July 2018

IASB® *Investor Update*

Our newsletter for the investment community

Editor's welcome

This summer issue marks four years since we published the first *Investor Update,* featuring a profile on the then-recently issued revenue Standard IFRS 15: *Revenue from Contracts with Customers*. Now we are seeing the changes in action, with the implementation appearing in 2018 interim results. Investment professionals should know that while we are monitoring implementation, regulators are also adapting to the new Standard. One of this issue's Spotlight articles highlights the recent efforts of the European Securities and Markets Authority (ESMA), which has issued publications on its enforcement priorities and on the disclosures required by new IFRS Standards.

Investors can also expect changes resulting from new Standards in 2019, when the effects of implementing IFRS 16 *Leases* shall appear in financial statements. Because we are halfway through the year and are also looking ahead to 2019, we share a Spotlight article which provides a reminder of what is on the way.

For our In Profile in this issue, it's a pleasure to hear the views of Selim Gogus of Credit-Suisse HOLT. He brings us some perspectives on his firm's unique approach to financial statement analysis and valuation. Selim is one of the new members of the International Accounting Standard Board (Board) Capital Markets Advisory Committee (CMAC), which is currently open to applications for new members.

We expect a busy second half of 2018 in investor outreach, as the consultation period for the Discussion Paper *Financial Instruments with Characteristics of Equity* attracts interest on the part of credit investors, among others. We look forward to hearing your views on this topic.

All the best,
Fred

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The *IASB* Investor Update *highlights market-relevant accounting topics that could affect the companies that investors follow. It also shares with investors information on standard-setting and insights from our dialogues with the investment community. We invite investors seeking further detail on accounting proposals and current requirements to contact us.*

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Spotlight: IFRS 16 *Leases*

Keep calm and carry all leases on balance sheet —IFRS 16 *Leases*

With the implementation date for the new leases Standard arriving shortly (1-Jan-2019), we highlight some aspects of the new lessee accounting model and disclosure requirements. We expect that investors will find these new requirements useful in analysing companies that make significant use of leases.

Why did the Board develop the new lessee accounting model?

During outreach on the leases project, investors told the Board that the current lessee accounting model fails to provide meaningful information for their analysis. For instance, disclosure on future lease commitments for operating leases are often inadequate; only sophisticated investors make the necessary adjustments to compare and analyse companies. The current off-balance sheet treatment for operating leases (even when lease payments are potentially unavoidable), does not accurately portray the underlying economics of leases. As a result, comparing companies that use operating leases with companies that use finance leases or make outright purchases of assets (with borrowings) is a challenge for many investors.

During the project's outreach, regulators also raised the issue of high-profile liquidations of companies with ballooned exposures to operating leases, highlighting the financial-stability blind spot resulting from off-balance sheet leases.

What are the key features of the new model?

IFRS 16 removes the distinction between operating and finance leases for lessees and introduces a single model for recognising and measuring almost all leases reported in the financial statements. IFRS 16 requires companies to recognise almost all leases on the balance sheet as the present value (PV) of lease payments that include all fixed payments (and optional payments that are reasonably certain) plus any residual value guarantees.

The discount rate used to calculate the PV must be the rate implicit in the lease. If the implicit rate is not readily available, the lessee's incremental borrowing rate is used to calculate the PV.

What changes in the financial statements?

On the profit and loss statement, lease expense will be divided into depreciation and interest expense components for all leases. The interest expense is determined using the effective interest rate method (the same method used for finance leases under IAS-17 *Leases*). If other subtotals in the P&L remain the same as those of 2018, the removal of the operating lease expense (under current requirements) would result in a higher EBITDA and operating profit on transition. The transitional impact on profit-after-tax will depend on the characteristics of a company's lease portfolio. For a stable portfolio of leases (new leases replacing old ones), the impact is not expected to be significant.

The balance sheet will reflect a right-of-use (ROU) asset and a corresponding lease liability at initial recognition (similar to finance leases under the IAS 17 model).

