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# IASB® *Investor Update*

## Our newsletter for the investment community

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

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## Editor's welcome

The autumn is upon us as we now enter the final stretch of 2017. It has been a busy time for the Investor Engagement team as we have hosted a variety of events to discuss a few of the IASB's current projects and Standards, such as the *Principles of Disclosure* Discussion Paper, Improvements to IFRS 8 *Operating Segments,* and the Post-implementation Review of IFRS 13 *Fair Value Measurement*.

In 2018, we expect the Primary Financial Statements (PFS) project to feature in our investor outreach activities, and in the meantime the project staff are keeping the Board busy with their research discussions. One of our Spotlight articles in this issue touches on the topic of presenting EBIT (earnings before interest and taxes), which we know is a key subtotal analysed by many investors. We've heard a range of views on this topic from investors so far, and discussions with the Board have highlighted the multifaceted nature of issues involved in defining subtotals such as EBIT and EBITDA. We will keep an eye on how discussions unfold to report back to you in future publications.

We have been hard at work on our investor education efforts supporting the major new Standards taking effect in 2018 and 2019—IFRS 15 *Revenue from Contracts with Customers,* IFRS 9 *Financial Instruments,* and IFRS 16 *Leases*. In the case of IFRS 15, we are even beginning to see some companies present helpful information to investors in advance of the changes taking effect. In this issue, we feature IFRS 15 in a Spotlight article and discuss how one step in the revenue recognition model can affect how companies recognise revenue. We are excited to continue educating investors about this new Standard and to see what new insights they obtain from the required enhanced disclosures.

We appreciate your interest in the *Investor Update* and look forward to hearing from you soon.

*All the best,*
*Fred*

## In this issue:

## Spotlight—To EBIT or not to EBIT

*Challenges and approaches to defining an EBIT subtotal* (sometimes considered as and labelled as 'operating profit', etc.).

### EBIT—a key ingredient of financial analysis

For many investors, financial analysis would be difficult without the use of an EBIT subtotal—a key ingredient in ratio analysis and relative valuation, and an input in a discounted cash-flow model. In some cases, companies report an EBIT to meet the analytical requirements of investors, and in other cases, investors make their own adjustments to reported EBIT to tailor it to their own analysis or valuation exercises. For example, not all investors prefer to exclude the share of profit from associates and joint ventures (JVs) from EBIT. Some investors and companies believe that including the results of closely integrated associates and JVs in EBIT better represents a company's performance.

### What is the problem with EBIT reported today?

IAS 1 *Presentation of Financial Statements* (1), permits companies to present subtotals not defined in IFRS Standards, such as EBIT or operating profit. Not all companies provide an EBIT subtotal or EBIT-type operating profit; those that do often present a company-specific version not directly comparable with that of other companies. Investors find this uneven reporting landscape frustrating.

### What are some of the challenges in defining EBIT?

A significant consideration in the EBIT calculation is the exclusion of interest (or finance income or cost). Existing Standards do not define interest or finance income or cost because debt is undefined in IFRS, but require companies to present finance cost in a separate line on the face of the P&L. It is difficult to arrive at a clear definition of EBIT without having a clear definition of interest cost.

### What is the Board doing about this issue?

The Board's Primary Financial Statements project is researching the possibility of developing requirements for presenting an EBIT-type subtotal comparable across companies.

### How is the Board approaching this issue?

The Board is exploring approaches that result in the isolation of certain line items into certain subtotals to enhance both comparability and transparency. These approaches include defining capital structure and therefore identifying corresponding finance cost or income items; creating an investing category on the P&L and identifying the items to include in this category; and creating new subtotals (for example, profit before investing, financing and income tax and EBIT or profit before financing and income tax).

With the implementation of such approaches, investors could potentially see better disaggregation of finance income, finance cost and share of profits from associates and JVs on the face of the P&L in a manner that enhances comparability of the reported subtotals.

### Approach discussed by Board in June 2017

Since investors commonly use EBIT when they want to compare performance independent of the company's capital structure, the staff are also exploring an approach that defines finance income and costs related to company's capital structure. The staff are considering defining capital structure as consisting of equity, assets and liabilities arising from financing activities (2), and cash and temporary investments of excess cash. This approach will require principles to determine the assets and liabilities to include or exclude from the capital structure (and determine the corresponding finance income or cost items).

The staff have identified the definition of financing activities (2) in IAS 7 *Statement of Cash Flows* as a starting point to develop the principles for defining capital structure. An issue with this approach is that current Standards do not clearly define 'borrowings' (3). To develop this approach, the staff are considering clarifying (1) the definition of 'financing activities' and (2) the interpretation of the term 'borrowings' in the existing definition of financing activities. Such clarifications may result in items, such as net pension and decommissioning liabilities falling outside of the capital structure and the finance cost or income related to such items shown separately from those related to capital structure.

