Primary Financial Statements
Update on outreach activities

Objective

1 The objective of the session is to provide EFRAG TEG members an update on EFRAG outreach activities and field-testing;

EFRAG Outreach activities from 30 June until 1 September 2020

2 From 30 June 2020, EFRAG participated or organised the following outreach activities:

(a) **Field-Test Workshop on 7 July** with preparers of financial statements – 5 corporates

(b) **Field-test workshop on 7 July** with preparers of financial statements – 4 Financial Institutions

(c) **Field-test workshop on 24 August** with preparers of financial statements – 2 Financial Institutions and 4 Corporates

(d) **Preparers roundtable on Primary Financial Statements (webinar)** on 1 September 2020

Field-testing activities

3 The EFRAG Secretariat is currently working on the summary reports of each workshop, which will be published on EFRAG website soon. Nonetheless, the purpose of this document is to provide a preview of the key themes that have been identified in the workshops.

4 The fieldwork was designed to provide EFRAG and the IASB with evidence of:

(a) how the proposals would be implemented in practice

(b) any need for further guidance, and

(c) the extent of process or system changes that may be needed.

Key themes identified for corporates (non-financial entities)

<u>Classification of income and expenses in operating, investing and financing category</u>

5 In general, participants had to rearrange the presentation of their income statement, including the introduction of new subtotals and reallocation of line items. However, the EFRAG Secretariat observed different experiences:

(a) For some participants, the proposed classification requirements are clear;

(b) For others, there is a need for clearer guidance in some areas. In particular, more guidance on:

   (i) the definition of investing category (e.g. more examples of incremental expenses incurred generating income and expenses from investments);

   (ii) definition of operating category (e.g. clearer guidance on the notion of the 'entity's main business activities', an important concept which also impacts the distinction between integral and non-integral associates and joint ventures. See also section below),

   (iii) the classification of other very specific line items such as:

   - classification of foreign exchange differences and hedging instruments (e.g. hedging instruments on intercompany and construction loans and foreign exchange differences arising from loans with subsidiaries)
   - interest from extended payment terms to customers and interest expense on trade payables,
   - interest on tax receivables,
   - contingent consideration from business combinations, and
   - other very specific line items (e.g. donations)

6 The EFRAG Secretariat also observed different experiences in terms of level of judgement involved:

(a) For some, no significant judgements were required;

(b) For others, it would involve a high degree of judgement on the classification of gains and losses, particularly on hedging instruments and foreign exchange differences. Participants also referred to the judgement used to reallocate the existing line items to the new categories (e.g. pure cash investments)

7 When referring to the cost, some referred to the high degree of costs related to the classification of gains and losses from hedging instruments and foreign exchange differences. Nonetheless, there were also participants that were already making this allocation.

8 Finally, participants discussed materiality considerations when presenting the operating, investing and financing categories. Participants noted that, for the purposes of the field-test, some items were presented even if they were close to zero (please see below). There were also questions on whether a separate subtotal is needed if, for example, investments are immaterial.

<u>Integral and non-integral associates and joint ventures</u>

9 This was one of the most discussed topics where participants provided many comments and expressed concerns.

10 As expected, the subtotal 'operating profit or loss and income and expenses from integral associates and joint ventures' is a new subtotal not used before. None of the participants had made this distinction of the face of the financial statements before

11 In general, companies made the split, even if some presented line items with amounts equal or close to zero. The information needed was available (subject to judgements) and no significant changes to the systems were required (although the classification of different investments in entities was becoming complex:

subsidiaries, different types of associates and joint ventures, investment entities, investments in equity instruments, cash equivalents, etc)

12 When referring the definition of integral and non-integral, participants expressed different experiences:

(a) Some considered that the classification of integral and non-integral was clear, all required information was available and low level of judgement

(b) Others suggested that the IASB expands paragraph 20D of IFRS 12 (e.g. is the supplier or customer relationship critical for the investor only or also for the investee) and considered that significant and professional judgements may be required. Some also considered that the definition of integral associate and joint venture was narrow as some of their associates and JV would be classified as non-integral while management considered them as integral (e.g. might exclude companies that generate revenues independently but are active in the same business area as the parent company, associates or joint ventures in a start-up phase, or research and development collaborations). These participants provided a number of suggestions to the IASB (e.g. focus more on notion of main business activities and similarity of the business activities)

13 Finally, some called for the IASB to further discuss how its proposals in general would apply to the separate financial statements, including the challenges that may arise in practice to those who prepare and use separate financial statements (e.g. how a parent company measures, in its separate financial statements, the investments in subsidiaries applying the equity method, as allowed by IAS 27. In this case, it is not clear if the parent's share of the net results of the equity accounted investments shall be presented in the operating or in the investing category).