Even though there is no effect on total net cash flow from the accounting change, removing operating lease expenses will result in higher cash flow from operations. Instead, the repayment of lease liability will flow through cash flow from financing. The interest expense for all leases will flow through either operating or financing cash flows.

What disclosures will companies provide?

Companies will be required to provide information for all material leases such as the breakdown of lease costs, total lease cash flows, ROU assets by asset major class of leased assets, and maturity analysis of lease commitments. Investors can use this information to determine the lease amounts recognised in the P&L, cash flows related to leases and capital expenditure-equivalent information.

When leases also contain complex features such as extension/termination options, variable lease payments, residual value guarantees, companies must provide additional disclosures to enable investors to understand the impact of such features on financial statements.

For a more detailed look, we encourage readers to check out this Investor Perspectives article.

Spotlight: ESMA and IFRS

Shining light on financial reporting enforcement

In this Spotlight article, we highlight the links between the enforcement priorities of European regulators and Board projects. We also examine the regulators' identification of financial reporting deficiencies in 2017.

A summary of European enforcement in 2017

In 2017, ESMA and European regulators evaluated corporate compliance with IFRS Standards in areas identified as European Common Enforcement Priorities (ECEP) for the 2016 annual financial statements. Enforcers publish and communicate these priorities to companies before they finalise their annual financial statements, with the goal of enhancing financial reporting quality. Below, we highlight 2016 enforcement priorities and share some findings published in the ESMA 2017 Annual Report[1]:

a) **Presentation of financial statements** Enforcers assessed whether presentation of financial performance and financial position followed the principles in IFRS Standards. In many cases, the enforcers acted on non-compliance with the requirements relating to the presentation of line items, heading and sub-totals, the presentation of segmental information and the application of ESMA's Alternative Performance Measures guidance.

b) **Distinction between financial liabilities and equity** Enforcers found that in 44 cases where the distinction between a financial liability and equity instrument was relevant and material, about 40% did not disclose the analysis made in their classification. In addition, many cases lacked the disclosure of key characteristics of the instruments.

What is the Board doing in these areas?

The Primary Financial Statements (PFS) research project is working to develop guidance on the structure and content of the P&L statement. The Board is currently debating defining subtotals such as earnings before interest and tax (EBIT) and management-defined performance measures for presentation on the P&L. The Board is aiming to finish its initial discussions in 2018 and to publish a consultation document in 2019. We expect a high level of investor engagement on this project around the world.

The Financial Instruments with Characteristics of Equity (FICE) project is exploring improvements to requirements in IFRS Standards (IAS 32 *Financial Instruments: Presentation)* for classifying financial instruments that have characteristics of both liabilities and equity. The Board is also examining presentation and disclosure requirements for such instruments.

The Board is currently seeking feedback on the issues discussed in the FICE DP. The comment deadline for this paper is 7 January 2019.

Transitional disclosure for IFRS 9 and IFRS 15

European enforcers have emphasised the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for companies to disclose reasonably estimable information about the expected impact of new Standards on financial statements. To examine the level of compliance with these requirements in the 2016 annual and 2017 interim reports, enforcers conducted a fact-finding exercise (results published in October 2017[2]).

The transition to IFRS 9 *Financial Instruments* has resulted in examples of comprehensive, high-quality transitional disclosures published in a timely manner. In Europe, ex-ante guidance from the Enhanced Disclosures Task Force and the European Banking Authority has supported this trend for a wide base of banks.

On the transition to IFRS 15, *Revenue from Contracts with Customers*, we have heard from numerous investors that companies have been slow to provide entity-specific transitional disclosures. In many cases, investors would have also liked transitional information to reflect disclosures on performance obligations, judgements and disaggregation of revenue.

[1] https://www.esma.europa.eu/document/enforcement-and-regulatory-activities-accounting-enforcers-in-2017

[2] https://www.esma.europa.eu/document/summary-results-fact-finding-exercise-ifrs-9-and-ifrs-15

In profile

In every issue, we feature IFRS events or interviews with key stakeholders or Board members. In this issue, we interview Selim Gogus, HOLT specialist at Credit Suisse, and member of the Capital Markets Advisory Committee (CMAC).

