THE FOOTNOTES ANALYST

Analytical Insights for Investors

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Dear Hans

Exposure Draft: General presentation and disclosure

We believe that the proposals in this ED will significantly enhance the value of financial reports for investors. In particular, we strongly support the proposed classification and subtotals in profit and loss, the enhanced disaggregation requirements and bringing management performance measures within the scope of audited financial statements. We also support the limited changes to the cash flow statement and the increased comparability that would result from the proposed presentation of equity accounted investments.

We have a number of suggestions for changes that we believe could further enhance the relevance of financial statements for investors, including:

- **Enhance the disaggregation requirements:** Disaggregation of dissimilar income and expense items is key for investors in understanding performance and forecasting cash flows. While we like the general approach taken in the ED, we believe that the end result may not be as much disaggregation as we would wish. We suggest an enhancement to this approach that we believe will produce a better outcome.

- **Drop or revise the unusual item requirements:** The separate presentation of unusual items is itself merely a component of wider disaggregation. If, as we suggest, the general disaggregation requirements are made more effective we do not see the need to, in addition, require the presentation of unusual items. If the IASB decides to retain the unusual item classification, we suggest that the definition is made broader.

- **Disaggregation to take into account taxation differences:** We support the proposal to present the tax and NCI effects of adjustments included in the calculation of management performance measures. However, we believe that understanding differences in taxation should not be dependent on whether an MPM has been published or not. Investors need better information about how the effective tax rate may differ for different gains and losses. Accordingly, we think that the effective tax rate should be included as a factor in determining the disaggregation applied to profit and loss items.

- **Separate category for capital expenditure cash flows:** While we support the limited changes to the cash flow statement in the interim, we believe that a separate project should be undertaken to improve cash flow reporting. However, to resolve the difference between the definition of the 'investing' categories in profit and loss and the statement of cash flows, we suggest a further amendment to place purchases of tangible and intangible fixed assets in a separate 'capital expenditure' category.

Our answers to the specific questions in the ED are given below.

Yours sincerely,

Steve Cooper and Dennis Jullens

The Footnotes Analyst is a blog for investors and analysts on financial reporting and equity analysis that is written by Steve Cooper and Dennis Jullens. Steve Cooper is a former IASB Board Member. Dennis Jullens is a lecturer at Amsterdam Business School, University of Amsterdam and a member of the EFRAG user panel. Both Steve and Dennis previously worked in investment banking, including as colleagues at UBS investment research.

Response to questions:

Question 1—operating profit or loss
Paragraph 60(a) of the Exposure Draft proposes that all entities present in the statement of profit or loss a subtotal for operating profit or loss. Paragraph BC53 of the Basis for Conclusions describes the Board's reasons for this proposal. Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

We agree.

Question 2—the operating category
Paragraph 46 of the Exposure Draft proposes that entities classify in the operating category all income and expenses not classified in the other categories, such as the investing category or the financing category. Paragraphs BC54–BC57 of the Basis for Conclusions describe the Board's reasons for this proposal. Do you agree with this proposal? Why or why not? If not, what alternative approach would you suggest and why?

We agree.

Question 3—the operating category: income and expenses from investments made in the course of an entity's main business activities
Paragraph 48 of the Exposure Draft proposes that an entity classifies in the operating category income and expenses from investments made in the course of the entity's main business activities. Paragraphs BC58–BC61 of the Basis for Conclusions describe the Board's reasons for this proposal. Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

We agree with the proposal. However, we think that the use of the concept of the 'entity's main business activities' may result in confusion, given that operating is both defined as a residual but also described as 'main business activities'. The relevance of referring to 'main business activities' appears to be identifying items that would normally be regarded as investing or financing but should instead be classified as operating. We support this but think this approach needs to be explained more clearly.

Question 4—the operating category: an entity that provides financing to customers as a main business activity
Paragraph 51 of the Exposure Draft proposes that an entity that provides financing to customers as a main business activity classify in the operating category either: • income and expenses from financing activities, and from cash and cash equivalents, that relate to the provision of financing to customers; or • all income and expenses from financing activities and all income and expenses from cash and cash equivalents. Paragraphs BC62–BC69 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

We do not agree with allowing a free choice.

