ITCG meeting—June 2019

Agenda Paper 3B

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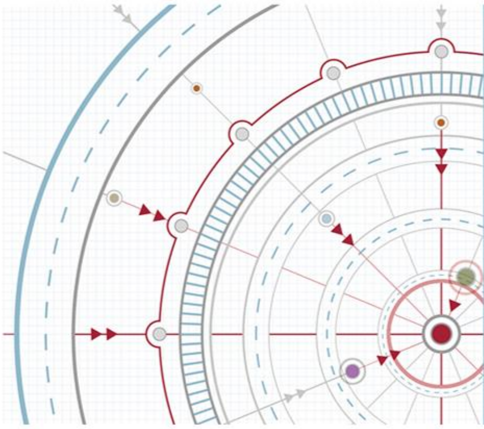

Tentative Board decisions in the Primary Financial Statements project

Background to Agenda Paper 3A

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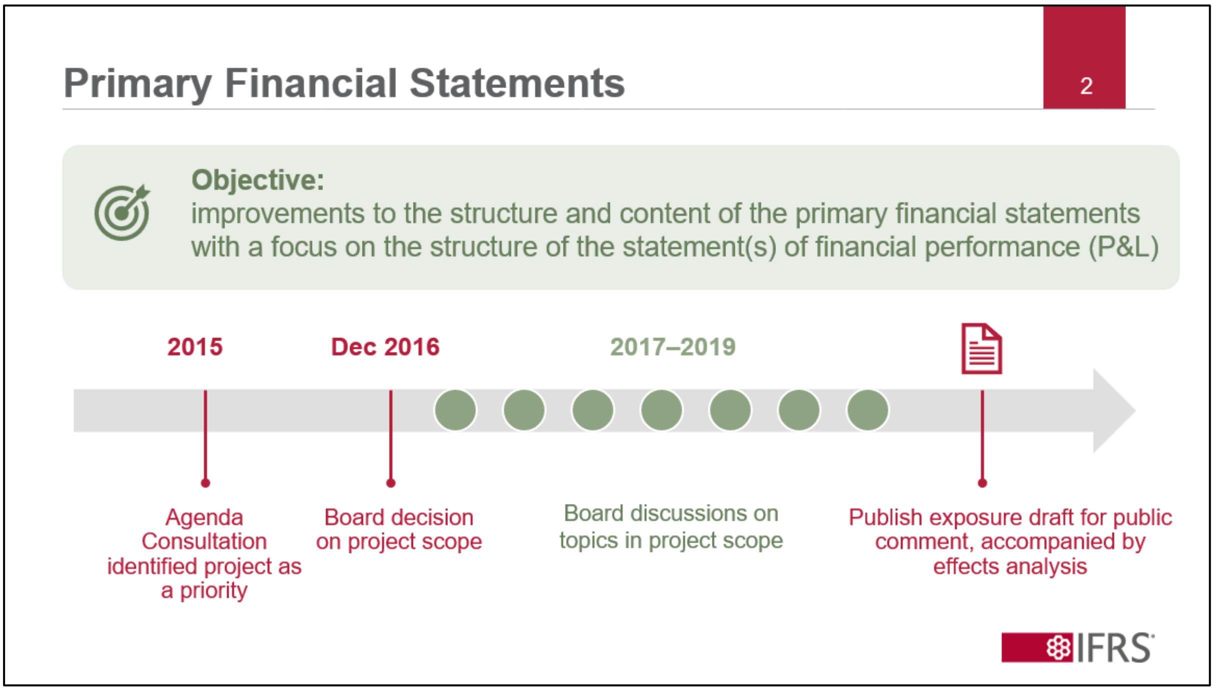
These slides will not be presented during the meeting. Please read through the slides and speaker notes in advance of the meeting.

