PRIMARY FINANCIAL STATEMENTS

EFRAG’s draft comment letter, outreaches and comment letters received

30 October 2020

EFRAG
European Financial Reporting Advisory Group

New subtotals and categories

EFRAG INITIAL POSITION

New subtotals and categories

- ‘Operating profit or loss’ is one of the most used subtotals and currently there is a lack of consistency in its use, labelling and definition. EFRAG supports the IASB's proposals to present an operating, investing and financing category in the statement of profit or loss to improve comparability and reduce diversity in practice. However, EFRAG expressed some concerns:
    - the newly created categories in the statement of profit or loss are not aligned with the presentation of cash flows in the statement of cash flows, however, they have the similar labelling
    - clear guidance is needed on the notion of 'entity's main business activity' to distinguish between categories in the statement of profit or loss
    - the ED proposals should consider the interaction with existing regulatory frameworks on presentation of financial statements
- Useful to also define EBIT and EBITDA as they are among the most used performance measures.
- EFRAG regrets also that the IASB has not further discussed the classification into profit or loss or OCI, and the recycling.

QUESTIONS TO CONSTITUENTS

New subtotals and categories

- EFRAG is also seeking constituents’ views on the presentation of specific line items:
  - Income and expenses from cash and cash equivalents - please see paragraph 55 of the DCL
  - time value of money, please see paragraph 76 of the DCL

Application to conglomerates (operating different lines of business)

- EFRAG is seeking views on whether more guidance is needed for the presentation of revenues and costs when they are allocated to different business activities on the face, including consistency with IFRS 8 Operating Segments and disclosure on judgement on the allocation process

FEEDBACK FROM FIELD-TESTS

New subtotals and categories

- Need for more guidance on:
  - Notion of the ‘entity’s main business activities’)
  - Definition of the investing category (e.g. more examples of incremental expenses incurred generating income and expenses from investments)
  - Materiality considerations
  - Very specific line items such as:
    - foreign exchange differences and hedging instruments (judgement involved and operational issues/high cost in splitting these components from the underlying items)
    - interest from extended payment terms to customers and interest on trade payables
    - contingent consideration from business combinations

OUTREACH ACTIVITIES

New subtotals and categories

- Many welcomed the IASB efforts to improve the content and structure of the primary financial Statements, in particular welcomed the new subtotal “Operating profit or loss” (good anchor point)
- Most users of financial statements welcomed the fact that associates and joint-ventures did not impact the ‘Operating profit or loss’ subtotal
- Many welcomed having more granular information on the face of the financial statements
- Some stakeholders discussed the definition of operating profit or loss. For example:
  - the definition of operating profit having a positive, default category and residual element
  - some called for the IASB to focus on the core profit of an entity
- Not useful to have the same labelling for the different categories in the statement of profit or loss and statement of cash flows when the different categories were not aligned
- Mixed view on the presentation of cash and cash equivalents and unwinding of discount

COMMENT LETTERS

New subtotals and categories – operating (1/3)

- One NSS would prefer changes to the requirement for segment reporting in IFRS 8 rather than the statement of profit or loss. More specifically, considered that it is better to maintain and improve segmentation of activities as part of the IFRS 8: IFRS 8 should require entities to present the operating profit - as defined - of each separate operating segment. It would create a direct link between the consolidated operating profit or loss and the operational performance of the segments
- Guidance needed on when an entity is permitted or even required to reassess what constitutes its main business activities as entities can have several main business activities and the main business activities may alter over time (incl. 2 NSS);
- Some think there will be an increase in MPMs (incl. corporate association);
- Corporate association expresses concerns that the proposals reduce primary financial statements to the status of a compliance document and will lead to performance reporting being communicated by other ways [another preparers association – financial sector - has a different opinion and is supportive];
- Entities could be required to provide ‘a description of the nature of the entity’s operations and its main business activities to help users understand the classification of income and expenses in the different categories

COMMENT LETTERS

New subtotals and categories – operating (2/3)

