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Proposed IFRS Standard aims to bring major changes to primary financial statements

Standard on general presentation and disclosures in financial statements: Big changes under review

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Investors want to see performance reporting improved, such as by requiring consistently defined subtotals in the statement of financial performance. The proposed Standard is a response to investor concerns, by introducing big changes in how companies present and disclose their financial information.

1. Introduction

The International Accounting Standards Board (IASB) is proposing major changes to primary financial statements by replacing IAS 1 Presentation of Financial Statements with a new Standard. The IASB's objective is to make it easier for investors to compare the performance and future prospects of entities by changing the requirements for presenting information in the primary financial statements, particularly the statement of financial performance.

The project intends to address three key requirements of investors:

- Greater consistency and comparability in the statement of financial performance, as the existing standard allows flexibility that has resulted in a diversity of measures being presented by companies
- Provision of more granular information that provides better data for analysis, rather than information that is either too aggregated (lacking sufficient detail) or so detailed that material information is obscured
- Increased transparency and discipline around the use of management performance measures (MPMs), to improve clarity about how these non-GAAP measures are defined and calculated.

The IASB's main proposals would require entities to:

- Structure the statement of financial performance to include specific defined sub-totals, e.g. "operating profit or loss", and present classification categories
- Further disaggregate financial information in useful ways, such as by presenting an analysis of operating expenses and identifying unusual income or expense items
- Disclose information about MPMs in the notes to the financial statements, including a reconciliation of MPMs to measures specified by IFRS Standards
- Improve the comparability of the statement of cash flows, e.g. by eliminating the current policy choice for classification of cash flows from interest and dividends.

2. Statement of financial performance

2.1 Defined subtotals and classification by category

Under the existing standards, differences arise between the statements of financial performance of companies, due to the permitted variability in presentation. For example, many companies present an ‘operating profit’ subtotal, which is currently not defined by IFRS Standards. Many investors use operating profit to assess margins and as a starting point for forecasting future cash flows. However, companies calculate operating profit in different ways, thereby reducing comparability between financial statements.

The proposed Standard requires companies to present three new subtotals in their statement of financial performance and allocate their income and expenses between four major categories.

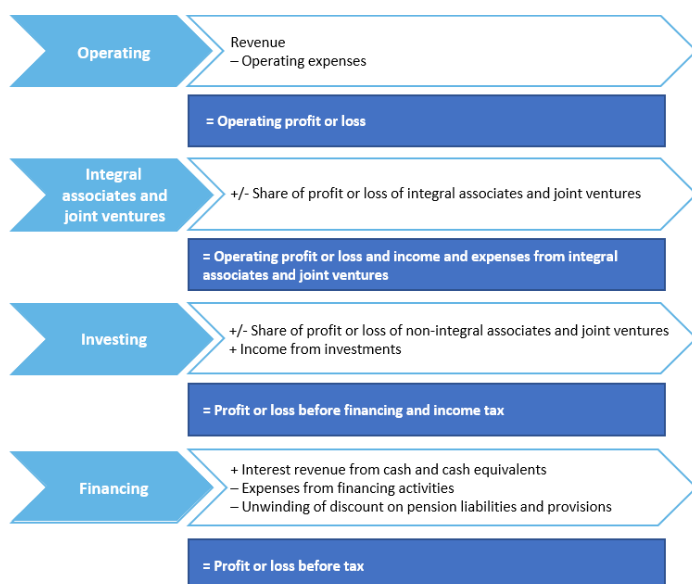
The proposed subtotals are:

- operating profit or loss
- operating profit or loss and income and expenses from integral associates and joint ventures
- profit or loss before financing and income tax.

A notable omission from the proposed subtotals is earnings before interest and taxes (EBIT), which is a commonly reported performance measure. This is because the IASB found that EBIT and similar subtotals are not comparable between companies due to the diverse ways in which they classify items between ‘finance income and expenses’ and ‘other income and expenses’. However, the IASB is proposing ‘profit or loss before financing and income tax’ as a required subtotal that serves a similar purpose as EBIT, as it allows users of financial statements to compare entities independently of how they are financed.

The four major categories of income and expenses that would align with these subtotals are: operating; investing; financing; and integral associates and joint ventures. Income tax and discontinued operations would also continue to be presented separately. Companies would be required to classify their income and expenses included in profit or loss into one of these four categories. However, companies would not be required to present the category labels on the statement of financial performance.

If the proposals are finalised without any changes, a statement of profit or loss would have the following basic structure:



Although the four categories have similar labels as in the statement of cash flows (i.e. operating, investing and financing activities), the IASB is not seeking full alignment between how they are defined in the two statements. The IASB has intentionally defined the investing categories in the two statements with different objectives. For example, cash flows from property, plant and equipment are included in the investing category in the statement of cash flows, but income and expenses from those assets would generally be included in the operating category in the statement of profit or loss. Careful consideration of classifications in the respective statements will be required, as it is possible that the similar labelling could create confusion when classifying income and expenses in the statement of financial performance, and cash inflows and outflows in the statement of cash flows.

