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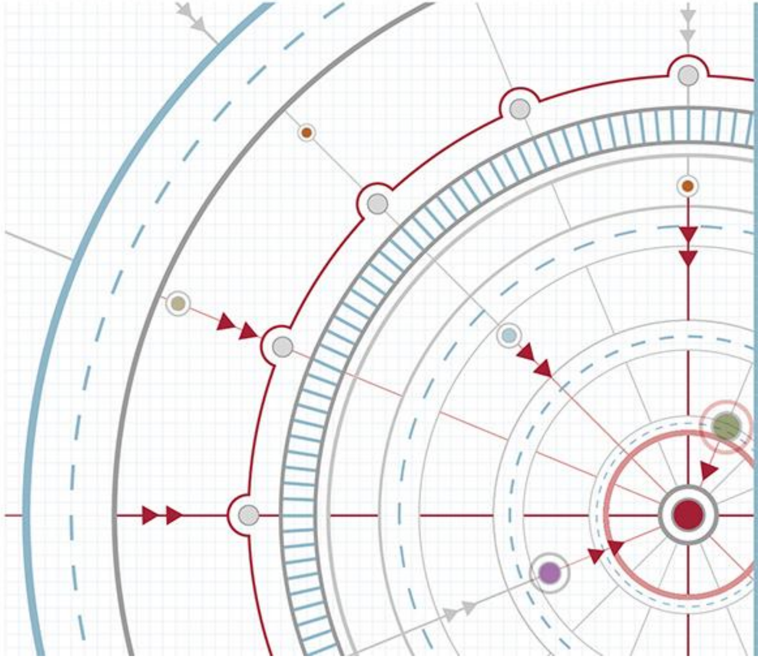


What is ‘Interest’ in EBIT?

Research forum

November 2017

The views expressed in this presentation are those of the presenter,
not necessarily those of the International Accounting Standards Board (the Board) or
IFRS Foundation.

Background

Hans Hoogervorst stated on 11th May 2016:

"We probably need to define more subtotals in the income statement. We may need to provide a principle-based definition of operating income which does not allow for obfuscating restructuring or impairment charges. We may need to create a rigorous definition of the commonly used non-GAAP metric EBIT. We may have to do all of the above—and maybe more."

Background

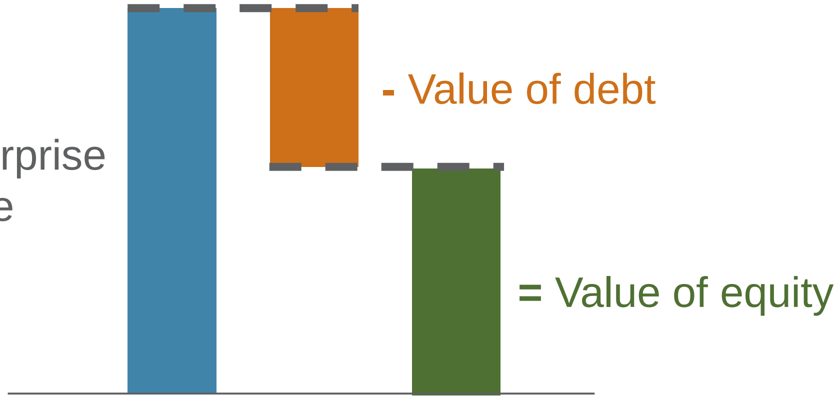
Since then the Board:

- has tentatively decided to require the presentation of at least one performance subtotal (EBIT) in the statement(s) of financial performance
- has tentatively decided to define the subtotal as profit before finance income/expenses and tax
- has been working on how to best describe finance income/ expenses

Background: Why is EBIT useful?

- Enterprise Discounted Cash Flows (DCF) models

EBIT → Forecast of **free cash flows** = cash flows available to all capital providers (investors, lenders and other creditors) → Enterprise value



- Multiples analysis: Enterprise value/EBIT
- Ratio analysis: eg EBIT margin (EBIT/Revenue), interest coverage (EBIT/interest)

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Objective of the case study

- To define/describe what interest in EBIT is and how it should be presented
  - Interest= finance component
- Why? Because in practice:
  - there is diversity in how the finance component is accounted for. Hence, a comparable finance component will lead to comparable subtotal(s)

Diversity in practice—impaired comparability

- Differences exist on whether the following items are accounted for as operating vs financing:

net interest on the net defined benefit liability

income or expenses arising from long term investments

Share of results from associates /joint ventures (JV)

eg gains or losses on disposal of financial assets or impairment of financial assets