We think that all entities should be required to only classify the income and expense from financing activities as operating if they relate to the provision of financing to customers. We recognise that this may be subjective, but we do not believe it would be arbitrary.

For companies where the only main business activity is the provision of finance to customers it may be preferable that all income and expenses that would be classified as investing and financing be regarded as operating. In effect, this means that the requirement for the presentation of subtotals before pre-tax profit is not applied to these companies. We believe the Board should explore this approach further.

Question 5—the investing category
Paragraphs 47–48 of the Exposure Draft propose that an entity classifies in the investing category income and expenses (including related incremental expenses) from assets that generate a return individually and largely independently of other resources held by the entity, unless they are investments made in the course of the entity's main business activities. Paragraphs BC48–BC52 of the Basis for Conclusions describe the Board's reasons for the proposal. Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

We agree.

Question 6—profit or loss before financing and income tax and the financing category
1. (a) Paragraphs 60(c) and 64 of the Exposure Draft propose that all entities, except for some specified entities (see paragraph 64 of the Exposure Draft), present a profit or loss before financing and income tax subtotal in the statement of profit or loss. 2. (b) Paragraph 49 of the Exposure Draft proposes which income and expenses an entity classifies in the financing category. Paragraphs BC33–BC45 of the Basis for Conclusions describe the Board's reasons for the proposals. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We agree.

Question 7—integral and non-integral associates and joint ventures
1. (a) The proposed new paragraphs 20A–20D of IFRS 12 would define 'integral associates and joint ventures' and 'non-integral associates and joint ventures'; and require an entity to identify them. 2. (b) Paragraph 60(b) of the Exposure Draft proposes to require that an entity present in the statement of profit or loss a subtotal for operating profit or loss and income and expenses from integral associates and joint ventures.

3. (c) Paragraphs 53, 75(a) and 82(g)–82(h) of the Exposure Draft, the proposed new paragraph 38A of IAS 7 and the proposed new paragraph 20E of IFRS 12 would require an entity to provide information about integral associates and joint ventures separately from non-integral associates and joint ventures. Paragraphs BC77–BC89 and BC205–BC213 of the Basis for Conclusions describe the Board's reasons for these proposals and discuss approaches that were considered but rejected by the Board. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We broadly agree with the proposal. However, we do not believe that the split between integral and non-integral is of vital importance. Understanding how associates and joint ventures fit into the entity's business model is important information for investors. While the proposed classification may help in this regard, it is not the only way this could be achieved.

In our view, the most important changes regarding associates and joint ventures is to eliminate the current inconsistency in presentation and to ensure that the share of profit is not included as part of group operating profit. We would prefer that equity accounted investments be separated from other investments reported in the investing category. Accordingly, if the integral / non-integral split is not carried forward we would support all equity accounted investments being presented in a separate category immediately below operating profit, in the same way as the proposal for integral associates and joint ventures in the ED.

We would be more supportive of the proposed split if the accounting for integral and non-integral associates were different. Reporting the share of profit and assets using equity accounting is, arguably, most relevant for integral associates. In our view, non-integral associates would be better accounted for using FVTPL, or at least included in the scope of IFRS 9, and accounted for in the same way as other equity investments for which there is no significant influence.

If a single category below operating profit is adopted for all associates and joint ventures, we think this should only include those accounted for using the equity method. If the fair value option is used, then we think these investments should be reported in the investing category.

On balance, we suggest that the proposal to report integral and non-integral associates separately is included in the final standard, albeit with additional guidance to help ensure that the classification is reasonably comparable across entities. In addition, a new project to reform equity accounting should, in our view, be added to the board's agenda (irrespective of any decisions that are made in the interim regarding presentation). This project should look at the conceptual basis for equity accounting, the various application issues that have arisen and, in particular, consider the relevance to investors of accounting for non-integral associates using fair value instead of equity accounting.

Question 8—roles of the primary financial statements and the notes, aggregation and disaggregation
1. (a) Paragraphs 20–21 of the Exposure Draft set out the proposed description of the roles of the primary financial statements and the notes. 2. (b) Paragraphs 25–28 and B5–B15 of the Exposure Draft set out proposals for principles and general requirements on the aggregation and disaggregation of information. Paragraphs BC19–BC27 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We agree with the proposed roles for the primary statements and the notes.

