

STAFF PAPER

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IASB® Meeting

Project	Primary Financial Statements		
Paper topic	Earnings before interest and tax (EBIT)		
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Purpose of paper

1. This Agenda Paper seeks your views on the staff's proposal to introduce an EBIT (Earnings before interest and tax) subtotal in the statement(s) of financial performance.
2. This paper does not address the following topics which we plan to discuss at a future meeting:
 - (a) whether an EBIT subtotal is relevant for entities whose ordinary activities are primarily financing activities (for example financial institutions); and
 - (b) how to classify finance income or expense arising from an entity's ordinary activities (for example, for conglomerates that provide financial services).

Summary of staff recommendations

3. In summary, the staff recommend:
 - (a) requiring the presentation of an EBIT subtotal in the statement(s) of financial performance.
 - (b) defining EBIT as profit before finance income/expenses and tax.

- (c) in order to have a comparable EBIT subtotal for entities with different capital structures, describing finance income/expenses as income/expenses related to the entity's capital structure. An entity's capital structure includes cash held and short-term investments.
- (d) providing guidance for items that need clarification about whether they are finance income/expenses, such as:
 - (i) net interest on the net defined benefit liability; and
 - (ii) income/expenses from long-term investments.

Structure of paper

- 4. The paper is structured as follows:
 - (a) what is EBIT? (paragraphs 5-9);
 - (b) current IFRS requirements and guidance (paragraphs 10-15);
 - (c) what is the problem? (paragraphs 16-18);
 - (d) staff analysis (paragraphs 19-48); and
 - (e) staff recommendations (paragraphs 49-53).

What is EBIT?

Description

- 5. EBIT is a performance measure often used in practice. EBIT is typically calculated as Earnings (ie profit) plus Interest (interest or more broadly, finance income/expenses) and Tax (ie income tax). Entities present EBIT with the aim of providing a performance measure that is independent of the entity's capital structure and income tax situation. In other words, it is a performance measure that aims to distinguish an entity's value-generating activities from its value distribution to capital providers (ie its 'financing activities') and the tax authorities. EBIT is sometimes presented as a subtotal in the statement(s) of financial performance.
- 6. We have noted that some preparers use the term 'operating profit' to refer to a subtotal that is broadly consistent with EBIT. However, the term 'operating profit' is

often used to refer to subtotals that exclude items other than finance income/expenses and tax. At the September 2016 World Standards-setters meeting, participants debated the characteristics of operating profit but they did not reach a consensus. In contrast to operating profit, the term EBIT is used relatively consistently in practice because the name itself reflects how the measure is calculated. For that reason, some stakeholders recommended during our outreach that the Board define EBIT, rather than operating profit.

How users use it?

7. Many users of financial statements think EBIT is useful because it achieves comparability of financial performance between entities with different capital structures. Accordingly, EBIT is commonly used for screening, ratio analysis, or as a starting point for forecasting cash flows. A 2016 CFA Institute survey found that 45.9% of 431 (mostly buy-side respondents) investors use EBIT in their analysis¹.

Earnings before interest, tax, depreciation, and amortisation (EBITDA)

8. In addition to EBIT, many users of financial statements also call for a standardised EBITDA subtotal (see paragraph 18). Some users told us that EBITDA is more frequently used in practice than EBIT. The CFA Institute survey mentioned in paragraph 7 found that 69.8% of investors use EBITDA in their analysis.
9. However, the staff do not think that the Board should pursue requiring and defining EBITDA for the following reasons:
 - (a) as discussed in the forthcoming *Principles of Disclosure* Discussion Paper, the presentation of an EBITDA subtotal in the statement(s) of financial performance is incompatible with the ‘function of expense’ method (paragraph 103 of IAS 1 *Presentation of Financial Statements*), because an EBITDA subtotal would disrupt the analysis of expenses.
 - (b) there are also some theoretical concerns about the concept of EBITDA². One of the main concerns we hear is that EBITDA is often used as a

¹ CFA Institute, ‘[Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures](#)’, 2016, p.21.

² CFA Institute, ‘[Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures](#)’, 2016, p.22-23.

measure of cash generation, but it is, in fact, a poor proxy for this. The Board may therefore not want to encourage the use of this measure, particularly as cash flow information is already available in the statement of cash flows.

- (c) During our outreach, users told us that, if a standardised EBIT subtotal is introduced, they would be able to calculate EBITDA by simply adding back depreciation and amortisation themselves.