2.2 Classifying share of profit or loss from associates and joint ventures, and foreign exchange

In addition to presenting new categories and subtotals, the proposed standard requires companies to differentiate between share of profit or loss from ‘integral’ and ‘non-integral’ associates and joint ventures. However, the definitions of ‘integral’ and ‘non-integral’ are imprecise, such that classifying items as one or the other will be highly judgemental. Identifying associates and joint ventures where the activities are closely related to the reporting entity’s main business activities (‘integral’) – as opposed to those where the activities have little or no effect on the main business activities (‘non-integral’) – could therefore be very difficult in practice.

Foreign exchange differences would be presented in the same category of the statement of profit or loss as the income and expenses that give rise to them. In a field study conducted by the European Financial Reporting Advisory Group (EFRAG)[1], participants noted that implementation of this requirement could give rise to substantial costs and efforts to implement, e.g. to classify existing foreign exchange accounts by category (i.e. operating, investing, financing).

[1] http://www.efrag.org/News/Project-432/EFRAG-summary-report-of-the-field-test-workshop-with-corporates-on-7-July-2020-, 8 September 2020

2.3 Operating category

The proposed subtotal for operating profit or loss is determined through the allocation of income and expenses to the operating category. The proposed Standard starts by providing a positive definition of the operating category, indicating that it consists of income and expenses from the entity's main business activities. However, it then introduces an explanation that in fact the operating category is a residual of income and expenses that are not classified as investing or financing. Consequently, the way in which the operating category is defined could be confusing for the preparers of financial statements.

Depending on the entity's main business activities, some types of income or expenses would be categorised differently. For example:

- Interest expenses are typically categorised as 'financing'. However, for some types of company they may be categorised as 'operating'. For example, it is proposed that some companies (such as banks) should be allowed to include interest expense in the operating category where providing financing to customers or investing is a main business activity. An entity that includes all its expenses from financing activities in the operating profit or loss subtotal would therefore not present a subtotal for profit or loss before financing and income tax.
- Interest income is typically categorised as 'investing'. However, it is included in 'operating' if the entity, in the course of its main business activities, invests in assets that generate a return independently of other resources of the entity, or if they result from a significant balance of cash and cash equivalents and the operations of the entity require such a balance.

In the EFRAG field study, a participant highlighted the challenges of separating the returns from investments made in the course of an entity's main business activities from those that are not. For example, investments in equity instruments held from a political or strategic perspective, and which therefore may not be related to the entity's main business activities, would need to be identified separately from investments that directly serve the business model of the entity.

2.4 Investing category

The IASB proposes to require entities to present an investing category in the statement of profit or loss that gives information about returns from investments that are generated individually and largely independently of other resources held by the entity. The category contains income and expenses from investments that are not classified as operating, including incremental expenses incurred generating income and expenses from investments.

2.5 Financing category

The IASB proposes to define financing activities as those activities involving the receipt or use of a resource from a provider of finance with the expectation that the resource will be returned to the provider of finance. Furthermore, the provider of finance will be compensated through the payment of a finance charge that is dependent on both the amount of the credit and its duration.

Under the proposal, entities would include the following items in the financing category, unless they relate to the entity's main business activities:

- Income and expenses from cash and cash equivalents
- Income and expenses on liabilities from financing activities
- Interest income and expenses on other liabilities

3. Disaggregation

Investors have told the IASB that the way in which some companies disaggregate information in their financial statements does not provide the information they need for their analysis.[2] For example, information that is too aggregated may hinder a user's understanding, while too much detail may obscure material information.

According to the IASB`s proposal, items with similar characteristics should be aggregated together whilst items that are dissimilar from other items should be presented separately. To facilitate the disaggregation principles, the IASB proposes changes to the analysis of operating expenses, and unusual income and expenses.

3.1 Analysis of operating expenses

In current practice, many companies use a mixture of both the nature or function of expense methods, which means that they may not choose the method that provides the most useful information. The new Standard proposes to clarify the presentation for the analysis of operating expenses included in operating profit or loss by prohibiting a mix of both methods.

An entity would be required to use the method that provides the most useful information, e.g. the method that most closely matches the way the business is managed; how management reports internally to the board or key decision makers; and industry practice.

3.2 Unusual income and expenses

To further improve disaggregation, the proposal introduces disclosure requirements for 'unusual' items to discourage aggregation of items into large, single numbers. The IASB proposes to define unusual items as income or expenses with limited predictive value, i.e. when it is reasonable to expect that income or expenses that are similar in type and amount will not arise for several future annual reporting periods.

