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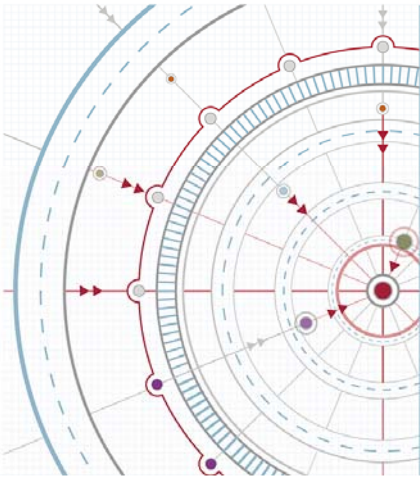

Agenda ref: 1

CASE STUDY

World Standard-setters
27 September 2016

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Background

Hans Hoogervorst recently said:

> *"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."*

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Objective and task

- The objective of this case study is to provide evidence to the Board about whether it is possible to define operating profit.

- IAS 1 *Presentation of Financial Statements* does not require entities to present an operating profit subtotal. However, it requires entities to present additional subtotals when such presentation is relevant to an understanding of the entity's financial performance.[1] Many entities choose to present an operating profit subtotal.
- The case study asks you to discuss the main characteristics of operating profit and apply those characteristics to various events.

[1]*See paragraph 85 of IAS 1:*

An entity shall present additional line items, headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

Information purposes

- Investors use information in financial reports to estimate the value of the reporting entity and to assess management's stewardship of the entity.

- To estimate the value of the reporting entity a variety of valuation techniques are used, such as:
  - Earnings ratios
  - Discounted cash flows

Earnings used to value a reporting entity

- Investors often adjust earnings for:
  - Significant events;
  - Changes in the scope of the business, acquisitions and disposals; and
  - 'Other' income or expenses that investors wish to analyse separately.
- Preparers may present additional subtotals to assist investors in calculating adjusted earnings; one of these subtotals may be operating profit.
- Defining operating profit and requiring an operating profit subtotal could provide a comparable starting point for investors to calculate earnings for the use in valuing an entity.

Estimating cash flows to value a reporting entity

- Discounted cash flows
  - Investors often use operating profit, adjusted for non-cash items, such as depreciation, amortisation and impairment to estimate future cash flows

How do investors use operating profit?

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- Other uses of operating profit include:
  - To assess the entity’s operating and financing activities separately.
  - Management remuneration targets may be based on operating profit as a measure of value creation.
  - Comparability with peers: a performance metric for benchmarking purposes.

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Developing the case study

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- Objective
  - To provide evidence to the Board about whether it is possible to define operating profit.

- Information
  - You are provided with the consolidated statement of profit or loss of a manufacturing company London Plc.
  - You are also provided with information about income and expenses that needs to be included in London Plc’s consolidated statement of profit or loss.

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Developing the case study

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- Tasks
  1. Discuss the main characteristics of operating profit.
  2. Using the Excel spreadsheet provided insert an operating profit line in London Plc's consolidated statement of profit or loss.
  3. For each item of income and expense described, decide whether it should be included in arriving at operating profit in London Plc's consolidated statement of profit or loss. When deciding:
     - Avoid discussing measurement and recognition aspects of existing IFRS Standards and Interpretations.
     - Other comprehensive income items are not eligible for being included in the calculation of operating profit.

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Expected feedback

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- Each group is asked to submit:
  - The main characteristics of operating profit.
  - London Plc's revised consolidated statement of profit or loss showing the calculation of operating profit.
  - The reasons why, or why not, each item of income or expense is included in operating profit.

- IASB staff members will assist you in completing the Excel spreadsheet.

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London Plc – Incomplete consolidated statement of profit or loss

CONSOLIDATED STATEMENT OF PROFIT OR LOSS	
	2016
Revenue	17,000
Cost of goods sold	(14,500)
Gross profit	2,500
Administration and marketing expenses	(500)
Net finance costs	(100)
Profit before taxation	1,900

- The above consolidated statement of profit or loss should be adjusted for the items on slide 12.

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Income and expenses to be included in London Plc's consolidated statement of profit or loss

INCOME / EXPENSE No	NATURE OF INCOME OR EXPENSE	EXAMPLES
1	Other income or expense	Two examples: a) Gains on sales of property, plant and equipment; and b) Disposals of intangible assets.
2	Significant event	An accident occurred at one of London Plc's factories causing an oil spill.
3	Impairment charge (non-cash item)	Three examples: a) Goodwill impairment; b) Inventory impairment; and c) Property, plant and equipment impairment.
4	Restructuring	Relocation of business activities.
5	Corporate structure	Two examples: a) Disposal of a subsidiary; b) Share of the profits of joint ventures; and c) Share of the profits of joint operations or associates.
6	Post-employment benefits	Components of the pension cost other than actuarial gains.
7	Foreign exchange	Two examples; a) Translation gains and losses—trade receivables; and b) Transaction gains and losses—property, plant and equipment.
8	Fair value volatility (non-cash item)	Forward contracts.

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Item 1: Other income or expenses

- London Plc sold property, plant and equipment. London Plc is required to recognise gains on sales of the property, plant and equipment of CU1,000.
- London Plc disposed of intangible assets. London Plc is required to recognise gains on disposals of intangible assets of CU500.