<u>Analysis of expenses</u>

14 The EFRAG Secretariat observed that there were no significant changes or concerns from those presenting operating expenses by nature. The observations came mainly from those that present an analysis of their expenses by function. For example, participants:

(a) called for more guidance on the presentation by function (e.g. no clear definition of items such as ‘cost of sales’ and ‘administrative expenses’) and on the use of the line item ‘other expenses’;

(b) considered that entities would have to make significant judgments to allocate some income and expenses by nature to the by function presentation (e.g. restructuring expenses and goodwill impairment losses).

(c) referred to the high costs (IT systems auditing) related to the disclosures of total operating expenses by nature when presenting by function on the face and duplication of some items as current IFRS Standards already require disclosures by nature (e g amortisation and depreciation).

(d) clarify the link between paragraphs B46 and B15 of the ED.

<u>Management performance measures</u>

15 Participants did not raise significant issues when identifying MPMs, which could be found in the notes, management commentary, presentation to analysts, guidance for the year and mid-term plan

16 Not all companies identified MPMs and but those that identified, the number of MPMs varied between one and four. Many participants noted that the definition seemed to be narrow, with some also disclosing other alternative performance measures that did not meet the definition of MPM. These participants explained that

they had presented other APMs because providing only a narrow number of MPMs would provide an incomplete picture of the entity's performance.

17 In general, information was readily available, except for the effects of income tax and non-controlling interest. Some participants noted that the computation of income tax effect can be complex, particularly when there are many different tax jurisdictions and when using constant currency performance measures.

18 Many participants also called for the IASB to clarify what public communication is. For example, whether it would include one-off verbal comments from management in a public event or a press release

19 There were also many questions on the interaction of MPMs with several other regulatory requirements (e.g. ESMA guidelines and local management report requirements) given their different scope. There were some concerns about providing similar, but not the same, information in different parts of the annual report. There were comments on the interaction with IFRS 8 Operating Segments (e.g. MPMs need to be bridged to the IFRS 8 key segment numbers)

20 Finally, some participants noted that they might revisit their performance measures considering the new proposed subtotals.

<u>Unusual items</u>

21 Some participants already provided information about non-recurring or unusual items; however they noted that the IASB proposed definition would change current practice.

22 The proposed requirements were often considered clear, the information available and no significant changes to the IT systems. However, some concerns have been expressed:

(a) the definition would restrict the number of unusual items identified and, consequently, disclosures will have very limited added value. For example, the definition excludes expenses caused by a restructuring program which takes two years;

(b) it would involve a significant degree of judgement and discretion to determine whether an item is unusual (e.g. the term 'several future annual reporting periods' and 'predictive value' will involve significant judgement); and

(c) questions on how to report the unusual amounts (part that is usual and the excess that is unusual) and how unusual items would be monitored and considered by the auditors.

<u>Others</u>

23 Participants mentioned that the requirements for aggregation and disaggregation were generally clear and well understood. However, a number of participants considered that these requirements would not change current practice and lead to more disaggregation of income and expenses.

<u>Statement of cash flows</u>

24 Most participants did not note significant challenges when applying the proposals for the statement of cash flows.

25 Many participants referred that the use of similar labelling for statement of cash flows and the statement of profit or loss would raise possible confusion over the differences between the categories in both statements.

Questions for EFRAG TEG

26 Does EFRAG TEG has any questions or comments?

Summary of the feedback received from financial institutions and conglomerates

Classification of income and expenses in operating, investing and financing category

27 In general, the proposed classification requirements are clear and the information is available for financial institutions. Nonetheless, participants reported different experiences on the changes to the presentation of the financial statements:

(a) No significant changes to the presentation – many participants did not have to significantly rearrange the presentation of their income statement. The few changes were mainly related to new subtotals on integral and non-integral associates and joint-ventures and the new definition of operating profit (i.e. reallocation of some line items);

(b) Significant changes to the presentation – for some participants, the changes in presentation were more significant, particularly for insurance companies and conglomerates that have banking and insurance activities. This significant impact was mainly because of the interaction of the IASB proposals with the new presentation requirements in IFRS 17 *Insurance Contracts*.

