Knowledge Investors

Knowledge investors is a periodic publication of Solutional Academy on current reporting topics in the asset management sector.

Replacing IAS 1

Presentation of Financial Statements

By: Mohamed el Annouri and Martin Stravers

Executive summary

The International Accounting Standards Board (IASB) published an Exposure Draft proposing new requirements for the presentation and disclosure of financial statements. The IASB introduces three subtotals in the Statement of Profit or Loss which divide the statement into four categories.

- Operating category
- Integral associates and joint ventures category
- Investing category
- Financing category

The IASB has also proposed requirements to have users move items of income and expenses from the investing and financing category to the operating category when this is part of their main business. This is the case for financial entities like investment funds and banks. In this article we look to the proposals from the perspective of investment funds.

Additional requirements for disaggregating information were also proposed. Guidance is provided on the role of the financial statements and the disclosure notes.

The IASB introduces a definition for unusual income and expenses and requirements for disclosures. The proposed definition is based on the predictive value of unusual income and expense items. Investment funds have income and expenses with a low predictive value in their ordinary course of business. Therefore, we deem a definition based solely on the limited predictive value to be insufficient for entities like investment funds. We expect that this will lead to numerous audit questions and discussions on items that reasonably fall within the ordinary course of business and what is classified as unusual. Parties involved with the reporting and its audit might very well have a different views on the distinction.

The IASB introduced a definition for 'Management Performance Measures' ("MPMs") and requires all MPMs to be disclosed in a single note to the financial statements. For investment funds the impact of this proposal is limited as the commonly used performance measures do not fall within the MPMs definition.

Solutional
info@solutional.nl
www.solutional.eu

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To align the Statement of Cash Flows with the proposed structure of the Statement of profit or loss, minor adjustments to the Statement of Cash Flows have been proposed. The IASB proposal requires entities to present interest and dividend cash flows in the same category as where the item of income or expense giving rise to the cash flow is included in the Statement of Profit or Loss. This is not possible for dividends paid as these are required to be classified as financing activities in all cases. This would give rise to a mismatch between the categorisation of the paid dividends in the Statement of Profit or loss and the Statement of Cash Flows.

Introduction

In December 2019, the International Accounting Standards Board (IASB) published an Exposure Draft (Exposure draft ED/2019/7 – General Presentation and Disclosures) proposing new requirements for the presentation and disclosure in financial statements as part of its Primary Financial Statements project. The Exposure Draft mainly focuses on the Statement of Profit or Loss. The proposed changes for the Statement of Financial Position and Statement of Cash Flows are limited. The aim of the Primary Financial Statements project is to develop improvements to the structure and content of the primary financial statements. The proposals in the Exposure Draft are aimed at replacing IAS 1 Presentation of Financial Statements with a new IFRS standard. The proposals will also result in limited amendments to other existing IFRS standards.

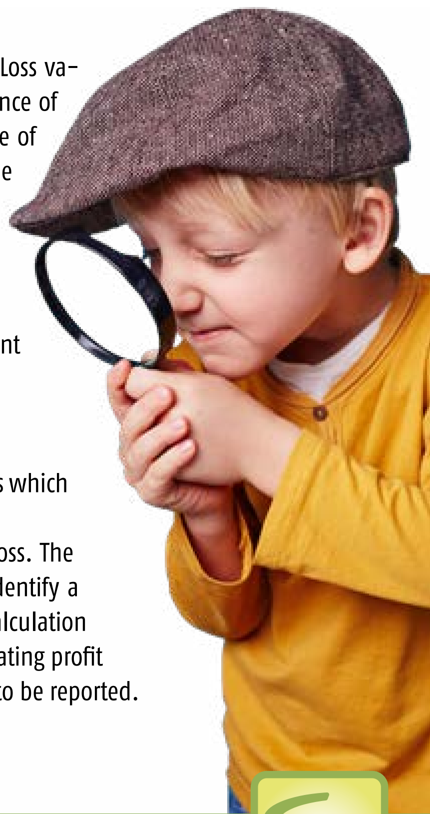
The proposals in the Exposure Draft respond to demands from stakeholders and users of financial statements. In their feedback to the IASB, users provided three main points: (1) The need for more comparability between different companies where different subtotals were used in the Statement of Profit or Loss, (2) more detailed information grouped in a way that provides better inputs for analysis and (3) a more transparent and disciplined way of performance measures in the financial statements.