We broadly agree with the principles for aggregation and disaggregation; however, we think that this needs to be more narrowly defined (the trigger for disaggregation should be more likely to be met) and should be reinforced by additional explanation and further examples.

Disaggregation of items that have different characteristics is vitally important for investors. Better disaggregation, clearer descriptions of disaggregated items and the end to the use of the term 'other' (unless supported by further analysis in the notes) may be the most beneficial changes for investors of a new IFRS based on this ED. However, we do not believe that the wording in paragraph 25(b) or the supporting explanations in B5-B11 will necessarily achieve this. We agree with the explanation in B11 that, if items have more dissimilar characteristics, then aggregation of these items is less likely to result in useful information. However, we think that only one dissimilar characteristic may be sufficient for disaggregation to be essential and that companies should be required to assess whether any one difference warrants disaggregation.

We suggest that the wording be changed so that items must be disaggregated if any one characteristic is dissimilar and, in the judgement of the entity, that dissimilarity is material to understand performance. We also think that it would help if reference is made to the objective of financial reporting regarding the *"… assessment of the amount, timing and uncertainty of (or the prospects for) future net cash inflows …"*. Sufficient disaggregation is essential for financial statements to achieve that objective. For investors to be able to forecast future cash flows they need to be able to relate individual items in financial statements to the underlying drivers of those items. If these drivers differ for different elements of a reported item, because these elements have different characteristics, then forecasting becomes very difficult.

Many individual standards have specific disaggregation requirements that are extremely helpful for investors. A good test of whether the general disaggregation requirements in the new general presentation and disclosure standard are sufficient is whether they would provide investors with the same level of disaggregation if the detailed requirements were not included in the more specific standard. We recommend that any final wording be tested in this way. For example, IAS 19 requires the disaggregation of the total expense regarding defined benefit pension schemes into a number of components. Without these requirements we question whether the proposals in the ED would produce the same split of, say, service cost from past service cost. In IAS 19 the different nature of service cost and past service cost is recognised and separate disclosure is rightly required, but in terms of the ED these two items have many more characteristics in common than not and it is not clear whether the general presentation and disclosure requirements would be effective in forcing the disaggregation.

Furthermore, we think that the general disaggregation requirements should apply in all situations, including where there are specific disclosure requirements in another standard, and that this should be made clear in the final standard.

Disaggregation is not only important where it means *less aggregation* of dissimilar items, but it is also important when it applies to the analysis of a single item into components that have different characteristics or different linkage to underlying drivers. For some specific financial statement items such disaggregation is already mandated. For example, in many standards, catch up adjustments related to prior periods must be separately disclosed and, more recently, extensive disaggregation requirements have been included in IFRS 17. However, there is no general requirement to provide this type of disaggregation. We suggest that a general principle of such disaggregation be introduced. A good example of where this would help investors is in respect of share-based payments. IFRS 2 only requires disclosure of the overall share-based payment expense analysed between equity-settled and cash-settled schemes. However, within these items are catch up adjustments related to prior periods and, for cash-settled schemes, adjustments in respect of share price changes. Each of these have very different characteristics compared with the other components. Only through further disaggregation of the share-based payment expense would investors be in a position to assess *the amount, timing and uncertainty of (or the prospects for) future net cash inflows.* Clearly IFRS 2 could be amended to achieve this (which we would support) but we also think that the same outcome could be achieved through better disaggregation requirements in the general presentation and disclosure standard.

An important dissimilar characteristic, which we think should prompt disaggregation, is differences in the tax impact of different items – see our answer to Question 11 for a discussion of taxation.

We do not agree with the proposals regarding immaterial items. If an item is truly not material, then whatever other item with which it is combined should not affect how investors interpret the financial statements. Therefore, we do not see why the description of the item should change. Indeed, changing it may well itself cause confusion. If, for example, a company has $1bn of PPE and $1m of biological assets, then we think that the two items could be combined but, in which case, the combination should still be called PPE, with no reference at all to the immaterial biological assets.

Question 9—analysis of operating expenses
Paragraphs 68 and B45 of the Exposure Draft propose requirements and application guidance to help an entity to decide whether to present its operating expenses using the nature of expense method or the function of expense method of analysis. Paragraph 72 of the Exposure Draft proposes requiring an entity that provides an analysis of its operating expenses by function in the statement of profit or loss to provide an analysis using the nature of expense method in the notes. Paragraphs BC109–BC114 of the Basis for Conclusions describe the Board's reasons for the proposals. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We agree that a full analysis of operating expenses *by nature* should always be provided, even if *by-function* is used in the primary statement.

