STAFF PAPER

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Project	**Primary Financial Statements**
Paper topic	Scope of the project – statement(s) of financial performance

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Purpose of paper

1. This Agenda Paper includes the staff's recommendations for possible improvements to the structure and content of the statement(s) of financial performance that could be included in a Discussion Paper as part of the Board's Primary Financial Statements project. Agenda Paper 21B discusses possible improvements to the other primary financial statements and segment reporting.

2. Our recommendations are based on what we learned in our initial research on the scope of the Primary Financial Statements project that we presented to the Board at its November 2016 meeting.[1]

Staff recommendations

3. The staff recommend that, in relation to the statement(s) of financial performance, the forthcoming Discussion Paper should explore the following topics:

   (a) requiring additional subtotal(s) in the statement(s) of financial performance—earnings before interest and tax (EBIT) and/or operating profit;

[1] Refer to Agenda Paper 21 – 21E in November 2016.

(b) removing some of the options for presentation of income and expenses in existing IFRS Standards (eg presentation of net interest cost on the net defined benefit liability);

(c) incorporating some commonly-used performance measures into IFRS Standards, including separate presentation of non-recurring, unusual or infrequently occurring items; and

(d) better ways to communicate information about other comprehensive income (OCI).

Structure of paper

4. This paper is structured as follows:

   (a) requiring additional subtotal(s)—EBIT and/or operating profit (paragraphs 5–13);

   (b) removing some of the options for presentation of income and expenses in existing IFRS Standards (eg presentation of net interest cost on the net defined benefit liability) (paragraphs 14–19);

   (c) incorporating some commonly-used performance measures into IFRS Standards, including separate presentation of non-recurring, unusual or infrequently occurring items (paragraphs 20–27); and

   (d) better ways to communicate information about OCI (paragraphs 28–31).

Requiring additional subtotal(s)—EBIT and/or operating profit

What did we learn?

5. IFRS Standards specify a limited number of subtotals that must be presented in the statement(s) of financial performance. Paragraph 85 of IAS 1 *Presentation of Financial Statements*, however, requires an entity to present additional subtotals in the statement(s) of financial performance when such presentation is relevant to an understanding of the entity's financial performance.

6. We learned that:

   (a) many users of financial statements would welcome an EBIT and/or operating profit subtotal(s) in the statement(s) of financial performance, because many use these subtotals as a starting point for their analysis. Users observed that while many entities already present these subtotals in accordance with paragraph 85 of IAS 1, these subtotals are not comparable because each entity may calculate these subtotals differently. For example, many entities define finance-related items differently.[2] Our literature review also supported requiring additional subtotal(s).[3]

   (b) 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. The respondents reached no consensus on whether to require an EBIT or operating profit subtotal.

   (c) at the September 2016 World Standards-setters meeting, we asked whether the Board should consider an operating profit and/or similar subtotals in the scope of the Primary Financial Statements project. 75% of the participants answered "Yes", although they did not reach consensus about whether the subtotal should be an 'all-inclusive' amount similar to EBIT or should exclude some items (eg non-core, outside management control or non-recurring items).

   (d) many of the entities in our analysis of financial statements presented an operating profit subtotal that corresponds broadly to EBIT (an EBIT-type operating profit). Of the 25 entities analysed, 19 presented a subtotal of this type.[4] 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 cost on the net defined benefit liability).

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[2] Refer to paragraph 23 and 24 of Agenda Paper 21D in November 2016.

[3] Refer to page 3 of Agenda Paper 21C in November 2016.

[4] Refer to paragraph 27 of Agenda Paper 21A in November 2016.

Should the Discussion Paper explore requiring additional subtotal(s) —EBIT and/or operating profit?

7. We suggest that the Discussion Paper explore requiring an EBIT and/or operating profit in the statement(s) of financial performance because:

   (a) introducing an EBIT subtotal would provide a comparable starting point for users’ analysis because many of them use an EBIT when developing estimates of future cash flows for their valuation purposes; and

   (b) introducing an operating profit subtotal would allow users to quickly get a sense of entities’ operating performance.