- Mixed views on the definition of operating P&L (default + residual)
  - The amounts that are operating because they did not belong in the investing nor in the financing category, could be disclosed separately.
  - Many do not support the option in par. 51 (like in EFRAG DCL) and have suggested different ways forward.
- EFRAG Question in par. 43: mixed views on the answer
- Missing specific guidance on specific items (contingent consideration, GW impairment)
  - One NSS: more related to investments or divestments decisions: GW impairment, IFRS 5 gains and losses, remeasurement of equity in case of gain or loss of control
  - Clarify how to deal with income and expenses from investments made in the course of an entity’s main business activities other than investments in associates and joint arrangements
- Mixed views on the need to include investments made in the course of the business in the operating and separately from the investment category

COMMENT LETTERS

New subtotals and categories – operating (3/3)

- One NSS: interest income and expenses from financing activities that are closely linked to a manufacturing activity (or another business activity that is presented within the operating category) shall be classified in the operating category
- Classification of forex components (cost/benefit), clarification when they relate to different line items, how to classify by nature/by function
- Classification of hedging derivatives and other derivatives (e.g. when they related to different line items)
    - One NSS proposes either an accounting policy choice for one single category or a classification in operating
    - One NSS: operating category on a net basis, when the hedged net exposure is referred to revenues and costs related to the main business activity
- One NSS respondent even considered that the IASB should consider re-exposure of topics that may require further significant development
- One NSS income and expenses from cash and cash equivalents should be classified in the operating category, when the entity provides financial services to customers as its main business activity, even if it is not providing finance to customers

COMMENT LETTERS

New subtotals and categories – financing

- Cash and cash equivalent and time value: mixed views
- Time value of money: mixed views, but majority of those that covered this topic consider that time value of operating liabilities should be classified in operating
- One regulator: the current definition seems not to take into account instruments where the resource will not be returned to the provider of finance (perpetual debt) or where a different resource is returned to the provider (convertible debt)
- One NSS proposes a number of specific items that should be presented in the financing category

COMMENT LETTERS

New subtotals and categories – investing

- Split views: many support and many have concerns
- More guidance (examples of investments made in the course of the business, how to identify returns that are largely independent, incremental expenses on investments that are expected to generate income or expenses)
- One NSS and auditors do not agree with the proposal of having a subtotal for investing category
- It should include also income from intangibles and GW impairment or contingent consideration

COMMENT LETTERS

New subtotals and categories – Banks

- One banking association and one NSS: Operating profit or loss' subtotal would only be relevant for entities that have a significant part of income and expenses in other categories (i.e. financing and investing
- Regulator and one NSS: propose that the IASB develop specific subtotals for these entities [again a debate on industry-specific standard?]
- One banking association: introducing own developed subtotal(s) in the statement of profit or loss (they would exclude GW impairment and impairment of financial instruments)
- One banking association: all investments were made in the course of their main banking business, no need to separate in two categories

COMMENT LETTERS

New subtotals and categories – Insurance

- Auditors: operating profit or loss would replace well understood existing measures and reduce comparability with insurers which report using other comprehensive income This would reinforce, rather than reduce, the need for MPM; the IASB should consider allowing a transfer of investment variance from operating to investing
- Separate the returns from investments made in the course of an entity’s main business activities from those that are not is not useful for insurers
- There should be an option to present in operating a line of integral/non integral or aggregated associates and JVs

Integral and non-integral associates and JVs

EFRAG INITIAL POSITION

Integral and non-integral associates and JVs

- EFRAG's research has shown that there is diversity in practice on the presentation of the share of profit or loss of associates and joint ventures
- EFRAG considers that separate presentation of integral and non integral associates and joint ventures will result in relevant information for users of financial statements and enhance comparability
- However, EFRAG highlights that such presentation will involve significant judgement and needs to be tested in practice
- EFRAG seeks views on:
  - the needs to expand the new paragraph 20 D of IFRS 12 for example to include additional indicators, to reduce the level of judgement involved when making a distinction between integral and non integral entities
  - whether it would be useful to separately present or disclose the income tax related to associates and joint ventures accounted for under the equity method

