STAFF PAPER

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Project	**Primary Financial Statements**
Paper topic	Earnings before finance income/expenses and tax (EBIT)—development of principles-based approach

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Purpose of paper

1. This Agenda Paper sets out further issues to address if the Board supports the staff recommendation of a principles-based approach to describing capital structure (Approach 3 in Agenda Paper 21A).

Structure of paper

2. This paper is structured as follows:
   - (a) summary of all of the staff recommendations both in this paper and Agenda Paper 21A (paragraph 3);
   - (b) areas to develop further in our principles-based approach (paragraphs 4-27);
   - (c) implications of the staff recommendations for classification of interest (paragraphs 28-36); and
   - (d) appendix—illustrative example of staff recommendations.

Summary of staff recommendations in this paper and Agenda Paper 21A (illustrated in the appendix)

3. The staff recommend:

    (a) defining EBIT as profit before finance income/expenses and tax (March 2017 recommendation);

    (b) defining finance income/expenses as

        (i) income/expenses related to the entity's capital structure; and

        (ii) interest on assets and liabilities not part of an entity's capital structure;

    (c) defining capital structure as equity, assets and liabilities arising from financing activities, and cash and cash equivalents;

    (d) clarifying the current description of financing activities;

    (e) providing guidance that income/expenses related to capital structure includes:

        (i) all income and expenses on items of capital structure that solely arise from financing activities; and

        (ii) income and expenses related to the funding aspect —for example, including the interest—of items of capital structure that do not solely arise from financing activities.

    (f) requiring the separate presentation below EBIT of:

        (i) income related to capital structure;

        (ii) expenses related to capital structure;

        (iii) interest income on assets outside capital structure; and

        (iv) interest expenses on liabilities outside capital structure.

Areas to develop further in our principles-based approach

4. In Agenda Paper 21A, the staff recommend using a principles-based approach to describing capital structure and:

    (a) defining capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents; and

(b) clarifying the current description of financing activities.

5. This paper develops the staff recommendation in Agenda Paper 21A further by considering the following issues:

(a) how might we clarify the current description of financing activities in IAS 7? (paragraphs 6-21);

(b) what do we mean by income and expenses related to capital structure? (paragraphs 22-26); and

(c) staff recommendation on (a) and (b) (paragraph 27).

How might we clarify the current description of financing activities?

What is the problem?

6. Paragraph 6 of IAS 7 defines *financing activities* as (emphasis added):

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

7. A major shortcoming in the definition of 'financing activities' is that the term 'borrowings' is not defined.

8. Paragraph 5 of IAS 23 *Borrowing Costs* describes the meaning of 'borrowing costs'. However, this definition is unclear because it provides a circular definition as follows (emphasis added):

> **Borrowing costs are** interest and other costs that an entity incurs **in connection with the borrowing of funds**.

9. Paragraph BC26 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* notes that the IFRIC concluded that the unwinding of the discount on a decommissioning liability is not a borrowing cost for the purposes of IAS 23 because it does not reflect funds (ie cash) borrowed.

10. Paragraph 60 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that the increase in a provision [in the scope of IAS 37] to reflect the passage in time is recognised as borrowing cost, but we think the intention is to prescribe the presentation of the cost as a 'finance cost', rather than a 'borrowing cost' in IAS 23.

11. To 'borrow'[1] means:

> The action of taking and using (something belonging to someone else) under agreement to pay it back later.

12. Paragraph 17 of IAS 7 provides the following examples of cash flows arising from financing activities:

    (a) cash proceeds from issuing shares or other equity instruments;

    (b) cash payments to owners to acquire or redeem the entity's shares;

    (c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

    (d) cash repayments of amounts borrowed; and

    (e) cash payments by a lessee for the reduction of the outstanding liability relating to a lease.

Staff analysis

Previous work by the staff

13. Based on the definitions and requirements in paragraphs 6-12, in March 2013 the staff recommended to the IFRS Interpretations Committee that the definition of financing activities in paragraph 6 of IAS 7 should be clarified by indicating that the **nature of a financing activity** involves[2]:

    (a) the **receipt** or **use** of a resource from a provider of finance (or provision of credit);

    (b) the expectation that the resource **will be returned** to the provider of finance; and

    (c) the expectation that the provider of finance **will be appropriately compensated** through a payment of a finance charge. The finance charge is **both dependent on the amount of the credit and the duration (time of the credit).**

[1] *Oxford English Dictionary* (10th ed).

