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 from the last TEG update.

EFRAG Outreach activities from 2 September 2020

2 From 2 September 2020, EFRAG participated in the following outreach activities and working group meetings:

(a) meetings with regulators of financial institutions;

(b) meeting with a Spanish users' representative;

(c) Meeting with pharmaceutical industry;

(d) Meeting with the Italian companies (OIC);

(e) *Outreach event on PFS with Accounting Standards Committee of Germany* (ASCG) on 7 September and 11 September 2020. For more details please click here;

(f) *Joint outreach event PFS with Dutch Accounting Standards Board* (DASB) on 16 September 2020. For more details please click here.

Key feedback received

3 EFRAG discussed the IASB proposals in a number of closed meetings (the views expressed in the closed meetings were those of the participants in the meetings and not necessarily those of the organization they belong to).

4 The feedback received during the closed meeting with experts from the **regulators** of financial institutions includes:

(a) questions on the 'free' accounting policy choice in paragraph 51 of the ED:

(i) for financial institutions, any distinction between 'providing financing to customers' and 'pure financing' is challenging. Thus, questions on the usefulness of the option in paragraph 51(a) for financial institutions as it would impair comparability; and

(ii) for corporates, the accounting option in paragraph 51(b) may result in the loss of relevant information for users (e.g. manufacturer providing financing to customers) and impair comparability;

(b) concerns about presenting gains and losses on derivatives in the investing category under certain conditions (i.e. exceptions related to grossing up of gains and losses or the undue cost or effort), particularly when referring to financial institutions. Instead, such gains and losses could be presented within operating profit;

(c) questions on the IASB's proposals on the distinction between integral and non-integral ("is it worth to make the distinction?"), particularly when associates and joint-ventures are not very material;

(d) need for more guidance on the description by nature and by function. For example, more guidance on the description 'administrative expenses', whether it is considered by nature or by function);

(e) identifying returns from investments that are not part of the entity's main business activities may be difficult for the entities that invest in the course of their main business activities; and

(f) need for the IASB to further discuss how its proposals would apply to the separate financial statements, particularly on the IASB proposals on integral and non-integral associates and joint ventures.

5 The feedback received in a closed meeting with **Spanish users of financial statements** includes:

(a) support the IASB's efforts to define and require the subtotal 'operating profit or loss' as it is one of the most used subtotals and currently there is a lack of consistency in its use, labelling and definition;

(b) noted that both the statement of financial performance and the statement of cash flows will have three different categories with similar labelling (operating, investing and financing) even if they are not aligned. These users considered that this would be confusing and could be misleading and questioned whether the categories could be aligned;

(c) the classification of cash and cash equivalents may depend on its use. For example, if it is cash and cash equivalents allocated to working capital (cash and cash equivalents used for operating needs), then any related income and expenses should be within operating profit. If it is large cash balances in excess of their operating needs, then income and expenses should be within financing category (i.e. linked to net debt). It was also noted that there may be some restrictions on the use of cash and cash equivalents (e.g. restrictions imposed by banks);

(d) the distinction between integral and non-integral provided useful information but suggested that such information could be provided in the disclosures. The IASB proposals to separately present a separate subtotal on integral associates and joint ventures may raise questions and confusion;

(e) questions on why an entity that provides an analysis of expenses by nature is not also required to provide disclosures by function;

(f) highlighted the importance of having information by operating business segments (not only for the reporting as a whole) for users to be able to estimate future cash flows;

(g) In general, welcomed the IASB proposals on MPMs and unusual items and called for this information to be presented also by operating business segment (IFRS 8 *Operating Segments*)

6 The feedback received from the **pharmaceutical industry** includes:

(a) In general, welcome the IASB proposals and the IASB's efforts to increase comparability;

(b) Need to further discuss the definition of operating category (ie primary or core business"), particularly the positive definition of operating profit and further consider interaction with IFRS 8 *Operating Segments*. This is to avoid operating profit being a dumping ground and not reflecting the operating business as viewed by management;

(c) Concerns about the complexity, costs and judgements involved in making the split of exchange differences and hedging instruments between operating, investing, financing. In some cases, such items are considered as being of the responsibility of the treasury department and presented within the financing category. There were also questions on the interaction of the IASB requirements and the concept of materiality (whether allocation would be required even if not material);

(d) Concerns about additional unnecessary clutter brought by paragraphs 27-28 (aggregation of immaterial items) on items such as other receivables and other payables;

(e) Need to clarify what kind of subtotals are possible (eg. unclarity of paragraph B47 of the ED);

(f) Supportive of the proposed distinction between integral and non-integral however need to clarify the definition of integral and non-integral associates and joint ventures, including guidance on strategic investments and guidance that considers the lifecycle of an investment. The IASB's proposed definition of integral associates and joint ventures seemed to be narrow as many associates generated a return independently from the entity and would be classified as non-integral;