28 In regard to the proposed classification requirements, participants highlighted that:

(a) financial institutions would be required to present the subtotal 'operating profit or loss', which would include most of the income and expenses of a bank or a conglomerate (i.e. very little presented outside operating profit. In some cases, unwinding of discount on pension liabilities and provisions were the only item presented outside of profit or loss but they were not very significant);

(b) on the accounting policy choice provided by paragraph 51 of the ED, financial institutions are expected to apply paragraph 51(b). Participants explained that any split between financing related to customers and pure financing would be artificial, require significant changes to the systems and would be costly;

(c) separating returns from investments made in the course of an entity's main business activities from those that are not can involve significant judgement and going through individual investments to determine if they were made in course of main business activities would be costly

(d) questions on the use of the investing category as a default category for income and expenses from derivatives used to manage net risk positions, including those that are not in hedging relationships. Currently, such gains or losses were classified within operating profit;

(e) the IASB should provide more guidance for the presentation of revenues and costs when they are allocated to different business activities on the face of the statement of profit or loss, including consistency with IFRS 8 and disclosure on judgement applied in the allocation process

(f) the final impact on presentation may depend on local regulators' guidelines

(g) judgement needed to identify main business activity

Integral and non-integral associates and joint-ventures

29 This was one of the most discussed topics where participants provided many comments and expressed concerns.

30 As expected, the subtotal 'operating profit or loss and income and expenses from integral associates and joint ventures' is a new subtotal not used before. None of the participants had made this distinction of the face of the financial statements before. For some such investments are immaterial

31 Participants provided many comments on the definition of integral and non-integral associates and joint ventures. For example:

32 Many participants considered that the IASB's proposals on the distinction between integral and non-integral associates and JVs was not always clear and needed to be improved. For example, some participants considered that:

(a) the indicators proposed in paragraph 20D of IFRS 12 were currently insufficient to ensure consistent application and considered that the proposed distinction would require a high level of judgment, thereby reducing comparability across entities.

(b) some of their investments which are viewed as integral associates and joint-ventures did not meet the proposed indicators. These participants suggested that the IASB reconsiders the proposed indicators and clarifies how the indicators shall be applied. For example:

(i) the focus should be on whether the associates and joint-ventures are strongly aligned with the entity's main business activity. When associates and joint-ventures have the same operating activities, they should be considered integral;

(ii) not only consider the reporting entity's perspective on a stand-alone basis but also the business relationship as a whole;

(iii) additional indicators are to be taken into consideration for common arrangements of associates and joint-ventures (e.g. start-ups, cooperations in R&D, cooperations in foreign markets).

(iv) For insurance companies most of their investments are made in the course of their main business activities and, thus all related income and expenses should be classified in the operating category, including non-integral associates and joint-ventures. This is because most of the investments (except for associates and joint-ventures that represent a cooperation in the insurance business and are an extension and part of the business; these would be, conceptually, qualified as integral) are made with the aim to generate investment returns to cover the expenses incurred in the context of the insurance business, namely to cover policyholders' claims.

(c) Many different distinctions (related parties, associates, unconsolidated structured entities, etc) lead to more complex IT systems

33 Finally, raised questions on the application of the proposed definition in the context of subgroups. For example, there was the question of whether an integral associate of a fully owned subsidiary should not be regarded as integral in the ultimate consolidated financial statements.

Analysis of expenses

34 The EFRAG Secretariat observed that there were no significant changes or concerns from those presenting operating expenses by nature. The observations came mainly from those that present an analysis of their expenses by function. For example:

(a) for banks, participants questioned whether the functional line item 'administrative expenses' could be permitted for entities reporting by nature and questioned whether the IASB should introduce restrictions on the mixed basis approach only when concerns actually arise (e.g. for entities that use the 'cost of sales' line item).