Investor engagement team: What is HOLT, and what led to the development of its proprietary methodology?

HOLT is a team in Credit Suisse that helps investors make better decisions by using an objective framework for comparing and valuing companies. The HOLT global database covers about 20,000 companies, reflecting c.98% of the Global Market Cap from across 67 countries. At the heart of the HOLT framework is the propriety Cash Flow Return on Investment (CFROI®)—a cash-based return on capital metric that is free from distortions in financial statements that may affect traditional accounting ratios like EPS, ROE, ROCE, etc.

Investor engagement team: Could you give us some insights into how the CFROI methodology goes beyond commonly used accounting ratios?

The CFROI methodology was developed with the intention to minimize accounting distortions in measuring a firm's economic performance, particularly distortions related to inflation. For example, a traditional ROIC (return on invested capital) is influenced by asset age—simply letting the assets depreciate can increase the ROIC measure. HOLT starts by looking at gross assets (adding back accumulated depreciation), eliminating the issues of old vs. new assets. The values are in turn inflation adjusted, allowing for comparison across time and countries. A time series of the CFROIs help in forecasting a firm's likely returns on future investments. This allows us to elegantly link corporate performance to valuation—where traditional accounting metrics do not.

Investor engagement team: What are the common adjustments made to financial statements?

Given the shortfalls of net income, the CFROI calculation adjusts financials to bring a company's net income closer to economic reality. Typically, we add back any non-cash charges such as depreciation and amortisation. We eliminate the P&L impact from pension accounting and only include pension service cost as the most relevant cost of running defined benefit schemes. We reverse out one-off items such as impairments, M&A costs, gains or losses on disposals in order to show a recurrent level of earnings. CFROI calculations also exclude Goodwill from the balance sheet, as we do not view it as an operating asset. We also capitalise operating leases and R&D as part of our gross assets.

Investor engagement team: How does the HOLT methodology adapt to new accounting standards (e.g. IFRS 9, 15, 16)?

The HOLT methodology is committed to continuous improvements whether based on adjustments made to deliver greater economic insights, or led by accounting standard changes. In the run up to the implementation of new Standards, we review the need to make specific adjustments, and at the same time take cues on the materiality of the change from early adopters. For instance, IFRS 16 brings us to an interesting crossroads as we have a long history of capitalising operating leases based on our uniform calculation. Reported values under IFRS 16 may differ from our adjustment, given assumptions around the contract life and discount rate, at which point we would assess whether to incorporate these values or continue with our adjustment systematically across all companies. Additional disclosure is vital for us to draw thorough conclusions.

Investor engagement team: In your view, what do you believe are the top three changes to current accounting (presentation or disclosure) that would deliver the biggest upside to investors?

Firstly, I would like to see more detailed and consistent segment disclosure because disclosures currently vary between companies—particularly for segmental balance sheet items. Secondly, I would like more consistency in the P&L given the number of adjustments we make to reported net earnings. This would aid comparisons between companies and data aggregation. Finally, I would welcome greater focus on transparency around "non-GAAP EPS", given the level of subjectivity in these adjusted numbers.

The investor engagement team thanks Selim for taking the time to speak with us.

Selim Gogus is an equity analyst within the Credit Suisse HOLT team, based in London.

His primary role is to advise institutional investors on key accounting, tax and valuation issues as part of their investment process. Prior to this position, he was at PricewaterhouseCoopers for 5 years in their audit and transaction services teams.

We Need Your Views

The Board sets Standards to help you, the investor, make decisions about companies. But we can't do it without your views. Your participation helps us understand whether potential changes to the Standards will provide you with the information necessary for investment analysis. Below are some of the projects that we expect to engage with investors on during 2018. For a full list of topics please visit the Workplan.

Financial Instruments with Characteristics of Equity

On 28 June 2018 the Board published the Discussion Paper *Financial Instruments with Characteristics of Equity.* The Discussion Paper sets out the Board's preferred approach to improving information companies provide in their financial statements about financial instruments they have issued.