In reply to the user demands, the IASB published the Exposure Draft with proposals that focus on 4 main areas:

- New subtotals in the Statement of Profit or Loss that provide relevant information and create a consistent structure to the Statement of Profit or Loss.
- Disaggregation to help an entity to provide relevant information.
- Disclosure of management-defined performance measures.
- Targeted improvements to the Statement of Cash Flows to improve consistency in classification.

Defined subtotals

The IASB acknowledges that the structure and content of Statements of Profit or Loss varies between different entities, which makes it difficult to compare the performance of entities. The issue is that the IFRS standards do not define subtotals. In a sample of 100 companies, the IASB found that 63 companies reported operating profit in the financial statements, using at least 9 different definitions for operating profit.



The IASB proposes to introduce three subtotals in the profit or loss statement:

1) operating profit;
2) operating profit and income and expenses from integral associates and joint ventures;
3) profit before financing and income tax.

With these subtotals the profit or loss statement would be divided in four categories which would give more structure and comparability to the profit or loss statement.
A lot of respondents suggested EBITDA as subtotal for the Statement of Profit or Loss. The IASB considered this but decided not to define EBITDA as the board could not identify a single underpinning concept. EBITDA is not used in some industries and the calculation method is diverse. As an alternative the IASB defined a comparable measure 'operating profit before depreciation and amortisation' which would be allowed but not required to be reported.

In the below figure we have illustrated the proposed General Model (non-financial entity) for the Statement of Profit of Loss. In the next paragraph we will explain how the General Model can be adopted for financial entities like banks and investment funds.

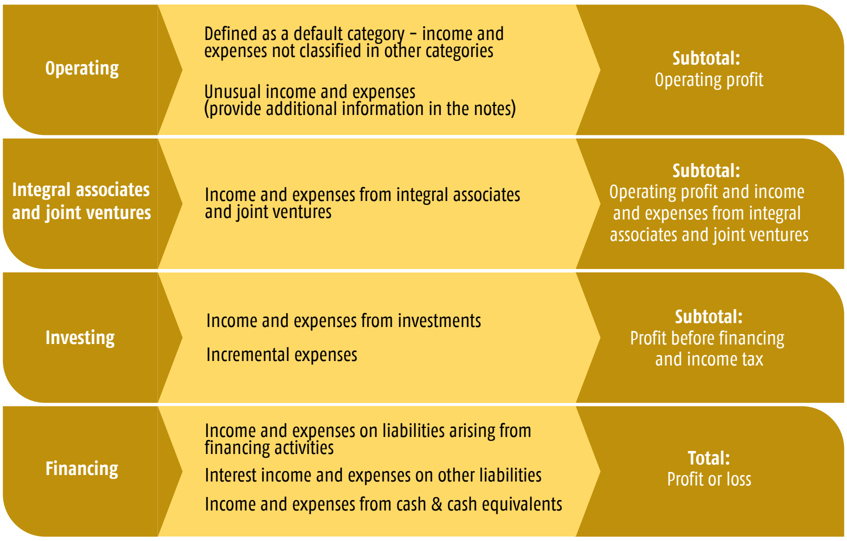


Figure 1.
Example of General Model for profit or loss

Foreign exchange gains or losses are classified in the same category as income or expense giving rise to the gain or loss. It is also not required to include subtotals in the statement of Profit or Loss when there are no items of income and expense within the category.