Current IFRS requirements and guidance

Subtotals in statement(s) of financial performance

- 10. IAS 1 does not require the presentation of specific subtotals above profit or loss in the statement(s) of financial performance.
- 11. Paragraph 85 of IAS 1 requires an entity to present additional line items, headings and subtotals in the statement(s) of financial performance when such presentation is relevant to an understanding of the entity's financial performance. Paragraphs 85A and 85B of IAS 1 provide requirements on how these additional subtotals should be presented.

Finance income and expenses

- 12. Paragraph 82 of IAS 1 and other paragraphs in IFRS Standards specify a limited number of line items that must be presented in the statement(s) of financial performance. This includes a line item for finance costs (ie expenses) (IAS 1, paragraph 82(b)) but not for finance income.
- 13. IFRS Standards do not provide a definition of finance income or finance expenses. However, the non-authoritative guidance on implementing IFRS 7 *Financial Instruments: Disclosures*, paragraph IG13 states that:
 - (a) total interest expense for financial liabilities that are not measured at fair value through profit or loss is a component of finance costs; and
 - (b) the line item for finance costs may also include amounts associated with non-financial liabilities.

14. In addition, several IFRS Standards and an IFRIC Interpretation require some specific expenses to be included in finance costs, such as:
- (a) a lessee's interest expense on the lease liability (IFRS 16 *Leases*, paragraph 49).
 - (b) increases in the carrying amount of provisions that reflect the passage of time (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 60). This requirement uses the wording 'recognised as borrowing cost' rather than 'finance cost', but we think the intention of the requirement is to prescribe the presentation of the cost as a 'finance cost'.
 - (c) unwinding of the discount on decommissioning, restoration and similar liabilities (IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, paragraph 8).
 - (d) increases in the present value that arise from the passage of time of the costs to sell a non-current asset (or disposal group) classified as held for sale (IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, paragraph 17).
15. Finally, IFRS 15 *Revenue from Contracts with Customers* requires the separate presentation of the effect of financing (interest revenue or interest expense) from revenue, when a significant financing component exists in contracts with customers. Paragraph 65 of IFRS 15 says:

An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. [...]

However, the Basis for Conclusions on IFRS 15, paragraph BC247 clarifies that when entities regularly enter into financing transactions as part of their ordinary activities (eg banks), interest could be part of income arising from ordinary activities and presented as a type of revenue.

What is the problem?

16. Users of financial statements told us that they need a comparable subtotal in the statement(s) of financial performance for screening, ratio analysis or as a starting

point for their own analysis. They observed that, while many entities already present additional subtotal(s) in accordance with paragraph 85 of IAS 1, these additional subtotal(s) are not comparable because each entity may calculate these subtotal(s) differently.

17. To better understand the use of the EBIT subtotal, we undertook an analysis of the financial statements of a number of entities.³ Many of the entities in our analysis presented an operating profit subtotal that corresponds broadly to EBIT (an EBIT-type operating profit). However, not all entities calculated the EBIT-type operating profit in the same way, because they classified some finance-related items differently (eg net interest on the net defined benefit liability) (see paragraphs 25-33).
18. Some users of financial statements are encouraging standard-setters to make EBIT a more comparable measure by providing a definition.⁴ A 2016 CFA Institute investor survey found that:⁵

A majority of respondents (55.1%) expect standard setters to define key subtotals (operating profit; earnings before interest and tax [EBIT]; and earnings before interest, taxes, depreciation, and amortization [EBITDA]).

Staff analysis

Should an EBIT subtotal be required in the statement(s) of financial performance?

19. As noted in paragraph 16 users need a comparable subtotal in the statement(s) of financial performance for screening, ratio analysis or as a starting point for their own analysis. For that reason, stakeholders recommended that we define EBIT and/or operating profit.
20. A few users noted that they do not need both an EBIT and operating profit subtotal, and that the Board could limit itself to only requiring one of the two. They also

³ Refer to [November 2016 AP 21A](#).

⁴ Refer to summaries for the [February 2016 CMAC meeting](#) and the [November 2016 CMAC meeting](#).

⁵ CFA Institute, '[Bridging the Gap: Ensuring Effective Non-GAAP and Performance Reporting](#)', 2016, p.29. 405 investors responded to this question.

acknowledged that the terms EBIT and operating profit are often used interchangeably. However, there was no consensus among users as to whether to require an EBIT or operating profit subtotal.