[2] See Agenda Paper 7 paragraph 84 for the March 2013 IFRS Interpretations Committee meeting.

14. It also stated that the staff view was that financing activities also include those purchase transactions that have been negotiated on extended credit terms.

15. Paragraphs 51-86 of Agenda Paper 7 for the March 2013 IFRS Interpretations Committee meeting provided detailed analysis of the staff proposal in paragraphs 13-14. The Interpretations Committee concluded that clarifying the application is a matter that is too broad for it to address. The staff think we could consider using the staff proposal in paragraphs 13-14 as additional guidance to clarify what we mean by financing activities if we think it gives an appropriate outcome.

Liabilities arising from financing activities

16. Based on the list in paragraph 17 of IAS 7 (in paragraph 12) and the common definition of to 'borrow' (in paragraph 11), the staff think that the following liabilities would clearly be 'borrowings' for all straightforward non-financial entities and should be part of capital structure. The staff think they would also arise from financing activities under the staff proposal in paragraphs 13-14:

    (a) debentures, loans, notes, bonds and mortgages;

    (b) lease liabilities, because an entity is borrowing a resource, the leased asset; and

    (c) trade payables negotiated on extended credit terms because the supplier is providing credit to the entity and the entity is essentially borrowing money from the supplier.

17. However the staff think it is less clear for the following liabilities and these are considered below:

    (a) net defined benefit liability;

    (b) decommissioning liabilities; and

    (c) other long-term provisions, for example warranty provisions, contingent consideration for a business combination, etc.

18. Arguments for considering the liabilities in paragraph 17 as arising from financing activities:

    (a) based on our outreach the preferred treatment of most users would be to treat the unwinding of the discount (or 'interest') on these liabilities as a finance cost. This is also the required treatment under IFRS Standards in most cases, apart from for the net interest on a net defined benefit liability where IAS 19 allows a choice.[3]

(b) one could argue that an entity could make a funding decision to borrow money to transfer, fund or settle these liabilities in most circumstances (ie the entity can make a conscious funding decision), for example, an entity might be able to transfer a defined benefit liability to an insurer or pay the government to take over a decommissioning liability.

19. Arguments for considering the liabilities in paragraph 17 as not arising from financing activities:

(a) some stakeholders argue that these are operating liabilities, and any interest on these liabilities is an operating cost, because:

(i) the liabilities do not arise from transactions in a financial market;

(ii) the counterparty is not an lending institution, for example, the defined benefit liability represents an obligation to pay a pension to the employees on retirement; and

(iii) there is no clear counterparty to the obligation in some cases (such as members of the general public), for example, for an obligation to restore a site;

(b) the reason why many users and preparers treat the interest on these liabilities as a financing cost could be linked to accounting practices, rather than underpinned conceptually. IFRS Standards generally require interest to be recognised as a finance cost.

(c) the liabilities generally arise because the nature of the obligation is that payment is not certain or the obligation can only be settled at a future, sometimes unknown, date and is not capable of being settled immediately. They have not arisen because the entity has consciously borrowed funds. Even if an entity is able to transfer the liability to a third party it would

[3] IAS 19 *Employee Benefits* does not specify how an entity should present net interest on the net defined benefit liability (see IAS 19 paragraph 134). This accounting policy choice leads to diversity in practice.

likely be at a significant extra cost and the entity may still retain a contingent liability in respect of the obligation.

(d) the staff does not think the criteria in (a)-(c) of paragraph 13 are met for these liabilities.

20. Considering the common definition of 'borrow' (paragraph 11), the staff think that it would be difficult to define borrowings, and hence financing activities, in such a way as to try to include liabilities such as defined benefit liabilities and long-term provisions. This is because they do not involve the borrowing of cash or other resources. For example, based on the staff proposal in paragraphs 13-14 to clarify financing activities, the staff think these kinds of liabilities would not be considered to arise from financing activities.