8. At this stage, we have not determined whether both EBIT and operating profit are needed. We would like to seek stakeholders’ views on this issue in the Discussion Paper.

Defining an EBIT subtotal

9. An EBIT subtotal is relatively easy to define, because it is simply calculated as profit before finance-related items and tax. However, it is less straight-forward to define what should be included in finance-related items (eg net interest cost on the net defined benefit liability) and the Discussion Paper would need to explore this issue.

Defining an operating profit subtotal

10. Defining an operating profit subtotal could be challenging. Previous standard-setting activities have explored defining an operating profit subtotal but were unsuccessful. At the September 2016 World Standards-setters meeting, participants debated the characteristics of operating profit but they did not reach a consensus. If we explore introducing an operating profit subtotal in the Primary Financial Statements project, we might consider a ‘residual approach’, ie defining an EBIT subtotal first and then, excluding specific non-operating items (eg investment income that is not included in finance-related items) to arrive at the operating profit subtotal, rather than directly defining what is ‘operating profit’. Alternatively we could adopt a principles-based definition or description of operating profit that is based on management judgement and/or the business model of the entity. We think that the Discussion Paper should explore all of these different approaches.

11. We do not think the operating profit subtotal should exclude non-recurring, unusual or infrequently occurring items. We think that any subtotal that excludes non-recurring, unusual or infrequently occurring items instead should be presented separately from operating profit, when an entity wishes to present it. We discuss this point in paragraphs 20–27.

Implications of requiring an EBIT and/or operating profit subtotal(s)

12. If we were to require an EBIT and/or operating profit subtotal(s), we would need to consider in the Discussion Paper whether different presentation requirements are needed for entities in different industries. For example, would an EBIT and/or operating profit subtotal(s) provide useful information about the financial performance of financial institutions? Could EBIT and/or operating profit be defined in a meaningful way for financial institutions?

13. In order to make an EBIT and/or operating profit subtotal(s) comparable amongst different entities, it may be necessary to remove some of the options for presentation of income and expenses in existing IFRS Standards. We consider the need to remove some of the options in existing IFRS Standards in the following section (see paragraphs 14–19).

Question for the Board
Does the Board agree that the Discussion Paper should explore requiring additional subtotal(s)—EBIT and/or operating profit?

Removing some of the options for presentation of income and expenses in existing IFRS Standards

What did we learn?

14. IFRS Standards provide some choices in the way some income and expenses are presented. These choices can make the information presented less comparable and many users told us that they would prefer not to have to spend as much time searching

for or making the information more comparable.[5] Users considered that some of the choices permitted in the following IFRS Standards can reduce the comparability of subtotals such as an operating profit:

(a) IAS 1 requires an entity to provide an analysis of expenses either by nature or by function. However, paragraph 100 of IAS 1 encourages, rather than requires, an entity to present that analysis in the statement(s) of financial performance. Given this flexibility, some entities choose not to present an analysis of expenses in the statement(s) of financial performance and instead disclose the information in the notes. Of the 25 entities we analysed, five did not present expenses by nature or by function in the statement(s) of financial performance.[6] When we showed users the range of presentation that entities provided, many users told us that they were not in favour of entities only providing information about expenses in the notes.

(b) IAS 19 *Employee Benefits* does not specify how an entity should present net interest cost on the net defined benefit liability, and as a result, different entities present this cost in different locations. 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.[7] Users told us that they manually adjust the net interest cost on the net defined benefit liability to make entities' financial statements comparable with those of other entities.[8]

(c) IAS 1 does not prescribe where on the statement(s) of financial performance the share of results of associates and/or joint ventures should be presented, and our research showed that entities presented it in various locations.[9] Even entities in the same industry presented it in different

[5] Refer to paragraph 12(b) of Agenda Paper 21D in November 2016.