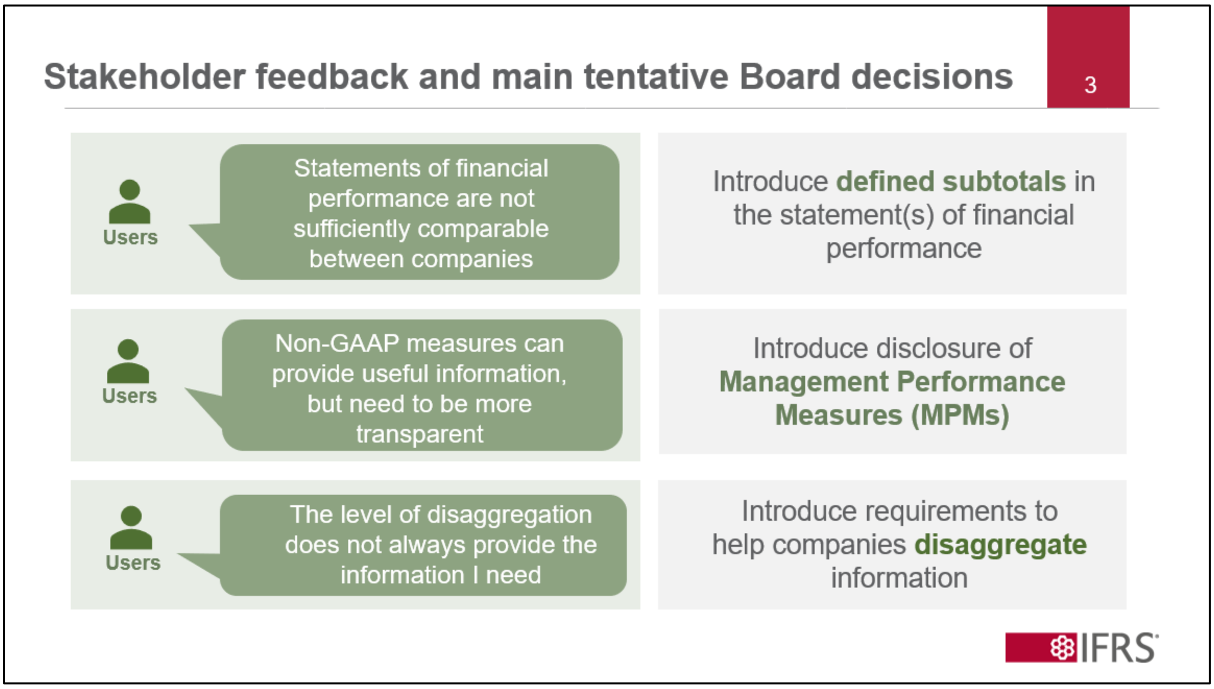


- The Primary Financial Statements project is part of the Board's work on Better Communication in Financial Reporting (see https://www.ifrs.org/projects/better-communication/), which also includes the Disclosure Initiative, the Board's Management Commentary project and the IFRS Taxonomy.

- The Primary Financial Statements project aims to help users make better decisions by improving the structure and content of the primary financial statements (ie the statement(s) of financial performance, the statement of financial position, the statement of cash flows and the statement of changes in equity), with a focus on the statement(s) of financial performance.

- The Board has developed a set of tentative proposals over the last two years and is planning to publish an Exposure Draft by the end of 2019. This document will be accompanied by an effects analysis, which describes the likely benefits and costs of the proposals—including the implications for electronic reporting. The feedback received at this ITCG meeting will be used as an input into the effects analysis.

- Feedback on the Exposure Draft will be used to help the Board develop the requirements of a new Standard on financial statement presentation. We expect to issue a Proposed IFRS Taxonomy Update to reflect the new requirements at the same time as the final Standard.



At the start of the project, the staff conducted research and consulted with users and preparers to identify the main problems with the presentation of financial performance. This slide summarises the main messages received and the main project proposals to address these issues:

- Users have repeatedly told us that the structure and content of the statement(s) of financial performance varies between companies, even within the same industry. This makes it difficult for users to assess and compare financial performance. The Board is proposing to improve comparability by requiring defined subtotals in the statement(s) of financial performance.