### Next steps for PFS project

Over the next few months, the staff will continue to develop such approaches to present to the Board. Investors who are keen to get involved can keep up to date by signing up for PFS project updates. Once the Board has finalised the different approaches, it will publish its findings in a Discussion Paper or Exposure Draft that will be open for comments in the comment period. We look forward to your interest and engagement in this topic.

(1) The IFRS Standard that sets forth presentation requirements for the profit or loss statement (P&L).
(2) Paragraph 6 of IAS 7 defines financing activities as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.
(3) Paragraph 5 of IAS 23 Borrowing Costs defines '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.
(4) The illustration ignores Capital gains/(losses), dividends, and FV changes for financial instruments

# Spotlight: IFRS 15—*Revenue from Contracts with Customers*

## A focus on performance obligations

*We analysed the disclosures in the 2016 annual and 2017 interim reports of numerous companies for updates on the implementation of IFRS 15. Many companies highlight 'identifying performance obligations in the contract' as a crucial aspect of IFRS 15 for their contracts. Our spotlight article focuses on some aspects of this step of the revenue model and the implications of this step on a company's analysis of its contracts.*

## What does IFRS 15 require?

IFRS 15 establishes a comprehensive framework for companies to determine 'when' and 'how much' revenue they can recognise. This requires a company to identify its performance obligations (POs) (i.e. promises to transfer goods or services) within a contract. In identifying POs, companies are required to consider not only the goods and services promised explicitly in the contract, but also those promised implicitly through customary business practices. For example, software companies will have to consider when-and-if-available software upgrades implicit to many software-licensing contracts.

POs are the building blocks of IFRS 15, and the Standard defines a PO as a promise to transfer a distinct good or service or to transfer a distinct bundle of goods or services. The identification of a PO is a two-step process. In the first step, a company evaluates whether the customer can benefit from the good or service on its own or with other readily available resources. The objective of this first step is to determine if the good or service is 'capable of being distinct'. In the second step, the company evaluates whether the promise to transfer the good or service is 'separately identifiable from other promises in the contract,' in other words, whether the promise is distinct within the context of the contract. The objective of the second step is to determine whether the company is transferring a good or service in the contract separately, so that it represents a separate PO, or whether the company is transferring a combined item, in which case the good or service is an input so that the promise to transfer the output (completed item) represents a single PO. If the conditions in both steps are satisfied, the promised good or service is distinct and the company accounts for it as a separate PO. If not, the company bundles the good or service with other promised goods or services until the company identifies a bundle of goods or services that is distinct.

A company recognises revenue only when it satisfies a PO, which is when or as it transfers the good or service underlying the PO to the customer. Therefore, how an entity identifies its POs will affect the timing and amount of revenue recognised.

## Implications for company analysis

Since different companies across sectors have different contracts with their customers, investors will need to review the impact of the new requirements company by company to identify changes to revenue recognition patterns after the transition to IFRS 15.

Investors will nonetheless find it easier to understand the conclusions arrived at by different companies in 'identifying POs', since they stem from a single comprehensive framework (as opposed to industry-specific rules that previously applied to some sectors due to lack of adequate guidance in current IFRS Standards).

## What disclosures can investors expect to see?

Investors should expect to see expanded disclosures about revenue recognition that will provide greater insights into the business model of the company and the contractual promises made to the customer. For instance, insights into whether a company's business model is to provide components, to integrate components into a final product or both to provide and integrate components, should be more evident based on the disclosures and the application of the 'identify the POs' step.

IFRS 15 will require companies to disclose information about the nature of goods or services included in the POs. Companies will also have to disclose the use of judgements in determining the 'distinct' goods or services included in contracts.

### Where can I find out more about IFRS 15?

**Investors can find more detail on IFRS 15 by reading the IASB's Project Summary in the Education Resources page.**

## Project Updates

The Board sets Standards for you, the investor—but we can't do it without your input. We need your help in understanding whether potential changes to the Standards will provide you with the information necessary for investment analysis. Below are updates on some of the projects we have been working on during 2017. For a full list of topics please visit the [Workplan](Workplan).

### Disclosure Initiative: *Principles of Disclosure*

*Throughout the Discussion Paper comment period, staff and Board members held outreach meetings with a wide variety of investors. We thank you for sharing your feedback with us, and include below some of the key messages we heard:*

- **Principles of effective communication—**these principles can be useful to improve communication. The focus should be on increasing transparency, consistency and comparability of information.
- **Roles of the Primary Financial Statements and the notes—**mixed reactions from investors. For some the location of information mattered, but for others, the exact location did not as long as relevant information was provided within a complete set of financial statements.
- **Location of information (cross referencing)—** investors were not against the placement of IFRS information outside the financial statements, however, companies should use cross-references in a balanced manner to avoid fragmentation of information, and financial statements becoming less understandable.
- **Location of information (Non- IFRS information)—**investors agreed that the Board should not prohibit the inclusion of non-IFRS information . Some stated that they are not concerned as long as the information is clearly identified as non-IFRS information, labelled, explained and reconciled.
- **Use of performance measures—**investors agree with the requirements for fair presentation suggested in the DP, as they could provide discipline when entities provide performance measures.
- **Fair presentation of EBITDA and unusual or infrequently occurring items—**providing guidance to help entities identify these items, and principles to present these items is important. Some investors thought the Board should define some of the more frequently used performance measures.
- **Disclosure of accounting policies—**investors agree that only accounting policies that relate to material items, transactions or events should be disclosed.