We do not agree with the proposed prohibition of the combination of a by-function and by-nature analysis in profit and loss. Although removing certain items from a by-function analysis and reporting them separately would make those functional expense items incomplete, we do not think this is a problem for investors. A by -unction analysis is not comparable across companies anyway, so any additional lack of comparability because of the removal of certain by nature items for separate analysis would make little difference. What is more important is that, for any one entity, the analysis provide is consistent over time and that items are described correctly for what they are.

We think that a combination of a by-function and by-nature analysis can provide greater clarity for investors and link the primary statements more closely with management performance measures.

For example, a by-function expenses analysis might exclude the by-nature asset impairment expense. Presenting this separately on the face of the income statement (and the function expenses clearly labelled as 'excluding asset impairments'), with the addition of a pre-impairment management performance measure sub-total, may give greater clarity than allocating the impairment expense by-function and only disclosing it and the MPM in the notes.

Question 10—unusual income and expenses
1. (a) Paragraph 100 of the Exposure Draft introduces a definition of 'unusual income and expenses'. 2. (b) Paragraph 101 of the Exposure Draft proposes to require all entities to disclose unusual income and expenses in a single note. 3. (c) Paragraphs B67–B75 of the Exposure Draft propose application guidance to help an entity to identify its unusual income and expenses. 4. (d) Paragraphs 101(a)–101(d) of the Exposure Draft propose what information should be disclosed relating to unusual income and expenses. Paragraphs BC122–BC144 of the Basis for Conclusions describe the Board's reasons for the proposals and discuss approaches that were considered but rejected by the Board. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We do not agree with the proposals regarding unusual items.

In our view these proposals are unnecessary (or at least would be unnecessary if the general disaggregation requirements were sufficiently comprehensive). We suggest that the proposals be dropped, and additional work done on disaggregation to ensure that all items with different characteristics, including those that may be regarded as 'unusual' or 'non-recurring', are reported separately, either on the face of the income statement or in the notes.

The examples provided in the ED regarding what is an unusual item and when they should be separately disclosed should be repurposed as examples of when disaggregation is necessary.

It is important that disaggregated items in profit and loss are described clearly for what they are. In our view it would be better for investors if the use of labels such as 'non-recurring' or 'non-core' were not permitted or at least discouraged. For example, unusually large restructuring expense should simply be labelled as restructuring, with the supporting explanations in the notes providing the context and comparisons. This would enable investors to draw their own conclusions about how each disaggregated item may or may not be predictive of future cash flows; investors should not be, in effect, told what and what not to include in their forecasts.

If the proposals to require separate presentation of unusual items are carried forward into a final standard, then we suggest that they are broadened. In our view, the definition is too narrow. We understand the desire to restrict what companies describe as unusual or non-recurring, but the restrictive nature of the definition may indicate to companies that it is acceptable to not disaggregate other items that are arguably unusual in other ways. For example, in our view, restructuring costs should be presented separately if the expense arises each year, but where the amount varies. Under the proposals such a restructuring expense would not be presented separately, unless caught by the disaggregation requirements; however, because these requirements are weak there is no guarantee investors will get this information.

Question 11—management performance measures
1. (a) Paragraph 103 of the Exposure Draft proposes a definition of 'management performance measures'. 2. (b) Paragraph 106 of the Exposure Draft proposes requiring an entity to disclose in a single note information about its management performance measures. 3. (c) Paragraphs 106(a)–106(d) of the Exposure Draft propose what information an entity would be required to disclose about its management performance measures. Paragraphs BC145–BC180 of the Basis for Conclusions describe the Board's reasons for the proposals and discuss approaches that were considered but rejected by the Board. Do you agree that information about management performance measures as defined by the Board should be included in the financial statements? Why or why not? Do you agree with the proposed disclosure requirements for management performance measures? Why or why not? If not, what alternative disclosures would you suggest and why?

We agree with the proposal to bring management performance measures within audited financial statements and the requirements for separate presentation and reconciliation.