- Research shows that many companies communicate their performance outside the financial statements using measures not defined by IFRS Standards (commonly called non-GAAP measures or alternative performance measures). Such measures include 'adjusted' or 'underlying' profit measures that have been adjusted for unusual items (eg restructuring expenses) and/or recurring items (eg share-based payment expenses). We have heard from users that such non-GAAP measures can be useful to them in their analysis but that this information is often not transparent and can be hard to reconcile with the IFRS numbers. Preparers have also told us that such non-GAAP information is useful, because it enables them to tell their company's story. The Board's tentative decisions on management performance measures aim to bring such measures into the financial statements and enhance their transparency.

- Finally, users say companies do not adequately disaggregate information in financial statements—dissimilar items are often lumped together, which makes information hard to analyse. The Board has developed a set of proposals to help companies disaggregate information in financial statements.

Introducing three defined subtotals in P&L

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	Revenue	16,500	
	Changes in inventories of finished goods and work in progress	(1,000)	
	Raw material and consumables used	(6,000)	
	Employee benefits expense	(4,000)	Operating
	Impairment of property, plant and equipment	(500)	
	Depreciation expense	(1,200)	
	Amortisation expense	(800)	
1	**Operating profit**	**3,000**	
	Share of profit of **integral** associates and JVs	500	
2	**Operating profit and share of profit or loss of integral associates and JVs**	**3,500**	
	Changes in the fair value of financial assets	250	
	Dividend income	50	Investing
	Share of profit of **non-integral** associates and JVs	100	
3	**Profit before financing and income tax**	**3,900**	
	Interest income from cash and cash equivalents	100	
	Expenses from financing activities	(1000)	Financing
	Unwinding of discount on pension liabilities and provisions	(100)	
	Profit before tax	2,900	

- The only (sub)total IAS 1 requires is profit or loss for the period, at the bottom of the statement(s) of financial performance. Users have told us that is not enough and have asked us for comparable subtotals higher up the statement of financial performance.
- This slide presents the three subtotals the Board is proposing to define and require. Note that the line items shown between the subtotals are only illustrative—they are not required line items and, in most cases, the Board has not defined the content of the line items, so they may not be comparable across companies.
- The three subtotals are defined bottom-up. In other words, the Board has defined each subtotal by specifying which items are *excluded* from profit or loss, rather than specifying which items are *included* in the subtotal. This is because previous attempts to define operating profit in a positive way by the Board and other standard-setters have been unsuccessful.
- The three subtotals are (starting from the bottom):

1. **Profit before financing and tax** (similar to what some companies and users today call 'EBIT'):
    - Users often want to compare companies' performance before the effect of financing and this subtotal enables that comparison. In other words, the profit before financing and tax subtotal facilitates comparison of companies with different capital structures.
    - Profit before financing and tax is defined as profit before:
        - Tax;
        - Expenses (income) from financing activities—the Board has defined 'financing activities' as involving: (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 the payment of a finance charge;

- Income from cash and cash equivalents; and
- The unwinding of a discount on liabilities not arising from financing activities.

2. **Operating profit and share of profit or loss of integral associates and joint ventures:**

   - Investors have told us that they value some types of investments separately from the main business of an entity. For example we understand that investors often value investment properties separately from a company's main business. To facilitate this analysis the Board is proposing to introduce an investing section to the P&L.
   - The Board has defined income (expenses) from investments as: 'income and expenses from assets that generate a return individually and largely independently of other entity resources'. For companies that are not financial institutions, this section aims to capture returns on investments in financial assets and other investments such as investment properties.
   - The investing category includes the share of profit or loss of associates and joint ventures that are *not integral* to the company's main business activities. The share of profit or loss of associates and joint ventures that are *integral* to business activities is presented above the 'Operating profit and share of profit or loss of integral associates and JVs' subtotal.

3. **Operating profit**

   - Operating profit is a commonly used measure of performance. However, it is not currently defined in IFRS Standards. As a result, companies define operating profit differently—reducing comparability. By requiring and defining an operating profit subtotal, the Board will improve comparability across companies.
   - Operating profit is defined as profit before tax, the share of profit of integral associates and joint ventures, income (expenses) from investments, expenses (income) from financing activities, income from cash and cash equivalents and the unwinding of a discount on liabilities not arising from financing activities.
   - Although operating profit is defined as a residual, it can be thought of as the result of a company's main business activities.