[6] Refer to paragraph 21 of Agenda Paper 21A in November 2016.

[7] Refer to paragraph 34 of Agenda Paper 21A in November 2016.

[8] Refer to paragraph 23 of Agenda Paper 21D in November 2016.

[9] Refer to paragraph 30 of Agenda Paper 21A in November 2016.

locations. These differences affect calculations of subtotals, such as an operating profit or profit before tax. Many users told us that they would prefer a consistent presentation of the results of associates and joint ventures.

Should the Discussion Paper explore removing some of the options for presentation of income and expenses in existing IFRS Standards?

15. We suggest that the Discussion Paper explore removing some of the options for presentation of income and expenses in existing IFRS Standards. Specifically, we recommend exploring whether to remove the options for presentation of the following income and expenses:

    (a) operating expenses;

    (b) net interest cost on the net defined benefit liability; and

    (c) share of results of associates and/or joint ventures.

16. Removing some of the options for presentation of income and expenses would enhance the comparability of the primary financial statements and reduce the extra burden currently placed on users to make the different entities' financial statements comparable.

17. If the Board requires additional subtotal(s) in the statement(s) of financial performance, as described in paragraphs 5–13, removing these options would enhance the comparability of these new subtotals.

18. However, there are challenges to removing these options. Stakeholders may have different views about how some types of income and expense should be presented. For example, we learned that some preparers prefer to present net interest cost on the net defined benefit liability in operating expenses because they consider that the cost was incurred as a part of their operations. In contrast, many users consider such costs financing in nature.

19. We have also heard from some stakeholders that the nature of the associates and joint ventures can affect the presentation of the share of the results of associates and joint ventures. Some entities consider their associates and joint ventures to be an integral part of their operating activities and hence include them in arriving at an operating

profit. However, other associates and joint ventures are considered to be investments and hence are presented below operating profit.[10]

Question for the Board
Does the Board agree that the Discussion Paper should explore removing some of the options for presentation of income and expenses in existing IFRS Standards?

Incorporating some commonly-used performance measures into IFRS Standards

What did we learn?

20. We learned that:

(a) users of financial statements support incorporating commonly-used performance measures into IFRS Standards. Users told us that they need information that allows them to assess the persistence or sustainability of an entity's financial performance, and many users support introducing a subtotal that excludes non-recurring, unusual or infrequently occurring items. While users acknowledged that many entities already present such information, some explained that the way in which management presents non-recurring, unusual or infrequently occurring items can be problematic because what is classified as non-recurring, unusual or infrequently occurring is not necessarily clear, and neither is the reason management has classified these items as such. In addition, users told us that the way in which management defines non-recurring, unusual or infrequently occurring can be problematic because many activities classified as non-recurring, unusual or infrequently occurring occur year after year.[11]

(b) at the September 2016 World Standards-setters meeting, we asked participants how the Board should present non-recurring, unusual or

[10] Refer to paragraph 32 of Agenda Paper 21A in November 2016.

[11] Refer to paragraph 25 of Agenda Paper 21D in November 2016.

infrequently occurring items if the Board were to require an operating profit subtotal. 62% of the participants supported requiring two subtotals—ie one before and one after the non-recurring, unusual or infrequently occurring items.

(c) our research showed that many entities use performance measures that are not specified by IFRS Standards, such as:

(i) adjusted operating profit (eg operating profit excluding non-recurring, unusual or infrequently occurring items); or

(ii) adjusted basic EPS (eg basic EPS excluding post-tax non-recurring, unusual or infrequently occurring items).

(d) some entities that we analysed presented these performance measures both inside and outside the financial statements, while others only presented them outside the financial statements.

(e) we observed that the way in which entities present the performance measures excluding non-recurring, unusual or infrequently occurring items is not necessarily transparent. For example, some entities did not state any policy for excluding items but simply stated the list of items that they had excluded. It was not clear whether these entities make adjustments on the same basis in different periods.[12] In addition, we observed that some items labelled as non-recurring, unusual or infrequent may in fact arise year after year.[13]

Should the Discussion Paper explore incorporating some commonly-used performance measures into IFRS Standards?