(b) for an insurance company, the structure of the statement of profit or loss would be significantly predetermined due to the requirements in IFRS 9 *Financial Instruments*, IFRS 17 *Insurance Contracts* and paragraph 65 of the ED. Such predetermined structure would imply the use of a mixed approach. Considering this, it was not clear how entities that are required to use a mixed approach shall apply the requirements regarding the additional disclosures by nature.

(c) for financial conglomerates, participants noted that it may be difficult to identify the most useful method of analysis of expenses (for the banking business the presentation by nature may provide the most useful information and for the insurance business it is the presentation by function that provides the most useful information);

(d) questioned the additional information value of providing disclosures by nature when an entity has assessed that the function of expenses method provides the most useful information to users of their financial statements. Analysis by nature for those reporting by function not possible without significant system changes and occurring in significant costs.

<u>Management performance measures</u>

35 Participants did not raise significant issues in regard to where to look for MPMs, no significant judgements required in identifying them and acknowledged that such requirements would provide additional assurance to users of financial statements.

36 However, participants expressed a number of concerns:

(a) noted that the definition of MPMs and the scope is not always clear. For example, questions on whether metrics required by regulators would be considered as MPMs;

(b) many questions on the interaction of MPMs with several other regulatory requirements (e.g. ESMA guidelines, local management report requirements and financial industry regulation);

(c) Complying with different regulations on APM/MPS will lead to excessive work and increase costs (governance, audit review, changes in IT systems).

(d) the definition seemed to be narrow and would only capture a limited number of APMs (for financial institutions many of those are focused on the balance sheet). These participants explained that only presenting a limited number of MPMs would provide an incomplete picture of the entity's performance.

(e) information that is required to be disclosed, in particular the income tax effect, is not always directly and easy available from the IT systems. The costs to calculate the income tax effect and the effect of non-controlling interests for adjustments made in calculating MPMs are significant. Some expect that pro rata allocation may not be reasonable and that another method would be needed.

(f) With the introduction of the subtotal 'operating profit or loss', management would have to reconsider its key performance measures as they were currently using operating profit or loss but with a different definition.

<u>Unusual items</u>

37 Participants noted that information needed was in general available but noted that it would have to be prepared manually by senior management.

38 For some participants the definition was clear. However, some also expressed some concerns:

(a) The definition of unusual income and expenses proposed by the IASB is too restrictive. Some agreed with EFRAG proposal to consider not only items that ‘will not arise for several future annual reporting periods’ but also items that presently occur in the business, but only for a limited period of time;

(b) It would involve a significant degree of judgement to determine whether an item is unusual (e.g. the term ‘several future annual reporting periods’ and ‘predictive value’ will involve significant judgement). These participants would appreciate more guidance on how to identify unusual items (e.g. losses related to the covid-19 pandemic situation such as loan impairment losses and fair value changes of financial assets).

(c) the question whether income and expenses are not expected by type and amount (or either by type or amount as suggested in BC131 of the ED) to recur in the future as well as with respect to the question of how many future reporting periods shall be taken into account in this assessment.

Others

39 Requirements for aggregation and disaggregation are generally clear well understood. No major issues identified in relation to general guidance on aggregation and disaggregation. Final impact on aggregation and disaggregation may depend on regulators’ guidelines.

40 Participants noted that in general the cash flow statement was not considered as bringing useful information about financial institutions.

Questions for EFRAG TEG

41 Does EFRAG TEG has any questions or comments?

Preparers roundtable on Primary Financial Statements

42 On 1 September, EFRAG, Business Europe and the IASB will jointly have a webinar to discuss the application of the IASB proposals for preparers and the experiences of the field testing of the IASB Exposure Draft *General Presentation and Disclosures (Primary Financial Statements)*.

43 The objective of the event is to collect input from the community of interested preparers that were unable to participate in the field-tests organised by EFRAG and the IASB.

44 The insights of the field testing will be presented and discussed with a panel of preparers.

45 The audience will be able to contribute to the discussion through polling surveys and Q&A sessions.

46 We are looking forward to receiving a wide range of views on the application of the IASB proposals for preparers and on the results of the field testing, contributing to the debate on primary financial statements.

47 An oral update will be provided in this meeting.

Questions for EFRAG TEG

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