- For some companies, such as financial institutions, the approach described above would result in income and expenses arising from the company's main business activities being presented below the operating profit subtotal. To address this issue, the Board has developed a set of principles which would require companies with particular business activities to include items from the investing and financing category in operating profit. For example, banks would include interest expenses in operating profit, rather than in the financing category.

Management performance measures (MPMs)

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Requirements for disclosure in the notes of performance measures not defined by IFRS Standards:

MPM Definition A measure of comprehensive income that is used in public communications with users of financial statements, outside financial statements, and which, in management's view complements IFRS-defined subtotals in communicating an entity's performance.

Single note disclosure should include:

- a reconciliation to the closest IFRS-specified (sub)total and effect of tax and non-controlling interests for each reconciling item (see example below)
- the entity's definition of the management performance measures
- an explanation of any changes in the definition over time

Adjusted operating profit (MPM)	4,400	Tax	NCI
Restructuring expenses for the closure of Factory A	(1,000)	200	(50)
Impairment of asset B	(400)	80	-
Operating profit (IFRS-specified)	3,000		

- The Board acknowledges that many companies communicate about their performance outside the financial statements using measures not defined by IFRS Standards, but which, in management's view, complement IFRS-defined totals or subtotals in communicating the company's performance. The Board has tentatively decided to require companies to include such measures in the notes to the financial statements as 'management performance measures' (MPMs).
- Companies can have more than one MPM. Companies are not required to identify MPMs if they do not use such measures. Only in very rare cases does the Board expect MPMs to fit as a subtotal in the structure of the statement(s) of financial performance.
- General constraints, such as faithful representation and consistent presentation over time, will apply to MPMs, but the Board has not specified any additional constraints on the calculation of MPMs. The Board's rationale was that, if any constraints are imposed, the measures would no longer represent management's view of performance. MPMs are generally not expected to be comparable across companies.
- To enhance the transparency of such measures, the Board has tentatively decided to require a set of accompanying disclosures for each MPM in the notes, including:
    - a reconciliation between the MPM and the closest subtotal or total specified by IFRS Standards—that is, those in paragraph 81A of IAS 1, the Board's proposed subtotals (see slide 4) and those included in a Board-specified list of measures that are not MPMs (profit before tax, profit from continuing operations, gross profit and operating profit before depreciation and amortisation).
    - the effect on tax and non-controlling interests for each reconciling item.
    - narrative disclosures that define the MPM, explain how it provides useful information about the company's financial performance and explain how its calculation has changed over time.

Disaggregation

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General	Improved principles, definitions and guidance on aggregation and disaggregation (eg to avoid large balances labelled 'other')
Expense analysis	• Companies are required to present their primary analysis of expenses by nature or by function in the statement(s) of financial performance. Additional line items or subtotals must not disrupt this structure. • When the primary analysis of expenses is presented by function, companies are required to disclose in the notes a full analysis of expenses by nature.

Example: expenses by nature	
Revenue	16,500
Changes in inventories	(1,000)
Raw material and consumables used	(6,000)
Employee benefits expense	(4,000)
Depreciation expense	(1,700)
Amortisation expense	(800)
Operating profit	**3,000**

Example: expenses by function	
Revenue	16,500
Cost of goods sold	(8,000)
Gross profit	(8,500)
Selling, general and admin costs	(5,500)
Operating profit	**3,000**

- The Board has tentatively developed guidance to help companies disaggregate information in financial statements, including specific guidance to address large line items in financial statements that are labelled 'other' (eg 'other expenses' or 'other liabilities').
- The Board has tentatively decided that companies are required to present their primary analysis of expenses by nature *or* by function in the statement(s) of financial performance. In other words, a mixed approach is not allowed. Additional line items or subtotals a company inserts must not disrupt this structure. In addition, if a company presents its primary analysis of expenses by function, it will be required to disclose a full analysis of expenses by nature in the notes. Consequently, information on operating expenses disaggregated by nature will be available for all companies.