FEEDBACK FROM FIELD-TESTS

Integral and non-integral associates and JVs

- This was one of the most debated topics where participants provided had many comments and expressed some concerns
- ‘Operating profit or loss and income and expenses from integral associates and joint ventures’ is a new subtotal not used before, however the information needed was available (subject to judgements) and no significant changes to the systems were required
- Nonetheless, the classification of investments in general is becoming complex: subsidiaries, different types of associates and joint ventures, investment entities, joint arrangements, financial instruments, etc)
- 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
- it would be useful to expand paragraph 20D of IFRS 12 to ease implementation (e.g. is the supplier or customer relationship critical for the investor only or also for the investee
- 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
- importance of having clear guidance on the notion of the ‘entity’s main business activities’

OUTREACH ACTIVITIES

Integral and non-integral associates and JVs

- This was one of the most controversial issues discussed by stakeholders with many:
  - questioning the relevance of the IASB proposal to require the split of integral and non-integral associates and joint-ventures (“is it worth to make the distinction?”)
  - questioning the need for a separate subtotal on integral associates and joint ventures (providing too much prominence to associates and joint-ventures), particularly users
  - questioning how the IASB proposals should be applied when considering immaterial associates and joint-ventures
  - expressing concerns about the level of judgement involved and supporting additional guidance to decrease the level of judgement.
  - suggesting having this information presented in the disclosures, others proposed alternative ways of defining integral and non-integral.
  - stating that there is room to improve the equity method but agreed that this should be addressed in a different project (e.g. presentation of income tax separately)

COMMENT LETTERS

Integral/Non integral

- Many do not support the split
- Concerns about the definition (largely independent, interaction with other standards); different proposals to adjust the definition
- Different proposals for additional indicators
- Linkage to the main business activity definition
- Proposal to move the split integral/non integral in the notes
- Some suggest to classify in operating
- Some want only integral in operating
- Misalignment between statement of cash flow and P&L
- Separate presentation of tax effect: some do not support (EFRAG Question par. 94)

Aggregation/Disaggregation

COMMENT LETTERS

Role of PFS and notes

- One NSS found the definition of the role of PFS and notes too descriptive. They propose focus on the overall position, performance, cash flows and stewardship of an entity, rather than the elements (assets, liabilities, equity, income, expenses) included in those financial statements.
- One NSS: the role of primary financial statements should be expanded to refer to the provision of useful information for assessing the prospects of future cash flows and for assessing management's stewardship of the entity's resources
- One NSS: understandability should be as important as comparability and consistency overtime

COMMENT LETTERS

Aggregation/Disaggregation

- Additional guidance is needed on the following:
  - to avoid that the proposals lead to presentation and disclosure of immaterial items
  - to clarify if items related to the same transaction can or cannot be split (par. 184 ACL) (regulator)
  - Cover reverse factoring
  - Clarify/provide additional example of the analysis required in paragraph 28 (detail of “other” items)
  - Clarification is necessary to apply the aggregation principles over time, including when using comparatives
  - Restatement of comparative if aggregation is changed overtime
- Auditors: the proposal for GW separately on the face is contradicting the proposal for GW in equity in the DP Bus Comb Disclosure GW Impairment
- One NSS clarify that notes may be included by reference to other reports
- There is an inconsistency between par. 42 and par. 65 and B46

Analysis of expenses

EFRAG INITIAL POSITION

Analysis of operating expenses

- EFRAG is sympathetic towards the IASB's proposal to continue requiring entities to present an analysis of expenses using either by function or by nature method, based on whichever method provides the most useful information to the users of financial statements
- However, EFRAG suggests that the IASB clarifies that paragraph B 47 of the ED allows, or even requires, a mixed basis of presentation when an entity presents line items under paragraphs 65 and B15 of the ED

Questions to constituents

- EFRAG seeks views on:
  - usefulness of having disclosures by nature in a single note when an entity assesses that presentation by function provides the most useful information and whether it will be costly to provide this additional info
  - usefulness of having in the statement of profit or loss a strict presentation either by nature or by function (i.e. a general presentation by nature or by function together with limited additional requirements as suggested in the ED by the IASB) or a mix presentation basis (i.e. no restrictions)

