing operations	X
Loss from discontinued operations	X
Profit for the period	X

The descriptions of subtotals as per staff proposals in this paper **Statement of Financial Performance**	
Revenue	X
Cost of sales	X
Gross profit	**X**
SG&A expense	X
Operating profit	X
Share of profit from integral associates and joint ventures	X
Operating profit and share of profit from integral associates and joint ventures	X
Share of profit of other associates and joint ventures	X
Change in fair value of financial assets	X
Dividends received on equity investments	X
Profit before financing and income tax	X
Interest income from cash and cash equivalents calculated using the effective interest method	X
Other income from cash and cash equivalents and financing activities	X
Expenses from financing activities	X
Net interest cost on net defined benefit liability	X
Profit before tax	X
Income tax expense	X
Profit for the period from continuing operations	X
Loss from discontinued operations	X
Profit for the period	X