Unusual items

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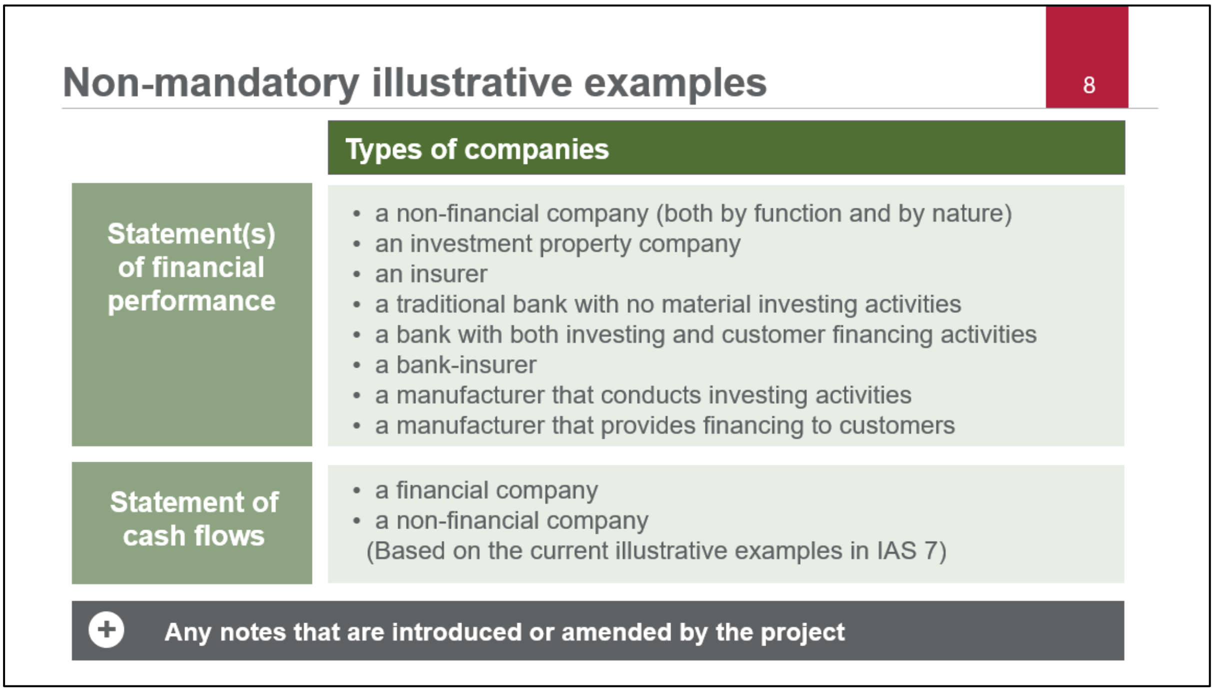
Definition	Income or expenses with limited predictive value because it is reasonable to expect that similar items will not arise for several future annual reporting periods. Similar items are income or expenses that are similar in type and amount.
Note disclosure	Disclose unusual items attributed to line items in the statement(s) of financial performance

	Unusual Items			
Line items in P&L that include unusual items	Restructuring of subsidiary A	Litigation costs arising from Case X	Bargain purchase of entity Y	Total unusual items incl. in P&L line item
Employee benefits expense	(300)			(300)
Impairment of non-financial assets	(150)			(150)
Professional fees	(70)	(50)		(120)
Other income			450	450
Expenses from financing activities	(80)			(80)
Profit before tax	(600)	(50)	450	(200)

- Information about unusual items is important to investors for predicting future cash flows. The Board has tentatively decided to require companies to disclose in the notes which components of income or expense have limited predictive value, that is, items that are unusual either in size or in type. The Board's definition and guidance are expected to strengthen discipline in this area.
- Note that companies may—but are not required to—adjust for (some) unusual items in the calculation of their MPMs. In addition, MPMs can be adjusted for items that do not meet the definition of 'unusual items', such as amortisation of acquired intangible assets.



- The Board has tentatively decided to develop non-mandatory examples to illustrate the Board's decisions in the project for some types of companies.
- The examples would mainly illustrate the presentation of the statement(s) of financial performance and the statement of cash flows. In addition, the Board will develop some examples of notes introduced or amended by the project, such as the MPM disclosures (including the reconciliation to the closest IFRS-defined subtotal) and the disclosure of unusual items.

Get involved

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