Source: Agenda Paper 21A, March 2017 Board meeting

What is the problem? Inconsistencies in calculation of subtotals: same industry

Company A	Company B	Company C	Company D
Revenue	Revenue	Revenue	Revenue
Operating expenses	Operating expenses	Operating expenses	Operating expenses
Net interest cost: net DB liability			Net interest cost: net DB liability
	Share of result of associates/ JVs		
Income or expenses arising from financial assets at FVTPL		Income or expenses arising from financial assets at FVTPL	
Operating profit	Operating profit	Operating profit	Operating profit
Finance income/ expense	Finance income/ expense	Finance income/ expense	Finance income/ expense
	Net interest cost on net DB liability		
Share of result of associates/ JVs		Share of result of associates/ JVs	
	Income or expenses arising from financial assets at FVTPL		Income or expenses arising from financial assets at FVTPL
Tax	Tax	Tax	Tax
			Share of result of associates/ JVs
Profit	Profit	Profit	Profit

Simple case—only difference is capital structure

In currency units (CU)	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
Selling general and admin	(3,000)	(3,000)
EBIT	3,000	3,000
Finance expenses	0	(1000)
Profit before tax	3,000	2,000

A comparable performance measure independent of capital structure

Part of capital structure?

Warranty/onerous contract/legal/ restructuring provisions

Net defined benefit liabilities

Trade payables with significant financing component

Bank loans
Bonds/notes issued

Not part of capital structure

Where to draw the line?

More clearly part of capital structure

Trade payables without significant financing component

Decommissioning provisions

Liabilities for deferred consideration in a business combination

Lease liabilities

Part of capital structure?

+ Capital structure, as a principle, could distinguish finance income or expenses from operating income or expenses, **BUT**

– finance expenses might occur from liabilities outside capital structure, eg decommissioning liabilities.

Capital structure might include[1]:

equity, assets and liabilities arising from financing activities?

+

cash and cash equivalents as a proxy for cash and temporary investments of excess cash?

[1]Agenda Paper 21A paragraphs 40-46 for September 2017 Board meeting.
Agenda Paper 21A paragraphs 12-44 for June 2017 Board meeting.

More differences: capital structure and decommissioning liability

In currency units (CU)	Entity A	Entity B
Revenue	10,000	10,000
Cost of goods sold	(4,000)	(4,000)
Gross profit	6,000	6,000
Selling general and admin	(3,000)	(3,000)
EBIT	3,000	3,000
Finance expenses related to capital structure	0	(1000)
Finance expenses on liabilities outside capital structure	(500)	0
Profit before tax	2,500	2,000

A comparable performance measure

Structured *gross* presentation based on *capital structure*

What about finance income?

In currency units (CU)	Entity C	Entity B	Entity A
Revenue	10,000	10,000	10,000
Cost of goods sold	(4,000)	(4,000)	(4,000)
Gross profit	6,000	6,000	6,000
Selling general and admin	(3,000)	(3,000)	(3,000)
A) Profit before investing, financing and tax	3,000	3,000	3,000
Income from investments	200	0	0
B) Profit before financing and tax	3,200	3,000	3,000
Finance income related to capital structure	10	10	0
Finance expenses related to capital structure	(1,010)	(1010)	0
Other finance income	105	0	0
Other finance expenses	0	0	(500)
Profit before tax	2,305	2,000	2,500

Two comparable performance measures: A & B

Structure by activities:

1. Operating
2. Investing
3. Financing by:
   a) capital structure
   b) other

Arising from capital structure or investing activities?

Finance income or expenses	Income from investments
arising from *financing* activities, ie activities that result in changes in the size and composition of the contributed equity and borrowings of the entity[1]	from assets/liabilities that generate a return for the entity individually and largely independently from other resources held by the entity[3]
Borrowing costs are interest and other costs incurred in connection with the borrowing of funds[2]	ie in stark contrast to returns from operations, from investments little value is created through the combination of different resources[3]

[1]Paragraph 6 of IAS 7 *Statement of Cash Flows*

[2] Paragraph 5 of IAS 23 *Borrowing Costs*

[3]Agenda Paper 21A, paragraphs 4 and 20-21 for November 2017 Board meeting

Arising from capital structure? Further guidance

A financing activity involves[1]:

- the receipt or use of a resource from a provider of finance (or provision of credit)
- the resource is expected to be returned to the provider of finance
- expected compensation of the provider of finance = payment of a finance charge based on the amount of credit and duration

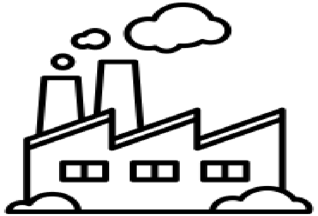
[1]Agenda Paper 21B paragraphs 13-14 for June 2017 Board meeting.
Agenda Paper 7 paragraph 84 for the March 2013 IFRS Interpretations Committee meeting.

Developing the case study

- Objective
  - To provide evidence to the Board about how to best present the finance component in the profit before investing, financing and tax considering the approaches presented on slides 8-14 or other principle-based approaches.
- Information provided:
  - the incomplete consolidated statement of financial performance of a manufacturing company London Plc
  - income and expenses that need to be included in London Plc's consolidated statement of financial performance

Developing the case study

- This case study does NOT address the ‘interest’ in EBIT for entities whose ordinary activities are primarily financing activities, for example:
  - financial institutions
  - conglomerates that provide financial services
- The focus of the case study is on a straightforward non-financial entity.