FEEDBACK FROM FIELD-TESTS

Analysis of operating expenses

- No significant concerns from those presenting today operating expenses by nature. Those that present today by function:
  - 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’
  - judgments to allocate some income and expenses by nature to the by function presentation (e.g. restructuring expenses and goodwill impairment losses)
  - 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
  - clarify the link between paragraphs B46 and B15 of the ED
  - Many considered that a mixed approach provided more flexibility to management to explain the entity’s performance

COMMENT LETTERS

Analysis of expenses (1/2)

- Many object to the option for the two methods, including European users, that would prefer by nature on the face
- Users are split: international association, international users consider both are useful, by nature not superior, while European users consider by nature is superior
- Generally, preparers and preparers organisations disagreed with the requirement to present by nature when presenting on the face by function, while users, some national standard setters and one regulator agreed with the requirement
- Concept of “by function is missing” / provide more examples
- Users suggest a matrix or partial matrix in the notes
- Two NSS and a corporate association: Investigate more which information about operating expense is needed by nature, more field test needed
- Cost/benefit concern of presenting by nature in the notes, depending on the current practice

COMMENT LETTERS

Analysis of expenses (2/2)

- One NSS suggests the split of opex by business lines and linkage to IFRS 8
- Many comment that presenting by nature when on the face is presented by function is costly, some including one NSS consider costs higher than benefits
- Clarify par. B65 in combination with B47, clarify par. B15
- Impairment of GW should be a separate line on the face
- Concerns with some of the indicators of B45
- Address the change in estimates (retrospective)
- Define costs to sales (auditors)

Management Performance Measures

EFRAG INITIAL POSITION

Management performance measures

- EFRAG welcomes the IASB's efforts to provide guidance on management performance measures (MPMs) which are often used in practice and additional guidance on non-IFRS measures could bring more transparency and consistency on their use
- EFRAG suggests to apply the MPM requirements also to the non-GAAP performance measures, presented within financial statements, that may not satisfy the proposed criteria of MPMs (e.g. adjusted revenues and ratios)
- EFRAG highlights a number of challenges in regard to the ED proposals

Questions to constituents

- Seeking views of its constituents on a possible alternative narrower scope: **Scope 1** (MPM in the financial statements and guidance in the MCPS) or **Scope 2** (MPM in communications released jointly with the annual or interim report, including earning releases)?
- Costs and benefits of splitting income tax effect and NCI for each item in the reconciliation as required by paragraph 106(b)?
- Will the IASB’s proposals on the statement of P&L lead to an increased number of MPMs?

FEEDBACK FROM FIELD-TESTS

Management performance measures

- 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
- Many participants noted that the definition seemed to be narrow, with some also disclosing other APMs that did not meet the definition of an 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
- 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
- Many participants also called for the IASB to clarify what public communication is
- 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
- Finally, some participants noted that they might revisit their performance measures considering the new proposed subtotals

OUTREACH ACTIVITIES

Management performance measures

- Support for the IASB's efforts to introduce discipline and transparency on the use of MPMs - important that such measures are audited
- Stakeholders expressed mixed views on the scope:
  - some considered appropriate to go for the indicators presented in all the communications issued jointly with the annual or interim results, particularly users of financial statements.
  - some would prefer disclosures only for the indicators that the entity presents in the financial statements, particularly preparers
  - many called for the IASB to clarify the meaning of 'public communication'

COMMENT LETTERS

Management performance measures

- Mixed views
  - Many disagree, including associations of corporates and insurers, but also international users. The latter consider that indicators on the face are more relevant (due to the use of data aggregators) and suggest to they propose to require companies to disclose MPMs just below the bottom line of the statement of profit or loss.
  - Many agree, including audit profession, regulator, four national standard setters and European users
- Many agree with EFRAG that ratios or measures containing financial position or cash flow items should be included in the scope
- Many say that separating tax and NCI is too burdensome
- Will number of MPM increase? Mixed views.

