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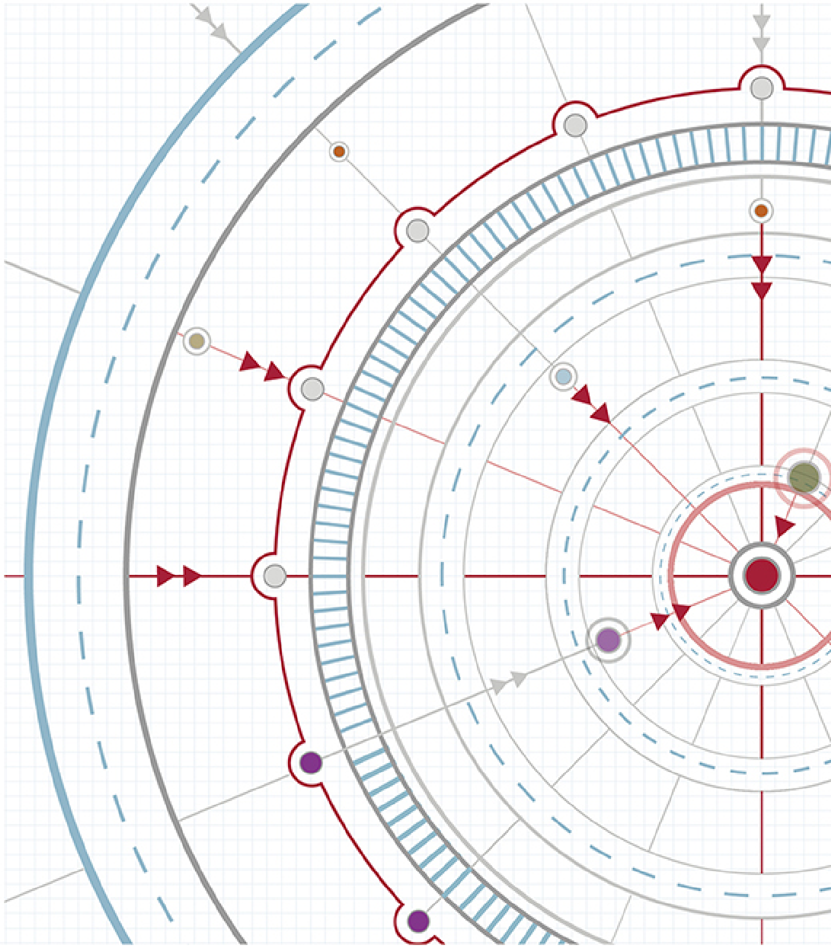

Primary Financial Statements

Financial institutions and performance reporting

Aida Vatrenjak, senior technical manager

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Agenda paper 4

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Introduction and purpose of the session

- In this session, we will brainstorm about useful subtotals for the presentation of financial performance of **banks**
- The Board discussion on the project has not yet included financial institutions[1]

[1] The Board discussion also excluded other entities providing financial services and investment entities. For simplicity, we are limiting discussion at this meeting to one type of financial institution.

Questions for CMAC members

Q1

Which performance metrics do investors commonly use when analysing banks?

Q2

Are those metrics readily available? Are they reported consistently?

Questions for CMAC members

Q3

Would any defined performance measures above profit before tax in the statement(s) of financial performance provide useful information to investors in banks? Why or why not?

Q3a

Could such measures be consistent with current project proposals for non-financial institutions:

- profit before investing, financing and tax; and
- profit before financing and tax?

Presentation of financial performance by banks

- Items commonly presented in statement(s) of financial performance
  - Interest income and expense
  - Commissions and fees
  - Trading income
  - Net gains or losses
- Significant differences in content of individual line items, eg interest – see next slide

Banks' presentation of financial performance—net interest income

- Net interest income = interest revenue – interest expense
- Different approaches by banks to what is included in 'interest':
  - all include interest from instruments measured at amortised cost;
  - some include interest component from fair value changes; and
  - some include interest from liabilities such as pension obligations.
- Interest expense arising from liabilities that form part of regulatory capital can be included in net interest income
- Some banks include credit losses in calculating net interest income or present the losses next to it; others present them further down the statement(s) of financial performance
- Can be hard to reconcile interest revenue and expense with underlying assets and liabilities—disaggregation by class can be varied and accounting policy vague

Example 1—P&L presentation and net interest note

Credit losses presented close to net interest

Consolidated Statement of Income

in € m.	2016
Interest and similar income	25,636
Interest expense	10,929
Net interest income	14,707
Provision for credit losses	1,383
Net interest income after provision for credit losses	13,324
Commissions and fee income	11,744
Net gains (losses) on financial assets/liabilities at fair value through profit or loss	1,401
Net gains (losses) on financial assets available for sale	653
Net income (loss) from equity method investments	455
Net income (loss) from securities held to maturity	0
Other income (loss)	1,053
Total noninterest income	15,307
Compensation and benefits	11,874
General and administrative expenses	15,454
Policyholder benefits and claims	374
Impairment of goodwill and other intangible assets	1,256
Restructuring activities	484
Total noninterest expenses	29,442
Income (loss) before income taxes	(810)
Income tax expense	546
Net income (loss)	(1,356)