21. Previous standard-setting initiatives have tried various approaches to define operating activities or operating profit but they were not successful. At the ASAF meeting in March 2017, ASAF members recommended that we define EBIT, rather than operating profit, because there is a reasonable consensus on what should be included in EBIT, making it easier to define.
22. EBIT is widely used in practice because it is a relatively comparable financial performance measure. Requiring an EBIT subtotal and defining what should, and should not, be included in that subtotal would increase comparability and hence help meet the demand from investors for a comparable subtotal in the statement(s) of financial performance.
23. Requiring and defining an EBIT subtotal is unlikely to meet the demand from some stakeholders for a more entity-specific measure of performance. As we have seen in practice, entities use their own performance measures to communicate their performance, which is often different from EBIT. We separately address this need by proposing that, in addition to presenting an EBIT subtotal, entities should be permitted to present a management operating performance measure (see Agenda Paper 21B).
24. Although defining EBIT is likely to be easier than attempting to define operating profit, there are nevertheless challenges:
 - (a) although the term EBIT is relatively consistently used as profit before finance income/expenses and tax, there is diversity in practice in the classification of finance income/expenses. This diversity and how it could be addressed are discussed in the rest of this paper.
 - (b) EBIT may be a relevant subtotal for non-financial institutions. However, it may not be a relevant subtotal for financial institutions because finance income/expenses arise from ordinary activities. Other types of entities, for example conglomerates, may have similar issues. As noted in paragraph 2, this issue will be discussed at a future meeting.

What are the similarities and differences in the EBIT-type subtotals presented in practice?

25. We have analysed the financial statements of 25 entities that report in accordance with IFRS Standards.⁶ This sample consists of large IFRS filers in five industries (ie construction and engineering, industrial conglomerates, beverages, food products and pharmaceuticals).⁷ An EBIT-type operating profit is widely used among the sample entities. Of 25 entities analysed, 19 entities presented an EBIT-type operating profit.
26. For this paper, we conducted additional analysis on the same sample of financial statements. We looked at how entities calculate their EBIT-type operating profit subtotal. We analysed what items are included in finance income/expenses in practice. We also looked at other companies that explicitly use ‘EBIT’ in their financial statements to understand how they calculate their EBIT.

Similarities

27. Entities calculate EBIT or EBIT-type operating profit as *profit before finance income/expenses and income tax*. The income tax component is simply the amount reported in the income tax line item in the statement(s) of financial performance and we have not observed significant diversity in the calculation of this tax component.
28. Although IFRS Standards do not define what is finance income/expenses, many entities classified the same items as finance income/expenses:⁸
- (a) interest expense;
 - (b) interest income;
 - (c) unwinding of discount on provisions;
 - (d) foreign currency gains/losses on financing transactions; and
 - (e) fair value gains or losses on financial assets or financial liabilities measured at fair value through profit or loss (excluding derivatives).

⁶ Refer to [November 2016 AP 21A](#).

⁷ Refer to [November 2016 AP 21A](#) paragraphs 8-10 for a more detailed description of the sample selection.

⁸ Refer to **Appendix A**.

Differences

29. Although many entities classified finance income/expenses similarly, we have observed diversity in practice in the classification of the following items:⁹
- (a) net interest on the net defined benefit liability;
 - (b) income/expenses arising from long-term investments; and
 - (c) share of results of associates/joint ventures.
30. Entities present the net interest on the net defined benefit liability either as an operating expense or finance expense. Of the 25 entities analysed, 14 presented this cost in finance expenses and seven in operating expenses, while four entities were not clear where in the statement(s) of financial performance they included it, although all of the entities analysed had defined benefit pension plans.¹⁰ We will analyse the treatment of this item further in paragraphs 43-45.
31. We also observed that income/expenses arising from long-term investments are presented either in operating income/expenses or finance income/expenses. We will discuss this further in paragraphs 46-48.
32. Entities present their share of results of associates/joint ventures in various locations in the statement(s) of financial performance. The following table illustrates this diversity in practice. Because the presentation of associates/joint ventures affects more than just the EBIT subtotal, we plan to discuss this issue at a future meeting.

Location of share of result of associates/joint ventures	Number of sample entities
(a) above EBIT-type operating profit	3
(b) above EBIT-type operating profit for joint ventures and below EBIT-type operating profit for associates	1
(c) below EBIT-type operating profit but above profit before tax	11
(d) above income tax, no EBIT-type operating profit presented	6
(e) below income tax, above profit	4

⁹ Refer to **Appendix A**

¹⁰ Refer to paragraph 34 of [November 2016 AP 21A](#).

33. In summary, entities present EBIT or EBIT-type operating profit as profit before finance income/expenses and tax. We have not seen diversity in practice in the tax component. However, we have observed different entities classifying items differently in finance income/expenses. In the following section, we will analyse how we could define or describe finance income/expenses.

How should the Board define or describe finance income/expenses?