COMMENT LETTERS

Management performance measures - List of indicators that are not MPM in paragraph 104:

- One NSS would like to see the list extended, as the IASB's proposals should aim to narrow the use of MPMs in practice by increasing the number of subtotals specified by IFRS Standards.
- International users suggest to delete par. 104 (Subtotals specified by IFRS Standards that are not management performance measures) so to have broader scope
- One regulator considers that only subtotals which are calculated from IFRS figures and are defined in IFRSs should be exempted from MPM requirements. Unless a requirement is introduced for issuers to disclose separately "depreciation" and "amortisation", either in the face of the financial statement or in the Notes, "operating profit or loss before depreciation and amortisation" should be considered an MPM.
- One standards setter considers that subtotal that is presented in the statement of profit or loss should not be considered as a MPM.

COMMENT LETTERS

Management performance measures – scope/presentation

- Majority says that the IASB current scope is too broad (reference to public communication), accountancy profession suggests the public communication could be limited to be limited to regulatory information or to the examples provided in paragraph B79 of the ED
- EFRAG question on scope: Scope 1 VS Scope 2
  - Few support Scope 1 (including two national standard setters and a banking association)
  - Majority of those that responded to the question Support scope 2
- Two respondents including one standard setter would prefer MPM disclosure in the management commentary instead than in the notes

Unusual income and expenses

EFRAG INITIAL POSITION

Unusual income and expenses

- EFRAG welcomes the IASB’s proposals as they would result in useful information and reduce diversity in practice
- EFRAG suggests the IASB to refine definition of unusual to include items that presently occur in the business, but only for a limited period (e.g. those identified in paragraph B15 of the ED such as restructuring costs)
- EFRAG notes that the translation of term ‘ may raise issues in some jurisdiction EFRAG considers that it would be useful to clarify whether entities can present unusual items on the face of the financial statements by specifically referring to ‘unusual line items’ and ‘unusual subtotals’ within the categories defined by the IASB or with the use of columns

FEEDBACK FROM FIELD-TESTS

Unusual income and expenses

- Some participants already provided information about non-recurring or unusual items; however they noted that the IASB proposed definition would change current practice.
- The proposed requirements were often considered clear, the information available and no significant changes to the IT systems. However, some concerns have been expressed:
  - 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)
  - 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
  - the definition would restrict the number of unusual items identified and, consequently, disclosures will have limited added value. For example, the definition excludes expenses caused by a restructuring program which takes two years

OUTREACH ACTIVITIES

Unusual items

- Stakeholders provided mix views on how unusual items should be defined:
  - some considered that the IASB definition is too narrow
  - some considered it too wide
  - some considered that there should be a list of line items for which entities have to provide disclosures (e.g. restructurings, impairments, litigations, etc)
  - some considered that it was difficult to agree on a common definition and management should provide its own definition of unusual items (particularly when considering that this would not impact the presentation of the income statement)
- Many questioned the applicability and interaction/addded value in conjunction with the IASB proposals on MPMs (likely to capture the same items)

COMMENT LETTERS

Unusual items (1/2)

- Majority agreed with the proposal
- Many disagree (judgmental, unclear, duplicating the MPM requirements)
- Many consider the scope too narrow (like EFRAG)
- Two (including a regulator) consider that the scope should be even narrower (Different from EFRAG's view, the regulator believes that income and expenses which have arisen in past annual reporting periods or that are expected to arise in future reporting periods (such as restructuring costs or impairment losses) should generally not be considered as "unusual")
- International users and one standard setter prefer "unusual line item" on the face
- One NSS suggests more discipline in specific guidance for disclosure including accounting policies applied, neutral unbiased approach.

COMMENT LETTERS

Unusual items – scope definition (2/2)

- Rather than defining unusual items, the IASB should base its requirements on:
  - the principle of the highlighting of items “with limited predictive value” and provide guidance on how to identify and present such items
  - the management’s view
  - identify a list of items
  - less emphasis to the future (one national standard setter)
  - use core/non-core category
  - unusual for the entity’s main activity rather than with limited predictive value
  - FV changes an loan loss impairments at list partially should be unusual in situations like the Covid crisis – refer to an unusual event

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