Today, IAS 32 *Financial Instruments: Presentation* sets out how companies classify financial instruments that they have issued as financial liabilities or equity in their financial statements.

IAS 32 proved robust during the global financial crisis of 2007–08 and it works well for most financial instruments. However, the Board observed that continuing financial innovation means that companies find it challenging to use IAS 32 to account for some complex financial instruments that combine features of both liabilities and equity.

The challenges of using IAS 32 to account for these complex financial instruments can result in diversity in practice. Such diversity, in turn, makes it difficult for investors to assess how these financial instruments affect the issuers' financial position and performance.

In addition, the Board is acutely aware that investors have been calling for better information about equity instruments.

To help address these challenges, the Board has developed an approach that would:

- provide classification principles with a clear rationale for why an instrument is classified as either a liability or equity without fundamentally changing the existing classification outcomes of IAS 32; and
- enhance the information provided through presentation and disclosure.

In the Board's view, its approach would help investors:

- get more comparable information about financial instruments issued by companies because the Board's preferred approach would improve the consistency in how those financial instruments are classified;
- get richer information through presentation about features of financial liabilities and equity that are not captured by classification. For example, the Board is considering possible presentation requirements that would show investors how companies' profit or loss and other comprehensive income are attributed among different equity instruments as well as among ordinary shares.
- get richer information through disclosure about features of financial liabilities and equity, such as the priority of financial liabilities and equity instruments at liquidation, potential dilution of ordinary shares and contractual terms and conditions relevant to understanding the features of instruments.

We would like to understand whether the Board's preferred approach set out in the Discussion Paper would provide information you would find useful. In some places, the Board explored more than one possible way to improve the information provided, and we need your views to determine which approach would best serve your needs. We intend to meet with a range of investors around the world on this consultation in the coming months.

Further information on this topic can be found on the project page here.

Targeted Standards-level Review of Disclosures

The Board expects to select one or two Standards for review in July 2018. The Board will then seek feedback from investors about the disclosure requirements in those Standard(s). The Board will be looking to understand in detail:

- *what* information investors would like to see;
- *why* that information is useful; and
- the types of *analysis* that investors would perform using that information.

The Board intends to use this information to improve the disclosure requirements in the selected Standard(s) and to help improve the Board's own process for developing effective disclosure requirements. The Board will be aiming to develop requirements that clearly reflect the objectives and information needs of investors to help preparers apply more effective judgement about what to disclose.

Further information on this topic can be found on the project page here.

We Need Your Views

Management Commentary

The Board has discussed plans for updating its Management Commentary *Practice Statement.*
The Board tentatively decided that in updating the Practice Statement it would consider the following four areas of content:

- **descriptions of business models, strategies and risks**—focusing on narrative and analysis of the entity's strategy, business model and operating environment;
- **current year financial performance analysis**—focusing on performance information applying IFRS Standards;
- **operational information**—focusing on strategically relevant operational performance analysis; and
- **forward-looking statements**—focusing on explanations and analysis of forecast information where provided.

The specific areas for consideration will evolve as the project develops over 2018, supported by consultation.

Further information on this topic can be found on the project page here.

Management Commentary Consultative Group

The Board has announced the formation of a consultative group on its Management Commentary project. The group will provide the Board with access to practical experience and expertise in developing, implementing and using management commentary regimes, and advise the Board as it develops proposals for updating the *Management Commentary* Practice Statement. The Board expects to announce the membership of the consultative group in July. The work of the consultative group will be supplemented by a wider outreach program with a broad group of stakeholders, including investors and analysts.

Further information on this topic can be found on the project page here.

Summaries of investor feedback

Below are some examples of how investor views were fed back to the Board on various projects. Further summaries of investor feedback can be found at our Investor Centre here.