**Next steps: comment period ended 2 October 2017, and the Board plans to discuss the feedback received in early 2018.**

### Better Communication in Financial Reporting—*Making disclosures more meaningful*

On 5 October 2017 the Board published a report of case studies describing companies' journey towards improving the way they communicate information in their financial statements to investors. The aim of the report is to illustrate how improvements can be made, and inspire other companies to initiate their own improvement projects.

The report, *Making disclosures more meaningful*, forms part of the Board's work under the theme of Better Communication in Financial Reporting, focusing on making communication of information in companies' financial statements more effective. As such, the report complements other initiatives by the Board, including its work on principles of disclosure; and the recently issued non-mandatory guidance on making materiality judgements.

**The 'Better Communication in Financial Reporting—*Making disclosure more meaningful*' report can be accessed [here.](here)**

### Primary Financial Statements

During 2017, in its Primary Financial Statements project, the Board has been discussing staff proposals for introducing additional subtotals in the statement(s) of financial performance, and improving disaggregation in the primary financial statements. At its September 2017 meeting, the Board tentatively decided to:

- prioritise introducing into the statement(s) of financial performance subtotals that facilitate comparisons between entities, such as EBIT, over introducing a management-performance measure subtotal;
- explore the introduction of an investing category into the statement(s) of financial performance; and
- make some improvements to the requirements for the analysis of expenses using the by-function or by-nature method.

**The Board will continue discussing topics in the project scope throughout 2017, and aims to publish a Discussion Paper or an Exposure Draft in the first half of 2018. We would like to thank the investment community for the input they have provided so far in this project.**

## Stay up to date

### Announcements

**IASB publishes Exposure Draft to clarify how to distinguish accounting policies from accounting estimates** The Board published for public consultation proposed narrow-scope amendments to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Exposure Draft is available to download here.

**IASB issues Practice Statement 2 Making Materiality Judgements and publishes Exposure Draft Definition of Material** The Board issued guidance on how to make materiality judgements, so that financial statements focus on the information that is useful to investors. Read the document here.

**Basel Committee on Banking Supervision and IFRS Foundation sign Memorandum of Understanding** The Basel Committee on Banking Supervision and the IFRS Foundation have announced a new cooperation agreement to foster long-term financial stability, enhance market discipline and further develop sharing of information. The MoU is available to download here.

### Speeches and events

**IASB Chairman's speech: The times, they are a-changin'** In a speech delivered at Accountancy Europe's event in Brussels, IASB Chairman Hans Hoogervorst sets out his views on developments in corporate reporting and their relevance to IFRS Standards. His full speech can be accessed here.

**A holistic look at IFRS Standards: the role of Post-implementation Reviews** IASB Board member Gary Kabureck explains how the PIR process works. Click here to read the full article.

**New IFRS 17 webcast: reinsurance contracts held** IASB staff present a webcast on the accounting for reinsurance contracts held in applying IFRS *17 Insurance Contracts.* The full webcast series can be accessed here or on our YouTube channel.

**IASB announces composition of the Transition Resource Group for IFRS 17 *Insurance Contracts*** The Board confirmed the membership of its IFRS 17 Transition Resource Group, established to support implementation of the new Standard issued in May 2017. Click here to view the full list of members.

### Reading material for investors

**Issue 4 of the Essentials published** In this issue of The Essentials we help investors prepare for the introduction of IFRS 17. You can access the document here.

**The September and July IASB *Updates* were published.** The IASB Update is a staff summary of the tentative decisions reached by the Board in its public meetings. Read the IASB *Updates* here.

**The role of the IFRS Interpretations Committee in supporting IFRS Standards** The IFRS Foundation has today published new materials to explain how the International Accounting Standards Board (Board) supports companies in their implementation and application of both new and existing IFRS Standards. The materials can be found here.

## Summaries of investor feedback

Below are examples of how investor views were fed back to the Board on various projects.

| Date | Summary of Investor Feedback Document |
|---|---|
| July 2017 | Investor reactions to IFRS 17 Insurance Contracts |
| January 2017 | Post-implementation Review of IFRS 13: Phase 1 outreach feedback<br><br>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<br>*Conceptual Framework*: summary of investor feedback |
| January 2016 | Fair Value Measurement—Unit of Account: investor feedback<br><br>Present Value Measurement—Discount Rates Research: investor feedback |

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