Staff view

21. The staff think it would be helpful to clarify what we mean by financing activities using the staff proposal in paragraphs 13-14 (or similar wording). If the Board agrees the staff would bring our analysis supporting this wording to a future Board meeting (as for the March 2013 IFRS Interpretations Committee meeting). The staff interpret the term 'borrowings' in the existing definition of 'financing activities' to mean that the liabilities in paragraph 17 (ie long-term provisions and net defined benefit liabilities) would not arise from financing activities, and so would not be part of an entity's capital structure. However, the staff think that lease liabilities and trade payables negotiated on extended credit terms would be part of capital structure.

What do we mean by income and expenses related to capital structure?

What is the problem?

22. At the March 2017 Board meeting, the staff proposed to define finance income/expenses as income and expenses related to capital structure.

23. We could define finance income/expenses as <u>all</u> income and expenses related to (ie corresponding to changes in) capital structure. For example, for a bank loan held by a non-financial entity, all the related income and expenses, such as interest, foreign exchange gains or losses, any fair value gains and losses, etc, would be included in finance income/expenses.

24. Such an approach is conceptually appealing as it would achieve alignment between the statement(s) of financial performance and financial position. However, such an approach may not work, because some liabilities we think should be part of capital structure also relate to an entity's operating activities, for example trade payables negotiated on extended credit terms and lease liabilities. Even though we consider a trade payable negotiated on extended credit terms to be part of capital structure, in determining finance income/expenses we would want to:

(a) include income and expenses related to the borrowing of money from the supplier (ie the interest and other costs in connection with the borrowing of funds); and

(b) exclude the cost of goods/services purchased.

25. Similarly, for lease liabilities, we would want to include the interest expenses in finance income/expenses, but we would not want to include gains or losses on lease modifications.

Staff view

26. The staff think that we should clarify that income/expenses related to capital structure includes:

(a) all income and expenses on items of capital structure that solely arise from financing activities (ie solely from activities that result in changes in the size and composition of the contributed equity and borrowings of the entity); and

(b) only those income and expenses related to the borrowing of funds/resources (ie the funding aspect of the transaction) for items of capital structure that do not solely arise from financing activities.

Staff recommendation about areas to develop further under a principles-based approach

27. The staff recommend:

(a) clarifying the current description of financing activities using the staff proposal in paragraphs 13-14 (or similar wording); and

(b) providing guidance that income/expenses related to capital structure includes:

(i) all income and expenses on items of capital structure that solely arise from financing activities; and

(ii) those income and expenses related to the funding aspect—for example, including the interest—of items of capital structure that do not solely arise from financing activities.

Question for the Board

Assuming the Board agrees with the staff recommendation to follow a principles-based approach to describing capital structure in Agenda Paper 21A, does the Board also agree with the staff recommendations in paragraph 27?

What are the implications of the staff recommendations for classification of interest

What is the problem?

28. The staff recommendations so far are:

(a) defining EBIT as profit before finance income/expenses and tax, and defining finance income/expenses as income/expenses related to an entity's capital structure (March 2017 recommendation);

(b) describing capital structure as consisting of equity, assets and liabilities arising from financing activities, and cash and cash equivalents (paragraph 44 of Agenda Paper 21A for this meeting); and

(c) clarifying what we mean by 'financing activities' and by 'income and expenses related to capital structure' (paragraph 27 of this paper).

29. These recommendations would result in the interest on assets and liabilities outside capital structure not being recognised as part of finance income/expenses. Therefore, based on our analysis in paragraphs 17-20, the interest on net defined benefit liabilities, decommissioning liabilities and other long-term provisions would not be included in finance income/expenses. The staff observe that such a change in presentation could have the following implications:

(a) it would be a significant change in practice in how we present the interest on these items;

(b) most users treat the interest on these items as financing income/expenses and they may want to continue with this practice; and

(c) a small change in an estimated discount rate can create a significant difference in the interest expense recognised. Therefore, if we include the interest on these items in EBIT, this could lead to volatility in reported EBIT. These implications may lead preparers to present, and users to use, adjusted EBIT figures.

Staff analysis

30. The staff think a distinction can be made between the following:

(a) interest and other costs payable as compensation for borrowing funds (an explicit cost of financing the entity and a borrowing cost in IAS 23); and

(b) interest that is computed as a result of the time difference between the date of recognition of a liability and the date of the cash flow to settle the liability (a cost that is by nature a financing-type of cost, but is not an explicit cost of financing the entity).