Unusual income and expenses would not be presented separately in the statement of financial performance. However, more extensive disclosures would be required in a note to the financial statements, disclosing all unusual income and expenses, e.g. the amount of each item and a narrative description of the transaction. Income and expenses from the recurring measurement of items measured at current value would not normally be classified as 'unusual'.

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[2] https://www.ifrs.org/projects/work-plan/primary-financial-statements/comment-letters-projects/ed-primary-financial-statements/, 15 September 2020

However, a key challenge for entities is that the assessment of whether it is reasonable that an item will not recur for several future annual periods is highly judgemental. The predictive criteria would make it difficult for companies to identify unusual items, and to ensure that the disclosure is complete and accurate. Some participants in the EFRAG field study found that significant judgements were required to interpret the meaning of 'several future annual reporting periods'. They also questioned how unusual items would be monitored and considered by the auditors.

It is important to note that income or expenses are classified as ‘unusual’ based on expectations about the future rather than past occurrences. Therefore, it would be possible for income or expenses similar to those reported in previous reporting period(s) to be classified as ‘unusual’.

4. Statement of financial position

The IASB is proposing new line items in the statement of financial position:

- the presentation of goodwill separately from intangible assets
- the presentation of investments in *integral* associates and joint ventures separately from investments in *non-integral* associates and joint ventures.

The IASB's rationale for separating out goodwill is that the characteristics of goodwill are sufficiently different to those of intangible assets, i.e. unlike other intangible assets, goodwill is an asset that is not identifiable and is measured only as a residual.

The proposal to present investments in integral associates and joint ventures separately from investments in non-integral associates and joint ventures is consistent with the presentation proposed in the statement of financial performance. Just as with the statement of financial performance, identifying associates and joint ventures where the activities are closely related to the reporting entity's main business activities ('integral') – as opposed to those where the activities have little or no effect on the main business activities ('non-integral') – could be very difficult in practice.

5. Statement of cash flows

The IASB also proposes amendments to *IAS 7 Statement of Cash Flows*. These are intended to simplify disclosures by eliminating current policy choices. An entity would limit the number of adjustments that are currently required to determine its operating cash flow under the indirect method, by starting with its operating profit or loss subtotal.

Furthermore, an entity would no longer have a choice about how to classify dividends and interest. For most entities, the new Standard would classify dividends and interest paid as cash flows from financing activities, and dividends and interest received as cash flows from investing activities.

6. Management performance measures (MPMs)

Companies often use ‘non-GAAP information’ to explain their financial performance to investors. This information can differ from the IFRS information, which can make it difficult for investors to identify which figures should be used when assessing the financial performance of an entity.

To promote transparency, the IASB proposes to define management performance measures (MPMs) as subtotals of income and expenses that:

- Are used in public communications with users of financial statements, and complement totals or subtotals in the IFRS Standards, and
- Communicate to users of financial statements management’s view of an aspect of the entity’s financial performance.

It is notable that the IASB does not prescribe how companies should calculate their MPMs. This is because MPMs are company-specific measures, and the IASB does not expect them to be comparable across companies. However, investors would be able to understand differences in how companies have calculated their measures using the proposed disclosures.

The IASB proposes that MPMs and all related information would be disclosed in a single note. For each MPM, the note would:

- describe why the MPM communicates management’s view of performance, including an explanation of how the MPM is calculated and how it provides useful information about the entity’s performance,
- provide a reconciliation between the MPM to the most directly comparable IFRS-total or subtotal, and
- disclose the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation, including how the tax effect is determined.

If an entity changes its calculation of an MPM, introduces a new MPM or removes a previous MPM, it would need to explain the change, addition or removal and its effects, and the reason for it.

There are some potential challenges in implementing the proposed MPM guidance that were identified by participants in the EFRAG field study. In particular, participants observed that they currently disclosed many non-GAAP measures that would not meet the definition of a MPM. For example, the proposed MPM definition excludes free cash flow, ratios (e.g. return on equity), adjusted revenue, and growth rates (e.g. constant currency revenue growth). Some participants felt that it was important for management to disclose these non-GAAP non-MPM measures, as these were important to explain to investors how management operated its business.

7. Conclusion

The measures proposed by the new Standard are intended to address investor concerns around the transparency and comparability of financial statements, however, preparers of financial statements may encounter difficulties when applying the guidance into practice. Some of the proposals call for significant judgements, such as classifying associates and joint ventures as 'integral' or non-integral', and identifying unusual income and expenses.

While we support the IASB`s initiative to improve how information is communicated in the financial statements, in particular the information included in the statement of financial performance, there are some areas that would need to be reconsidered by the Board, e.g. the proposals on unusual items and MPMs and the determination of the operating category.

The IASB is currently considering feedback on their proposal in developing its final requirements. Although the IASB does not propose an effective date for the new Standard, entities would be given at least 18-24 months between finalization of the new Standard and the initial application to prepare for the transition.

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