Question 1 to WSS:

a) Would you include the gains on sales of property, plant and equipment of CU1,000 in operating profit? Why or why not?

b) Would you include the gains on disposals of intangible assets of CU500 in operating profit? Why or why not?

Item 2: Significant event

- An accident occurred at one of London Plc's factories causing an oil spill. London Plc is required to rectify the damage caused by the oil spill.
- A liability for the costs of rectifying the oil spill of CU300 is required to be recognised.

Question 2 to WSS:

Would you include the costs of rectifying the damage caused by the oil spill of CU300 in operating profit? Why or why not?

Item 3: Impairment

- ***Goodwill impairment***

London Plc has a wholly-owned subsidiary that is a separate cash-generating unit (CGU).

A sudden and unexpected change in consumer demand occurs and London Plc's subsidiary cannot respond to it. No restructuring plan is in place yet.

London Plc decided that the carrying amount of the CGU has declined by CU500. London Plc is required to recognise an impairment loss of CU500. 100 per cent of the impairment loss will all be allocated to goodwill.

Question 3 to WSS:

a) Would you include the goodwill impairment loss of CU500 in operating profit? Why or why not?

Item 3: Impairment ctd...

- ***Inventory impairment***

London Plc estimates that the net realisable value of its night-vision systems inventory is below cost, due to a decline in selling prices. London Plc is required to recognise an impairment loss of CU700 so that the inventory is carried at its net realisable value.

Question 3 to WSS:

b) Would you include the inventory impairment loss of CU700 in operating profit? Why or why not?

- ***Property, plant and equipment impairment (PPE)***

London Plc decides that the recoverable amount of an item of plant is lower than its carrying amount.

London Plc is required to recognise an impairment loss of CU950.

Question 3 to WSS:

c) Would you include the PPE impairment loss of CU950 in operating profit? Why or why not?

Item 4: Restructuring

- ***Relocation of business activities***

  London Plc has publicly announced a detailed formal restructuring plan to transfer one of its manufacturing activities to another region where labour costs are lower.

  London Plc is required to recognise restructuring costs of CU300 associated with this restructuring plan.

Question 4 to WSS:
Would you include restructuring costs of CU300 in operating profit? Why or why not?

Item 5: Corporate structure

- ***Disposal of a subsidiary***

  Latinos SA is a subsidiary of London Plc. At the end of the year 20X6, London Plc sells Latinos SA to a third party. London Plc is required to recognise a loss on disposal of CU100 in total, which includes exchange differences relating to the foreign operation reclassified from other comprehensive income to profit or loss of CU20.

Question 5 to WSS:
a) What, if any, disposal loss (CU100 or CU80) would you include in operating profit? Why or why not?

Item 5: Corporate structure ctd...

- ***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—which is part of 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 for each joint venture.

Questions 5 to WSS:

b) Would you include the profits of CU100 for each joint venture in operating profit? Why or why not?

c) Would you change your answer if the joint ventures were either joint operations or associate entities? Why or why not?

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Item 6: Post-employment benefits

- London Plc sponsors a defined benefit pension plan. The components of the pension cost that are required to be presented in the consolidated statement of profit or loss for the year are:
  - Current service cost = CU450
  - Past service cost = CU10
  - Net interest on the net defined benefit liability = CU50
  - Actuarial gains = CU40
- Actuarial gains should be ignored, since IAS 19 *Employee Benefits* requires them to be recognised in other comprehensive income (OCI).
- The past service cost arises from a restructuring plan to transfer its manufacturing activities to another region.

Question 6 to WSS:

Which components, other than the actuarial gains, of the pension cost listed above would you include in operating profit? Why or why not?

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Item 7: Foreign exchange

- ***Translation gains or losses—trade receivables***

During December 20X6 London Plc sold goods overseas and recognised foreign currency trade receivables. The foreign currency trade receivables were translated and recognised at CU8,000 of local currency. On 31st December 20X6 London Plc is required to recognise a foreign currency gain of CU600 of local currency arising from translating trade receivables at the year-end exchange rate.

Question 7 to WSS:

a) Would you include the foreign currency translation gain of CU600 in operating profit? Why or why not?

Local currency —the currency of the primary economic environment in which the entity operates; and Foreign currency —a currency other than the local currency of the entity.

Item 7: Foreign exchange ctd...

- ***Transaction gains or losses—property, plant and equipment (PPE)***

On 1 June 20X6 London Plc took delivery of property, plant and equipment (PPE) from an overseas manufacturer for CU5,000 of foreign currency.

On 1 June 20X6 London Plc recognised the PPE and the amount payable in respect of the PPE.

On 30 July 20X6 London Plc settled the amount payable.

Due to the movement in exchange rates, London Plc is required to recognise a foreign currency loss of CU500 of local currency on the settlement of the amount payable.

Question 7 to WSS:

b) Would you include the foreign currency transaction loss of CU500 in operating profit? Why or why not?

Item 8: Fair value volatility

- *Forward contracts*

London Plc uses copper as an important ingredient in its manufacturing process. To mitigate market price risk associated with copper it enters into forward contracts for copper. However, these contracts are not designated as hedging instruments.

At the reporting date, there is a fair value gain on the copper forward contracts of CU350.

Question 8 to WSS:
Would you include the gain of CU350 arising from the fair value changes in the copper forward contracts in operating profit? Why or why not?

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