34. As noted above we have observed some diversity in practice for classification of finance income/expenses when arriving at an EBIT subtotal. If our objective is to have a comparable EBIT subtotal it will be necessary to define or describe finance income/expenses.
35. As noted in paragraph 7, the EBIT subtotal is used by users of financial statements to compare the performance of entities independent of their capital structure. Accordingly, we think that we should describe finance income/expenses in a way that helps this comparison (ie the definition of finance income/expenses should be linked to the capital structure of the entity).
36. The capital structure of an entity could be viewed narrowly as the equity and debt financing of an entity and it is clear that income/expenses directly arising from debt finance (eg interest expense for bank loans) are finance income/expenses.
37. However, it is possible to take a wider view of what comprises the capital structure of an entity and include income and expenses from cash and short-term investments in our definition of finance income/expenses.¹¹ How an entity manages its cash and short-term investments is interrelated with its decisions on debt and equity financing. Cash or short-term investments that are not used in operations can be used to pay dividends, repay debt, buy back shares etc. Accordingly, we think that income and expenses that arise from cash or short-term investments should also be considered as finance income/expenses related to the entity’s capital structure. We think that such an approach is consistent with preparers’ practice and the view of many users:¹²

¹¹ Some long-term investments may also form part of the capital structure of the entity. This issue is discussed in paragraphs 46-48.

¹² Morgan Stanley, ‘ModelWare (ver. 1.0): A Road Map for Investors’, 2004, p. 50

The decision of whether to leave resources in cash and investments or to pay down debt or return the capital to shareholders is a decision about cash management and capital structure.

38. Therefore, in order for the EBIT subtotal to be comparable between entities with different capital structures, we think that finance income/expenses should be described as income/expenses related to the entity's capital structure. An entity's capital structure includes cash held and short-term investments.
39. Classification of some items as finance income/expenses using this description is relatively straightforward. Paragraphs 41-42 discuss income and expenses that fall into this category.
40. However, classification of other items as finance income/expenses is less straightforward. In some such cases it may be necessary for entities to exercise their judgment when classifying income or expenses as being related to the entity's capital structure. However, in other such cases, in order to achieve comparability, it may be necessary for the Board to develop guidance. In particular, the following paragraphs discuss providing guidance on:
 - (a) net interest on the net defined benefit liability (paragraphs 43-45); and
 - (b) long-term investments (paragraphs 46-48).

Income/expenses clearly related to an entity's capital structure

41. There are some liabilities that are clearly a part of an entity's capital structure, such as bank loans and debt instruments issued in financial markets (eg bonds, commercial paper). We think that all income and expenses related to these liabilities should therefore be part of finance income/expenses. Examples in this category include:
 - (a) interest expense;
 - (b) debt extinguishment and debt restructuring costs;
 - (c) fair value gains and losses from these liabilities;
 - (d) foreign currency gains or losses on these liabilities; and
 - (e) gains and losses on derivatives related to these liabilities (eg interest rate swaps).

42. We think that most users share the view that both cash and short-term instruments that cash is temporarily invested in are part of an entity's capital structure. We therefore think that the income and expenses related to these assets should be part of finance income/expenses. Examples in this category include:
- (a) interest and dividend income from short-term investments;
 - (b) gains and losses on disposal of short-term investments;
 - (c) impairments of short-term investments;
 - (d) foreign currency gains and losses on cash and short-term investments; and
 - (e) fair value gains and losses on short-term investments.

Net interest on the net defined benefit liability

43. IAS 19 *Employee Benefits* does not specify how an entity should present net interest on the net defined benefit liability. This accounting policy choice in IFRS Standards leads to diversity in practice (see paragraph 30). We observed that even in the same industry, there are differences in how entities classify this item as either in operating or finance expenses. We think this is mostly due to a difference in views on the nature of the net interest on the net defined benefit liability rather than a difference in business models.
44. For example, some stakeholders argue that the net defined benefit liability is an operating liability and therefore advocate the classification of the net interest as an operating expense together with the service cost.¹³ These stakeholders consider net interest to be a part of the cost of labour. However, other preparers and many users of financial statements classify this item as a finance expense.¹⁴ Many users told us that IFRS Standards should eliminate this accounting policy choice to achieve comparability.
45. We agree with those users and think that this policy choice should be eliminated. In some cases, accounting policy choices can help an entity faithfully represent its financial performance or position. However, we think this accounting policy choice is

¹³ S. Penman, 'The Design of Financial Statements', CEASA Occasional Paper, 2016, p. 40

¹⁴ Moody's, 'Financial Statement Adjustments in the Analysis of Non-Financial Corporations', 2015, p. 5-6., Standard & Poor's, 'Corporate Methodology: Ratios And Adjustments', 2013, p. 25-28, Morgan Stanley, 'ModelWare (ver. 1.0): A Road Map for Investors', 2004, p. 50.

different because the nature of the expense (ie net interest on the net defined benefit liability) is the same, but entities have a free choice how it should be presented.

