IFRS

STAFF PAPER

February 2016

CMAC meeting

Project	Primary Financial Statements		
Paper topic	Operating profit		
CONTACT(S)	Denise Durant	ddurant@ifrs.org	+44 207 246 6469
	Koichiro Kuramochi	kkuramochi@ifrs.org	+44 207 246 6496

Purpose of this meeting

1. The Primary Financial Statements project is an early stage research project which will examine the purpose, structure and content of the statement(s) of profit or loss and other comprehensive income, statement of financial position (the balance sheet), statement of cash flows and statement of changes in equity (collectively 'the primary financial statements').

2. As part of our initial research work on the Primary Financial Statements project, we are exploring the use of an operating profit (loss) sub-total in the statement of profit or loss.

3. At this meeting, we would like to get your views on the 'operating profit (loss)' sub-total. In particular, we would like you to discuss the following questions:

Questions for CMAC members
1. Do you use the operating profit (loss) sub-total in your analysis? If yes, how do you use the information about operating profit in your analysis?
2. Should entities be required to present an operating profit (loss) sub-total in their financial statements?
3. If so, how should operating activities and the operating profit (loss) sub-total be described or defined?

4. Would a single description or definition of operating activities and operating profit (loss) work for all industries and business structures?

5. Should any description or definition of operating activities or operating profit (loss) be aligned with the description or definition of cash flows from operating activities in the statement of cash flows?

6. Should operating activities or the operating profit (loss) sub-total be defined strictly (thereby increasing comparability) or should management have the flexibility to present items in a way that best reflects the circumstances of the entity?

4. The rest of this paper provides you with background to help you discuss these questions. The appendix to this paper summarises the Board's previous attempts to define operating activities. Please note that as this project is at an early stage so the discussions we would like to have during this meeting are exploratory in nature.

Operating profit – requirements and description

5. Prior to 2003, IAS 1 *Presentation of Financial Statements* required entities to present the results of operating activities as a line item in the statement of profit or loss. However, when IAS 1 was revised in 2003 that requirement was removed. The Basis for Conclusions on IAS 1 explains the Board's reason for making this change:

> BC55 IAS 1 omits the requirement in the 1997 version to disclose the results of operating activities as a line item in the income statement. 'Operating activities' are not defined in IAS 1, and the Board decided not to require disclosure of an undefined item.

6. Despite the fact that there is no requirement to present an operating profit (loss) sub-total in the statement of profit or loss, many entities choose to do so.[1]

[1] Many entities also present an 'adjusted' operating profit (loss) sub-total. However, at this meeting we would like to focus on 'unadjusted' operating profit (loss).

7. If the Board were to decide to reinstate a requirement to present an operating profit (loss) sub-total it would need to explore whether and how to define or describe operating profit (loss) or operating activities.

8. The Basis for Conclusions on IAS 1 includes the following discussion about entities that choose to present an operating profit (loss) sub-total[2]:

> 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.

9. Although IAS 1 does not define operating profit (loss) or operating activities, IAS 7 *Statement of Cash Flows* defines operating activities, investing activities and financing activities in the context of the cash flow statement:

> *Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
>
> *Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

[2] The Basis for Conclusions on a Standard accompanies but is not part of that Standard.

> *Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.[3]

Operating profit (loss) – comparability vs flexibility

10. Because IAS 1 does not define or describe operating activities or what items should be included in arriving at the operating profit (loss) sub-total, entities have discretion about whether and how to report operating profit (loss). For example, our initial research shows that some companies report some or all of the following line items above operating profit (loss) and others report some or all of them below operating profit (loss):

    (a) Foreign exchange gains and losses.

    (b) Share of results of associates and joint ventures.

    (c) Interest cost of defined benefit pension schemes.

11. If the Board were to decide to provide guidance on the operating profit (loss) sub-total one of the key questions it would need to address would be whether to adopt a strict definition of operating profit (thereby increasing comparability) or allow management the flexibility to present items in a way that best reflects the circumstances of the entity:

    (a) Arguably, it would be easier to compare financial statements of entities if the line items mentioned in paragraph 10 were treated consistently in arriving at the operating profit (loss) sub-total. For example, the Board could take the view that the interest cost of defined benefit schemes is an employee cost that should always be deducted in arriving at operating profit. (Alternatively, the Board could decide that the interest cost of defined benefit schemes is a finance cost that should always be reported with other finance costs below operating profit.)

    (b) However, it can also be argued that allowing management the flexibility to present items in a way that best reflects the circumstances of the

[3] IAS 7, paragraph 6

entity could result in more useful information in the financial statements. For example, some entities may believe that the results of (some or all of) their associates are a key part of their operating activities and, hence, would choose to include those results in arriving at operating profit (loss). Other entities may view their investments in (some or all of) their associates as incidental to their main activities and, hence, choose to report the results of those associates below the operating profit (loss) sub-total.

12. Another challenge for the Board would be whether it would be possible to develop a single description or definition of operating activities that would work for all industries (for example, banks, insurers, manufacturing companies) and all business structures.

Appendix – Previous attempts to define operating activities

A1. In 2001 the Board added to its agenda the performance reporting project (later renamed the 'financial statement presentation project' or 'FSP'). In 2004 the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB) (the 'boards') decided to work on financial statement presentation as a joint project.

A2. In October 2008 the boards published the Discussion Paper *Preliminary Views on Financial Statement Presentation* (the '2008 Discussion Paper'). In the 2008 Discussion Paper the boards focused on the split between business activities (operating and investing) and financing activities. Business activities were described as those conducted: 'with the intention of creating value, such as producing goods or providing services'. Further, operating activities (included as part of the business activities section) were defined as (emphasis added): '…primary revenue and expense-generating activities'[4].

A3. Respondents to the 2008 Discussion Paper held mixed views with regards to the definitions of business and operating activities and many indicated that the proposed definitions were too broad and should be more specific.

A4. In July 2010 the staff of the IASB and the FASB posted on each board's website a staff draft of an Exposure Draft (the '2010 Staff Draft') reflecting the boards' cumulative tentative decisions on financial statement presentation. In the 2010 Staff Draft, operating activities were defined as activities 'that are part of the entity's day-to-day business'; also, as activities 'that generate revenue through a process that requires the interrelated use of the entity's resources'.[5]

A5. The 2010 Staff Draft was not exposed for comment and the boards did not officially receive any feedback on the revision of the definitions and classification criteria.

A6. The FSP project was suspended by both boards in 2010 so that they could focus on completing new Standards on revenue recognition, leases, insurance contracts and financial instruments. The boards were also concerned that fundamentally

[4] Refer to paragraphs 2.31 –2.32 of the 2008 Discussion Paper

[5] Refer to paragraphs 72 –73 of the 2010 Staff Draft.

changing the structure of the financial statements at the same time as they planned to issue all of those Standards would overwhelm preparers and users. In addition, feedback on the FSP project had indicated that many of our constituents had significant concerns about some of the proposals (mainly, the application of the cohesiveness principle across all the primary financial statements and the use of the direct cash flow method to provide cash flow information).

A7. So the boards decided to focus on other projects and to suspend the FSP project.