We also agree with the proposals regarding the disclosure about the tax and NCI impact of the individual adjustments in MPMs. However, we believe that disaggregated information about tax and NCI should not be limited to situations where MPMs happen to be disclosed.

In our view, disaggregation of taxation (or at least disclosures about different tax effects) is necessary for any item where the tax effect is significantly different from other transactions. For example, the tax payable related to a business disposal gain or loss can be very different from the effective tax rate applicable to the business as whole. We think that this information needs to be provided to investors (ideally as an analysis of the tax charge itself in order to identify the amount of tax related to that disposal) irrespective of whether the business disposal gain or loss is excluded from an MPM subtotal.

Furthermore, we think that differences in effective tax rates applicable to different items in profit and loss is a reason why those items should be disaggregated. If the difference in tax is significant, and relevant for investors to understand performance and to their forecasting of future cash flows, then this, by itself, should be sufficient to result in the disaggregation of these items. For example, if some impairment charges are tax deductible but others are not then understanding this is important to understanding performance and the effective tax burden. As presently drafted, we do not believe that the requirements would produce sufficient disaggregation in this situation.

Question 12—EBITDA
Paragraphs BC172–BC173 of the Basis for Conclusions explain why the Board has not proposed requirements relating to EBITDA. Do you agree? Why or why not? If not, what alternative approach would you suggest and why?

We agree

We note that the board proposes that operating profit before depreciation and amortisation be a subtotal specified by IFRS. We do not object to this approach but suggest that the subtotal should also be before deducting impairment of tangible and intangible fixed assets. These impairments are in effect depreciation and amortisation catch-up adjustments and we see no reason to treat them differently. Considering most EBITDA measures used in practice are also before impairments, this approach will make the new defined subtotal closer to EBITDA and that, as a result, it may in practice supersede EBITDA in management communications. Although we do not see much analytical merit in EBITDA, we recognise its widespread use and anything that contributes to greater consistency would be welcome.

Question 13—statement of cash flows
1. (a) The proposed amendment to paragraph 18(b) of IAS 7 would require operating profit or loss to be the starting point for the indirect method of reporting cash flows from operating activities. 2. (b) The proposed new paragraphs 33A and 34A–34D of IAS 7 would specify the classification of interest and dividend cash flows. Paragraphs BC185–BC208 of the Basis for Conclusions describe the Board's reasons for the proposals and discusses approaches that were considered but rejected by the Board. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

We agree

We understand that there is some concern regarding the use of the term 'investing' in both the SCI and SCF, but with somewhat different application. Ideally, we think that there should be consistency in classification across the three main primary statements and urge the board to consider changes, in the future, to the SFP and SCF. However, in the short-term we do not believe the use of the term investing in the SCI and SCF will cause undue confusion and should not be a reason to modify or delay this project.

Although we support a more comprehensive review of the presentation of cash flows, we believe that the limited changes that are proposed in this ED are beneficial and should go ahead. One further limited change which we think would also be useful, and which would resolve the problem of 'investing' being used to mean two things, would be to split the investing category in the SCF into two components, with capital expenditure separated from other investing flows. This would make capex more prominent and produce an investing section in the SCF that is consistent with the investing section in the SCI.

Question 14—other comments
Do you have any other comments on the proposals in the Exposure Draft, including the analysis of the effects (paragraphs BC232–BC312 of the Basis for Conclusions, including Appendix) and Illustrative Examples accompanying the Exposure Draft?

In addition to using the operating, investing and financing classification in profit and loss, we think that the same approach should be used for the statement of financial position. Although 'cohesiveness' is more of a challenge for the statement of cash flows, we think that this should also be aligned as much as possible. We recognise that these changes are not possible in the current project and we would not wish for any delay in the improvements to the statement of comprehensive income.

We support the proposed terminology changes to other comprehensive income but believe that more fundamental reform is needed for this statement. The use of OCI has increased in recent years. We think that it is time for a more comprehensive review of OCI that goes beyond merely presentation and terminology.

It is unclear how the MPM requirements interact with measures of segment performance. Segment profit would seem to meet the definition of an MPM if it is not equal to one of the defined IFRS subtotals, in which case we think that the MPM requirements and disclosures should also apply to the that segment profit. We also think that if an MPM is presented for the entity as a whole then that same MPM should be presented for each segment.