21. Many entities already present performance measures that separately present non-recurring, unusual or infrequently occurring items and users rely on such measures. Hence, we think that the Discussion Paper should explore incorporating some commonly-used performance measures that separately present non-recurring, unusual or infrequently occurring items into IFRS Standards. Users of financial statements

[12] Refer to paragraph 39 of Agenda Paper 21A in November 2016.

[13] Refer to paragraph 46 of Agenda Paper 21A in November 2016.

have told us that separate presentation of non-recurring, unusual or infrequently occurring items is important because it helps them in making forecasts about future cash flows. However, they also think that transparency and discipline of these performance measures should be enhanced.

22. We should consider incorporating only those performance measures that are widely used and that would present an entity's performance fairly. We observed that many entities present the following performance measures that exclude non-recurring, unusual or infrequently occurring items and we suggest limiting the scope of the performance measures that we consider to only the following measures:

    (a) adjusted operating profit (operating profit excluding non-recurring, unusual or infrequently occurring items); and

    (b) adjusted basic EPS (basic EPS excluding post-tax non-recurring, unusual or infrequently occurring items).

23. We think that we should allow, rather than require, entities to present these performance measures, because some entities do not use them.

24. When an entity presents additional subtotals in accordance with paragraph 85 of IAS 1, paragraph 85A of IAS 1 already provides guidance that the subtotals shall:

    (a) be comprised of line items made up of amounts recognised and measured in accordance with IFRS;

    (b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

    (c) be consistent from period to period, in accordance with paragraph 45; and

    (d) not be displayed with more prominence than the subtotals and totals required in IFRS for the statement(s) presenting profit or loss and other comprehensive income.

25. When entities present adjusted operating profit or adjusted basic EPS that excludes non-recurring, unusual or infrequently occurring items, we think that above guidance may not be sufficient to achieve a standardised presentation, sufficient transparency and the level of discipline around presentation that users need. Accordingly, we think that we could explore additional guidance for these performance measures including:

(a) explaining how adjusted operating profit and adjusted basic EPS can be presented, when entities present these performance measures;

(b) explaining when and how items can be presented as non-recurring, unusual or infrequently occurring items; and

(c) presenting a historical record of non-recurring, unusual or infrequently occurring items.

26. It may prove difficult to define non-recurring, unusual or infrequently occurring items as stakeholders have different views regarding which items fall into these categories. We think the Discussion Paper should explore different approaches to defining such items including:

(a) prohibiting some items from being classified as non-recurring, unusual or infrequently occurring; and

(b) permitting entities to present their own view of what is non-recurring, unusual or infrequently occurring (with supporting disclosure requirements).

27. We note that the upcoming Discussion Paper on *Principles of Disclosure* will suggest expanding the scope of the current guidance on performance measures in IAS 1 to cover all performance measures in the financial statements.[14] We will consider any feedback on those suggestions as we develop our proposals in this area.

Question for the Board
Does the Board agree that the Discussion Paper should explore incorporating some commonly-used performance measures into IFRS Standards, including separate presentation of non-recurring, unusual or infrequently occurring items?

[14] **Appendix A** summarises those discussions.

Identifying better ways to communicate information about OCI

What did we learn?

28. We learned that:

    (a) some users see OCI as a black box, or 'dumping ground', and do not analyse OCI items in detail; and

    (b) many users were not certain that improving the presentation of OCI would provide additional relevant information for their analysis.[15]

Should the Discussion Paper explore better ways to communicate information about OCI?

29. While we recognise that our research did not show significant demand for improvements in this area from users, we, nevertheless, think that the Discussion Paper should explore better ways to communicate information about OCI. We think that OCI includes important information about financial performance and improving the presentation of items included in OCI may make the income and expenses included in OCI more understandable to users of financial statements.