(g) In regard to providing disclosures by nature when presenting by function, the IASB proposals would require a significant change of the IT systems and to maintain a double reporting functionality; users would usually not request this information; one participant remarked that projections are done by segment (IFRS 8) and therefore he requested the usefulness of the total expense by nature requirement;

(h) Need for more guidance on presentation by function (e.g. definition of cost of sales, administrative expenses, etc) and noted that there is a risk of arbitrary allocation across the functions of line items such as "other operating income & expenses", "restructuring", "impairment", etc;

(i) Concern about the inclusion of some MPMs only: the IASB proposals and ESMA guidelines have a different scope and, therefore, reconciliations of APMs and MPMs would be in two different places (inside or outside of financial statements) and not aligned. Participants also raised questions on whether cross reference is possible;

(j) Users of financial statements often ask for unusual items, particularly those included in paragraph B15 of the ED. The IASB proposals regarding the proposed definition of unusual items seem to be vague, narrow and highly judgemental. If to proceed, the IASB should consider comprehensive implementation guidance, including how to apply it within the group (parent and its subsidiaries);

(k) Potentially confusing because items under the scope of the IASB definition of unusual items are likely to be covered by the IASB's proposals of MPMs.

(l) The IASB has to strike the right balance between the cost of implementation and the benefits for users, particularly for disclosures by nature when presenting by function and allocation of income and expenses that arise from exchange differences and hedging;

(m) implementation period of 18-24 months might be challenging if a significant change to the IT systems is required.

7 In the closed meeting on PFS with the **OIC and Italian companies,** participants:

(a) definition of operating category should be improved, in particular the notion of "entity's main business activities" and the link to the presentation of reportable segments under IFRS 8;

(b) there are challenges related to the classification of income and expenses that arise from foreign exchange differences and hedging instruments. For example, it could be useful to clarify the guidance on grossing up (paragraph 57-58 of ED) related to the classification of derivatives entered into for risk management purposes of net exposures of revenue and costs on commodities. More specifically, clarify that the derivatives can be classified in the operating category on a net basis, when the hedged net exposure is referred to revenues and costs related to the main business activity (i.e. when the hedged items are all in the operating category);

(c) For one participant (Financial Institution), the proposal on new sub-totals and categories may not add much value in terms of the resulting information for banks.

(d) more guidance and examples on some topics such as investing category, hedging instruments (eg ineffective hedging portion) and acquisition-related costs incurred in a business combination (operating);

(e) significant judgement is required to distinguish between integral and non-integral associates and joint ventures and more guidance is needed on this topic. Also difficulties in assessing whether there is a significant interdependency between an entity and an associate or joint venture (which perspective should be assessed). One participant suggests to include the strategic nature of the investment as an indicator for the assessment (to distinguish between integral and non-integral). Finally, it could be useful to move the clarifications provided by the amendment to IFRS 12 into the new Standard;

(f) clarify the interaction between the new guidance in IFRS 12 on integral and non-integral with IFRS 5 and IAS 28 (e.g. long term interest);

(g) the IASB's proposals on MPM, i.e. to provide the income tax effect and effect on NCI for each item in reconciliation, is very burdensome, especially when preparing consolidated financial statement including interim financial statements;

(h) more guidance is required to clarify what the IASB intends for "public communications";

(i) the scope of MPM should be wider rather than limited to subtotals of income and expenses in order to provide a more comprehensive view of how management operates its business;

(j) the IASB should take into account the interaction of the proposed definition for unusual items with the ones of Regulators (such as national securities regulators);

(k) the definition of unusual items seems to be too restrictive and significant judgement is required, in order to define unusual income and expenses (eg the period to be considered as "several future years" and the concept of "limited predictive value");

(l) unclear whether entities would classify the entire amount or only the portion in excess of the reasonably expected amount as unusual;

(m) the interaction between the proposed requirements and their application in the separate financial statements is not clear;

(n) in accordance with the IASB proposals both the statements of P&L and statement of cash flows will have three different categories with similar labelling (operating, investing and financing). It was suggested that the consistency of the content of the two statements could be improved.