31. The staff note that it would be the interest in paragraph 30(b) that would fall outside finance income/expenses based on our interpretation of capital structure above. Based on the distinction in paragraph 30, the staff does not think that this is conceptually the wrong outcome for describing finance income/expenses. Nevertheless the staff are aware of the implications of such an approach as outlined in paragraph 29.

32. The staff think that if the Board is concerned about excluding the interest in paragraph 30(b) from finance income/expenses, we could also include it as part of total finance income/expenses but require it to be presented separately. We could also consider whether we want to include interest on assets outside of capital structure as part of total finance income/expenses.

33. Separate presentation, below EBIT, of interest on liabilities (and assets) outside capital structure has the following advantages:

(a) it would provide users with more information, including the flexibility to measure EBIT as including or excluding the interest on items outside capital structure (since they could add this line item to EBIT to give a pure capital structure view of EBIT); and

(b) it would reflect the distinction in paragraph 30.

34. Separate presentation, below EBIT, of interest on liabilities (and assets) outside capital structure has the following disadvantages:

(a) it would mean that we stray away from our objective for EBIT of facilitating the comparison of entities with different capital structures. However, it would be easy for users to calculate a pure capital structure view of EBIT as explained in paragraph 33(a).

(b) it would require us to define both ‘income/expenses related to capital structure’ and ‘interest on liabilities (and assets) outside capital structure’.

35. The staff support presenting interest arising on both assets and liabilities outside capital structure below EBIT. This would provide both consistent classification of interest and symmetry between the treatment for assets and liabilities. However, if the Board does not think that interest on assets outside capital structure should be shown below EBIT (because, for example, interest received is required to be classified as an investing or operating cash flow in IAS 7), we could restrict the interest on items outside capital structure presented below EBIT to:

(a) only interest expenses on liabilities outside capital structure; or

(b) interest income/expenses on liabilities outside capital structure and any assets restricted for the specific purpose of settling those liabilities—this would include net interest on defined benefit plan assets.

Staff recommendation about how to address these implications for classification of interest

36. The staff recommend requiring income and expenses related to capital structure to be presented separately from interest on assets and liabilities outside capital structure, both below EBIT. The staff observe that paragraph 82 of IAS 1 requires a separate line item for finance costs, but not for finance income. Assuming we want to present

finance income and finance expenses separately, the staff recommend that we should require the following separate line items below EBIT, which together comprise total finance income/expenses:

(a) income related to capital structure;

(b) expenses related to capital structure;

(c) interest income on assets outside capital structure; and

(d) interest expenses on liabilities outside capital structure.

The appendix provides an illustration of this presentation.

Question for the Board

Assuming the Board agrees with the staff recommendations so far (see paragraph 28), does the Board also agree with the staff recommendations in paragraph 36?

Appendix—Illustrative example of staff recommendations

Statement(s) of financial performance (by function)[4]

Revenue	10,000
Cost of goods sold	(4,000)
Gross profit	6,000
SG&A	(3,000)
EBIT	3,000
Income related to capital structure	200
Expenses related to capital structure	(1,000)
Interest income on assets outside capital structure	300
Interest expenses on liabilities outside capital structure	(400)
Net finance income (expense)	(900)
Profit before tax	2,100
Income tax expense	(600)
Profit or loss	**1,500**

[4] Not taking into account the proposals regarding a management performance measure (Agenda Paper 21C) or the presentation of the share of the profit or loss of associates and joint ventures (Agenda Paper 21E)

Note X—Finance income and expenses

A breakdown of the entity's finance income and expenses is provided below:

Interest income on cash and cash equivalents	50
Foreign exchange gain on borrowings	50
Gain on hedging instruments related to capital structure	100
Income related to capital structure	200
Interest expense on bonds and notes	(400)
Interest expense on bank loans	(300)
Interest expense on leases	(150)
Interest expense on trade payables	(100)
Fair value loss on borrowings measured at FVTPL	(50)
Expenses related to capital structure	(1,000)
Interest income on trade receivables	200
Interest income on loans to related parties	100
Interest income on assets outside capital structure	300
Net interest on net defined benefit liability	(200)
Unwinding of the discount on decommissioning provisions	(100)
Unwinding of the discount on warranty provisions	(100)
Interest expenses on liabilities outside capital structure	(400)
Net finance income (expense)	**(900)**