Net Interest Income

in € m.	2016
Interest and similar income:	
Interest-earning deposits with banks	684
Central bank funds sold and securities purchased under resale agreements	359
Interest income on financial assets available for sale	1,313
Dividend income on financial assets available for sale	205
Loans	12,311
Interest income on securities held to maturity	67
Other	1,417
Total Interest and similar income not at fair value through profit or loss	16,357
Financial assets at fair value through profit or loss	9,279
Total interest and similar income	25,636
Interest expense:	
Interest-bearing deposits	2,583
Central bank funds purchased and securities sold under repurchase agreements	255
Other short-term borrowings	179
Long-term debt	1,759
Trust preferred securities	437
Other	1,083
Total Interest expense not at fair value through profit or loss	6,295
Financial liabilities at fair value through profit or loss	4,634
Total interest expense	10,929
Net interest income	14,707

Accounting policy extract – Net interest income – Interest from all interest-bearing assets and liabilities is recognized as net interest income using the effective interest method. The effective interest rate is a method of calculating the amortized cost of a financial asset or a financial liability and of allocating the interest income or expense over the relevant period using the estimated future cash flows. The estimated future cash flows used in this calculation include those determined by the contractual terms of the asset or liability, all fees that are considered to be integral to the effective interest rate, direct and incremental transaction costs and all other premiums or discounts.

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Example 2—P&L presentation and net interest note

Credit losses presented with other provisions further down the statement

Consolidated income statement

For the year ended 31 December	2016 £m
Continuing operations	
Interest income	14,541
Interest expense	(4,004)
Net interest income	10,537
Fee and commission income	8,570
Fee and commission expense	(1,802)
Net fee and commission income	6,768
Net trading income	2,768
Net investment income	1,324
Other income	54
Total income	21,451
Credit impairment charges and other provisions	(2,373)
Net operating income	19,078
Staff costs	(9,423)
Infrastructure costs	(2,998)
Administration and general expenses	(2,917)
Provision for UK customer redress	(1,000)
Provision for ongoing investigations and litigation relating to Foreign Exchange	–
Operating expenses	(16,338)
Share of post-tax results of associates and joint ventures	70
Profit/(loss) on disposal of subsidiaries, associates and joint ventures	420
Profit before tax	3,230
Taxation	(993)
Profit/(loss) after tax in respect of continuing operations	2,237
Profit after tax in respect of discontinued operation	591
Profit after tax	2,828

Net interest income

	2016 £m
Cash and balances with central banks	186
Financial investments	740
Loans and advances to banks	600
Loans and advances to customers	12,958
Other	57
Interest income[a]	14,541
Deposits from banks	(265)
Customer accounts	(1,514)
Debt securities in issue	(990)
Subordinated liabilities	(1,104)
Other	(131)
Interest expense[a]	(4,004)
Net interest income	10,537

Accounting policy extract: Accounting for interest income and expense: Interest income on loans and advances at amortised cost, financial investments debt securities, and interest expense on financial liabilities held at amortised cost, are calculated using the effective interest method which allocates interest, and direct and incremental fees and costs, over the expected lives of the assets and liabilities…

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Common alternative performance measures for banks

- Operating profit, cost/income ratio; common adjustments for:
  - credit loss provisions
  - goodwill impairment
  - restructuring costs
- Adjusted net income; common adjustments for:
  - investment disposals
  - own credit risk
  - non-recurring transactions or provisions
- Return on equity; can use adjusted net income and differing definitions of equity

Valuation of non-financial entities

- Earnings before interest and tax (EBIT) is used for analysing **non-financial** entities in exercises such as:
  - Discounted cash flow (DCF) models to derive an enterprise value (EV) estimate (ie for some, EBIT can serve as a starting point for estimating free cash flows)
  - Comparing enterprise value multiples (eg EV/EBIT or EV/EBITDA)

Valuation of banks

- Users prefer other approaches for analysing banks, such as:
  - Dividend Discount Models (DDM) or Residual Income models (ie methods that typically use net profit rather than EBIT)
  - Comparing equity-based multiples (eg Price/Earnings or Price/Book Value)

A measure of profit before financing and tax does not feature as an input for the most commonly used valuation methodologies applied to banks.

Could profit before financing and tax be useful for banks?

- We are not aware of a measure of profit before financing and tax being used in the analysis of banks today (some credit rating agencies split operating and financing interest when analysing insurance companies)
- Banks subject to only **minimum** capital requirements, still can have different capital structure – comparison of performance before impact of capital structure could have merits

What would presentation of profit before financing and tax mean for banks?

- Would depend on interpretation of capital structure for banks
  - Most liabilities could be considered ‘operating’ and thus profit before financing would be the same as profit after financing
  - Link to regulatory capital could be explored and thus some expenses would be classified as financing – however some banks may consider liabilities included in regulatory capital as ‘operating’ and would not agree with presenting related expenses as financing

Resources on banks' performance reporting

- ESMA 2013 report on IFRS financial statements of financial institutions in Europe highlights differences in presentation in financial statements
- Recent European study by Mazars on the use of alternative performance measures (APM) in financial information provides more details on most common APMs

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