8 In the public event on PFS of the **Accounting Standards Committee of Germany** participants:

(a) suggested that the IASB further considers the definition of operating profit, particularly the residual element included in the definition, which was not considered useful. Similarly, the IASB should further consider the term 'main business activity', which seemed narrow;

(b) noted that there is a need for the IASB to further consider the definition of the investing category;

(c) noted that cash and cash equivalents were often not material, thus would welcome a simple approach;

(d) participants from the automotive industry welcomed the accounting policy choice in paragraph 51 of the ED;

(e) were concerned that the IASB's ED is silent with regards to the use of new categories within the other comprehensive income (OCI);

(f) explained the challenges related to the allocation of exchange differences, particularly within a group (parent and its subsidiaries);

(g) considered that the definition of integral seems to be narrow (e.g. could exclude strategic investments related to potential future main business activities) and would require judgement. Some asked for more guidance and examples while others specified that separation is not useful (all could be operating) or would require effort (cost benefit discussion). Nonetheless, those that invest in relation to their main business activities should present such investments as integral (e.g. insurance companies);

(h) suggested that integral associates and joint ventures could be part of the operating category with a separate line item and analysts could exclude the post tax result afterward;

(i) welcomed the IASB proposals on aggregation and disaggregation. However, would welcome more guidelines on how to break down the information in the disclosures;

(j) noted that more guidance is needed on when line items and subtotals mentioned in the ED have to be presented, particularly when taking into account materiality considerations;

(k) raised questions on the relevance of the criteria provided in paragraph B45 and concerns related to changing from by function presentation to by nature and vice-versa;

(l) would welcome guidance on when the ED allows, or even requires, a mixed basis of presentation;

(m) questions on the need for by nature disclosures when presenting by function, particularly when considering that such requirement would be costly. Expected effort from the necessary system adjustments would be disproportionate to the benefit. Some reported they were never asked for such type of information;

(n) noted that there is currently diversity in practice what is presented in the line items when presenting costs by function; participants addressed to the IASB that such guidance should be part of the current project to ensure comparability and to avoid implementation costs at a later stage;

(o) welcome the guidance on unusual items, although the IASB proposed definition for unusual items seemed to be narrow. Instead, the IASB could rely on the management view on unusual items;

(p) discussion whether the classification should be “unusual” from the addressee's point of view or from the user's point of view;

(q) there should be an option for entities to include in the financial statements cross references to the performance measures presented in the management report;

(r) expressed concerns in relation to the definition of public communication, limit to subtotals of profit and loss and exemptions like gross profit or Operating profit before depreciation of amortisation;

(s) not useful to have both the statement of financial performance and the statement of cash flows with three different categories with similar labelling (operating, investing and financing) when they are not aligned. On the proposal from ASCG that the cash flow statement should be, wherever possible, aligned with the income statement, mixed views were expressed;

(t) agreement with EFRAG that there should be a separate project on IAS 7 *Statement of Cash Flows.*

9 In the public outreach event jointly organised by EFRAG, the IASB and the ***Dutch Accounting Standards Board*** **(DASB)** participants:

(a) in general welcomed the IASB proposals to provide more structure to the financial statements which would improve comparability;

(b) welcomed the IASB’s efforts to define ‘operating profit or loss’ that is a key performance measure for users of financial statements and highlighted the importance of having a residual element. Users also welcomed that associates and joint ventures were presented outside off operating profit;

(c) considered that having a subtotal for integral associates and joint ventures would give too much prominence to this matter;

(d) noted that unwinding of discount of provisions were often linked to operating liabilities, thus participants challenged the classification of such items in the financing category;

(e) acknowledged the discussion around the classification of cash and cash equivalents but noted that the income and expenses that arise from cash and cash equivalents are often not material;

(f) noted that integral and non-integral associates and joint ventures would be in the same category in the statement cash flows (financing activities) while in the statement of profit and loss integral and non-integral associates in joint ventures would be two different categories. This seemed to be inconsistent;

(g) the split between integral and non-integral associates and joint ventures was considered interesting by preparers but not fundamental. When applying the IASB proposals, many associates and joint ventures would be classified as non-integral while management treated them as integral (i.e. would provide wrong information to users of financial statements) and this split was likely to lead to difficult discussions with the auditors Conversely, users considered that the IASB could require better disclosures on associates and joint ventures rather than separate presentation on the face;

(h) preparers highlighted the challenges of providing disclosures by nature when presenting by function and noted that currently users were not asking this to preparers. It was also noted that currently there is lack of guidance on the allocation of income and expenses to the line items presented by function;

(i) Users considered that information by nature and the use of a mixed basis was useful, particularly for restructurings and impairments;

(j) Support from users of financial statements on the IASB proposals focused on MPMs however questions on how non-IFRS metrics like return on debt could be aligned with the IFRS subtotals as they were not easily reconcilable (if scope was widened);

(k) Preparers noted there is already present in ESMA and US guidance, thus it would not be a significant change;

(l) struggled with the definition of unusual items. In his view the identification of unusual items would not give additional insights on the reporting.

Questions for EFRAG TEG

10 Does EFRAG TEG has any questions or comments?