30. Our focus is on improving the presentation of items currently reported in OCI rather than on which items should be included in OCI. In order to increase the understandability of the OCI category we could consider dividing OCI into different categories and labelling them in a more understandable way (for example, 'Income and expense to be recognised in profit or loss in the future').

31. However, this approach involves challenges. Introducing new sections to the statement(s) of financial performance would increase complexity and could be controversial with some stakeholders.

Question for the Board
Does the Board agree that the Discussion Paper should explore better ways to communicate information about OCI?

[15] Refer to paragraph 28 of Agenda Paper 21D in November 2016.

Appendix A—Current requirements for performance measures and likely content of the Discussion Paper *Principles of Disclosure*

Current requirements and guidance

A1. Some amounts commonly used as performance measures are specified by IFRS Standards, for example revenue and profit or loss.

A2. Furthermore, IAS 1 *Presentation of Financial Statements* requires an entity to:

a. present additional line items, headings and subtotals:

   i. in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance (paragraph 85 of IAS 1); and

   ii. in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position (paragraph 55 of IAS 1).

b. provide additional information if it is relevant to an understanding of the financial statements (paragraph 112(c) of IAS 1).

A3. In December 2014, the Board published amendments to IAS 1, which imposed the following additional requirements for subtotals presented in accordance with paragraphs 55 and 85 of IAS 1:

a. Those subtotals shall:

   i. consist of line items made up of amounts recognised and measured in accordance with IFRS Standards;

   ii. be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

   iii. be consistent from period to period; and

   iv. not be displayed with more prominence than the subtotals and totals specifically required in IFRS Standards for that statement.

(paragraphs 55A and 85A of IAS 1)

b. Entities must reconcile any additional subtotals in the statement(s) presenting profit or loss and other comprehensive income with the subtotals or totals required in IFRS Standards for that statement (paragraph 85B of IAS 1).

A4. Paragraphs 37-40 of the IFRS Practice Statement *Management Commentary* provide guidance on use in management commentary of performance measures and indicators. That guidance describes performance measures as quantified measurements that reflect the critical success factors of an entity.

The Board's preliminary views on performance measures

A5. The Board plans to issue a Discussion Paper *Principles of Disclosure* that is likely to include suggested guidance on the use of performance measures. This suggested guidance would expand the scope of December 2014 amendments described in paragraph A3.

A6. The Discussion Paper is likely to suggest that the Board should develop guidance stating that performance measures should be:

a. displayed equally or less prominently than the subtotals and totals in the primary financial statements required by IFRS Standards;

b. reconciled, where possible, to the most directly comparable measures specified in IFRS Standards, to enable users of financial statements to see how the performance measure has been calculated;

c. accompanied by an explanation of:

   i. how the performance measure provides relevant information about an entity's financial position, financial performance or cash flows;

   ii. why the adjustments to the most directly comparable measures specified in IFRS Standards in (b) have been made; and

   iii. any other information necessary to aid understanding of the measures.

d. neutral, free from error and clearly labelled so they are not misleading;

e. accompanied by comparative information for all prior periods presented in the financial statements;

f. classified, measured and presented consistently to enable comparisons over time, except when IFRS Standards require a change in presentation, as stated in paragraph 45 of IAS 1; and

g. presented in a way that makes it clear whether the performance measures form part of the financial statements and whether they have been audited.

A7. In addition, the Discussion Paper is likely to suggest that the Board should:

a. clarify that the following subtotals in the statement(s) of financial performance are permitted in IFRS Standards if such subtotals are presented in accordance with paragraphs 85–85B of IAS 1:

    i. the presentation of EBIT and EBITDA in the statement(s) of financial performance presented by nature; and

    ii. the presentation of EBIT, but not EBITDA, in the statement(s) of financial performance presented by function.

b. develop definitions for unusual or infrequent items and requirements for their presentation in the statement(s) of financial performance.