Date	Summary of Investor Feedback Document
April 2018	Goodwill and Impairment research project—recent feedback from CMAC and GPF
February 2018	Principles of Disclosure Discussion Paper—investor feedback summary IFRS 17 *Insurance Contracts*—investor education activities update
July 2017	Investor reactions to IFRS 17 Insurance Contracts
January 2017	Post-implementation Review of IFRS 13: Phase 1 outreach feedback Post-implementation Review of IFRS 13: Matrix of areas of experience with IFRS 13 shared by stakeholders
November 2016	Primary Financial Statements: result of outreach on scope of project
April 2016	2015 Agenda Consultation: overview of investor feedback
March 2016	Amendment to IFRS 4: applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts:* investor feedback *Conceptual Framework*: summary of investor feedback

Stay up to date

Announcements

IFRS Foundation leaders urge constituents to respond to a European Commission consultation Chair of the Board, Hans Hoogervorst and Chair of the IFRS Foundation Trustees, Michel Prada respond to the European Commission consultation on *Fitness Check on the EU Framework for Public Reporting by Companies* and call for broad participation in the consultation. To find out more, click here.

The Board completes revisions to its *Conceptual Framework* The Board issued a revised version of its *Conceptual Framework for Financial Reporting* that underpins IFRS Standards. Supporting materials can be found here.

Sue Lloyd reappointed for a second term as Board Vice-Chair The Trustees of the IFRS Foundation appointed Sue Lloyd to serve a second term as Vice-Chair of the Board. Find out more here.

IFRS Foundation publishes 2017 Annual Report The IFRS Foundation published its annual report, including the audited financial statements, for the financial year that ended 31 December 2017. The document can be accessed here.

Makoto Takahashi appointed as IFRS Foundation's Office Director in Tokyo Makoto Takahashi replaces Mitsuhiro Takemura as Office Director of the Asia-Oceania Foundation's regional liaison office in Tokyo. Click here to read the full announcement.

Speeches and events

Joint IFRS Foundation and CFA Institute event: Transforming the impact of financial information—the role of technology On 5 June the IFRS Foundation and CFA Institute hosted their third joint event for the investment community. The event took place at Guildhall London and featured a panel discussion on the role of technology in transforming financial information. Further details about this event can be found here.

The IFRS Foundation Conference was held in Frankfurt on 28-29 June and brought together the Board and staff with private sector and regulatory leaders in financial reporting as well as accounting professionals and other people interested in IFRS Standards. Visit the conference page for more information.

IASB Chair Hans Hoogervorst delivered a keynote speech entitled 'IFRS Standards as enlightened self-interest' at the IFRS Foundation's conference in Frankfurt. Mr Hoogervorst provided an update on the adoption of IFRS Standards around the world and the current focus areas of the International Accounting Standards Board. Click here to read the full speech.

The Capital Markets Advisory Committee held its annual joint meeting with the Global Preparers' Forum at the Board's offices in London on 14 & 15 June. A summary of the meeting will be published in the coming weeks and will be available here. The next CMAC meeting takes place in London on 1 November.

Resources for investors

Sue Lloyd: IFRS 9 and equity investments Sue Lloyd, Vice-Chair of the Board, discusses IFRS 9 and explains the Board's thinking behind the requirements for equity instruments in the Standard. The article can be accessed here.

Investor Perspectives: Insurance Contracts—Accounting to reflect economics Board member Darrel Scott offers his perspective on the new information about insurers' financial performance that will be available when IFRS 17 is applied. Read more here.

Webinar: Introducing the revised Conceptual Framework for Financial Reporting Board member Françoise Flores and technical staff provide an overview of the revised Conceptual Framework for Financial Reporting. To watch the webinar, please visit our dedicated page.

New IFRS 17 *Insurance Contracts* webcast: recognising the contractual service margin in profit or loss IFRS Foundation staff present a webcast on IFRS 17 *Insurance Contracts* that provides a basic overview of recognising the contractual service margin in profit or loss. The webcast is available here

May 2018 TRG for IFRS 17 meeting summary and podcast available The Transition Resource Group for IFRS 17 Insurance Contracts held a meeting on 2 May 2018. Click here for the meeting summary and podcast.

Register for investor alerts

Click here to register for investor email alerts to stay up to date with accounting changes, investor-focused activities and other IFRS Foundation events.