Although there are arguments in favour of treating this expense together with the service cost, we think it should be classified as a finance expense as this reflects the approach of many users and data aggregators who treat it as a finance expense. In addition, we note that:

- (a) more entities in our sample classified this expense in finance expenses; and
- (b) this approach is also consistent with a recent FASB decision¹⁵ that, when an entity presents an operating profit subtotal, the interest cost of pensions should be presented below operating profit.

Long-term investments

- 46. In paragraph 42 of this paper, we argue that income/expenses arising from cash and short-term investments are finance income/expenses. However, we acknowledge that what constitutes a short-term investment is subjective and that some long-term investments can be viewed as part of the capital structure of the entity. For example, an entity may have cash that it invests for the long term rather than using it to return capital to shareholders or repay debt.
- 47. Other types of long-term investment are clearly not part of an entity's capital structure. For example, an entity might hold an equity stake in a business for strategic purposes without having control, joint control or significant influence. We consider that any income related to an investment of this type would not be finance income/expenses.
- 48. In order to introduce a comparable EBIT subtotal, we think finance income/expenses should be defined as clearly as possible. However, in cases such as long-term investments where the reasons for holding the item can be different between entities, we think that it is appropriate for management to exercise judgement when classifying the related income/expenses as financing. Nonetheless, this management judgement should be based on the principle that finance income/expenses are items of income/expense that are related to the capital structure of the entity.

¹⁵ the Financial Accounting Standards Board reached this decision on 2 November 2016 in its project on [Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost](#).

Staff recommendations

49. The staff recommend requiring the presentation of an EBIT subtotal in the statement(s) of financial performance. Users need a comparable subtotal in the statement(s) of financial performance for screening, ratio analysis or as a starting point for their own analysis.
50. EBIT is widely used in practice because it is a relatively comparable financial performance measure. Requiring an EBIT subtotal and providing principles for what should, and should not, be included in that subtotal would increase comparability and hence help meet the demand from investors for a comparable subtotal in the statement(s) of financial performance.
51. The staff recommend defining EBIT as profit before finance income/expenses and tax. In order for the EBIT subtotal to be comparable between entities with different capital structures, we think that finance income/expenses should be described as income/expenses related to the entity's capital structure. An entity's capital structure includes cash held and short-term investments.
52. Classification of some items as finance income/expenses using this description is relatively straightforward, however, classification of other items as finance income/expenses is less straightforward. We recommend the Board provide guidance for the following items where classification is less straightforward:
 - (a) net interest on the net defined benefit liability—we think that the policy choice in IAS 19 should be eliminated because this reduces comparability. We think that net interest on the net defined benefit liability should be classified as a finance expense as this reflects the approach of many users and data aggregators who treat it as a finance expense.
 - (b) long-term investments— we think that management should exercise judgement when classifying income/expenses related to long-term investments as financing. Nonetheless, management judgement should be based on the principle that finance income/expenses are items of income/expense that are related to the capital structure of the entity.
53. Requiring and defining an EBIT subtotal is unlikely to meet the demand from some stakeholders for a more entity-specific measure of performance. We separately

address this need by proposing that, in addition to presenting an EBIT subtotal, entities should be permitted to present a management operating performance measure (see Agenda Paper 21B).

Question for the Board

Does the Board agree with the staff recommendations in paragraphs 49–53?

Appendix A—Finance income/expenses analysis for 25 companies¹⁶

Similarities—consistency in classification of finance income/expenses

Item	Finance	Operating
Interest expense	21	1
Interest income	20	1
Unwinding of discount on provisions	15	-
Foreign currency gains/losses on financing transactions	15	1
Fair value gains or losses on financial assets or financial liabilities measured at fair value through profit or loss (excluding derivatives)	8	2

Differences—diversity in practice in classification of finance income/expenses

Item	Finance	Operating
Net interest on net defined benefit liability	14	7
Long-term investments—Dividend income from financial assets at fair value through OCI	10	4
Long-term investments—Gain/losses on disposal of financial assets at fair value through OCI	7	5
Long-term investments—Impairment of financial assets at fair value through OCI	6	4

¹⁶ Observations are not reported in the table when: (a) the entity did not have this type of income/expense; (b) it is not clear how the item was classified; or (c) the item was not strictly allocated to either the finance or operating category.