Developing the case study

- For each item of income and expense described, decide where it should be included in London Plc's consolidated statement of profit or loss. When deciding, avoid discussing:
  - measurement and recognition aspects of existing IFRS Standards and Interpretations
  - amounts that IFRS Standards include in other comprehensive income

Examples

London Plc incomplete consolidated statement of financial performance

In currency units (CU)	London Plc
Revenue	10,000
Cost of goods sold	(4,000)
Gross profit	6,000
Selling general and admin	(3,000)
Profit before investing, financing and tax	3,000
Income from investments	0
Profit before financing and tax	3,000
Finance expenses	0
Finance income	0
Profit before tax	3,000
Income tax	(600)
Profit after tax	2,400

This incomplete consolidated statement of profit or loss should be adjusted for the items on slide 20.

List of income and expenses

Income and expenses related to:	Example no
Post employment benefits: net defined benefit liability and net defined benefit asset	1 (a)-(b)
Trade payables with a significant financing component	2
Trade receivables with a significant financing component	3
Decommissioning liabilities: unwinding of the discount and changes in discount rates	4 (a)-(b)
Share of profits from joint ventures integral and peripheral to the entity's business operations	5 (a)-(b)
Financial instruments: bank loan and equity investment	6 (a)-(b)
Income taxes	7

Item 1: Post-employment benefits

London Plc sponsors a net defined benefit pension plan. The interest component of the pension cost that is required to be presented in profit or loss for the year is CU100.

Question 1 to Research Forum:

a) Where would you present the expense of CU100:
   i. below or above profit before investing, financing and tax? Why?
   ii. related to capital structure? Why or why not?

b) If London Plc recognised a net defined benefit asset with an interest income on it of CU100 instead of an expense:
   i. would that change your answers in (a)? Why or why not?
   ii. would that income arise from investing activities? Why or why not?

Item 2: Trade payables

London Plc has purchased raw materials on credit terms from its suppliers. The interest expense required to be presented in profit or loss for the year is CU150. Assume that the contracts with the suppliers include a significant financing component.

Question 2 to Research Forum:

Where would you present the expense of CU150:

i. below or above profit before investing, financing and tax? Why?
ii. related to capital structure? Why or why not?

Item 3: Trade receivables

London Plc has sold goods on credit terms to customers. The interest income required to be presented in profit or loss for the year is CU200. Assume that the contracts with the customers include a significant financing component.

Question 3 to Research Forum:

Where would you present the income of CU200:

i. below or above profit before investing, financing and tax? Why?

ii. related to capital structure? Why or why not?

Item 4: Decommissioning costs

London Plc is involved in nuclear activities and has recognised a provision for decommissioning costs.

Interest expense on the provision (the unwinding of the discount) is CU600 and is required to be recognised in profit or loss.

Question 4 to Research Forum:

a) Where would you present the expense of CU600:
   i. below or above profit before investing, financing and tax? Why?
   ii. related to capital structure? Why or why not?

b) Would you change your answers if CU100 out of CU600 reflects the effect of changes in discount rates?

Item 5: Share of profits from joint ventures

- London Plc has two joint ventures:
  - Europe: although London Plc has joint control of Europe, the investment is a new activity and not part of London Plc’s core operations.
  - International: integral to London Plc’s core operations as it undertakes an important part of London Plc’s manufacturing processes. This year London Plc’s share of the profits is CU100 and CU150 for Europe and International respectively.

Questions 5 to Research forum:
Where would you present the profits of CU100 and CU150 for each joint venture:

i. below or above profit before investing, financing and tax? Why?

ii. related to capital structure? Why or why not?

Item 6: Financial instruments

- London Plc has a bank loan and has to recognise in profit or loss an interest expense of CU100.
- London Plc has invested in shares of another company. London Plc needs to recognise in profit or loss fair value gains of CU50 arising from this investment.

Question 6 to Research Forum:

a) Where would you present the expense of CU100:
   i. below or above profit before investing, financing and tax? Why?
   ii. related to capital structure? Why or why not?

b) Where would you present the income of CU50:
   i. below or above profit before investing, financing and tax? Why?
   ii. related to capital structure? Why or why not?

Item 7: Interest and penalties related to income taxes

London Plc needs to recognise in profit or loss interest of CU200 comprising of:

- CU50 charged because of a late/underpaid tax payment, ie penalty and
- CU150 because of the time difference between the instalment payment due date and the actual payment date

Question 7 to Research Forum:
Where would you include the expenses of CU50 and CU150:

i. in tax or financing? Why or why not?
ii. related to capital structure? Why or why not?

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