Application of the General Model to financial entities

Operating profit is designed to include income and expenses from the entity's main business activities. The General Model would therefore not be suitable for financial entities like banks and investment funds where the main activity of business consists of investing or financing activities. For these situations, the IASB proposes principles that require to move income and expenses from the investing and/or financing categories to the operating category when these represent the main activities of an entity. For example, in the case of an investment fund where the income and expenses from equities and bonds are classified as investing activities under the General Model, these are required to be moved to the operating category as investing is the main activity of an investment fund. Income and expenses from cash and cash equivalents could also be moved from the financing category to the operating category as long as it fits within the strategy of the investment fund as part of its managed assets. An entity providing mainly financing activities, for example a bank, is required to move the income and expenses from financing activities to customers from the financing category to the operating category.

For the movement of income and expenses from the financing category an entity is required to make an accounting policy choice to move all the income and expenses from the financing category or only move those related to providing financing activities to customers. This option is provided by the IASB as not all entities may be able to determine the portion of income and expenses that relate to the financing activities provided to customers.

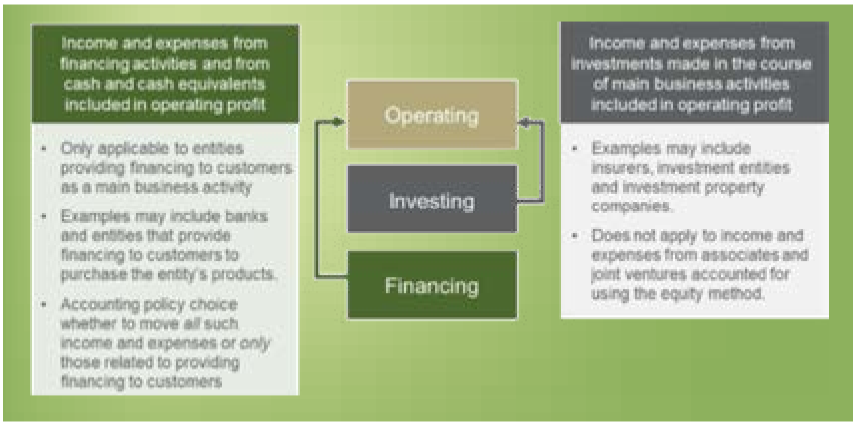


Figure 2.
Graph for moving income and expense items from the investing and financing category: Exposure Draft General Presentation and Disclosure , IFRS Foundation, June 2020, Retrieved from www.ifrs.org on 1 March 2021.

We can conclude that the General Model is designed with the objective to fit an entity's strategy and present this in the different categories. The different categories do not entail fixed components but provide a structured overview of the Statement of Profit or Loss where the main activities of the entity are always presented in the operating category.

Disaggregating information

One of the concerns that users expressed to the IASB relates to the quality of disaggregation in the primary financial statements, including disclosures about unusual income and expenses. Users of the financial statements deem the currently provided information insufficient and require more granular information.

The IASB proposed additional guidance to address this concern and strengthen the requirements for disaggregating information. The first proposal is to provide guidance on the roles of the financial statements and the disclosure notes. These roles should help entities deciding on which information to include in the primary financial statements and the notes. The role of the primary statements is to provide a structured and comparable summary of an entity's assets, liabilities, income, expenses and cash flows. The notes are supposed to provide further information necessary to understand the items included in the primary financial statements and supplementary information that is necessary to meet the objective of the financial statements.

The IASB has also proposed requirements for additional line items, including separate line items for integral associates and joint ventures, non-integral associates and joint ventures, income or expense from financing activities and goodwill.

The board also proposes principles for aggregation and disaggregation:

- Identify assets, liabilities, equity, income and expenses that arise from individual transactions or other events;
- Classify items into groups based on shared characteristics (at least one characteristic – for example based on measurement method or exposure of risk); and
- Separate those line items in the notes based on further characteristics (material items).

Entities should use meaningful labels for groups of immaterial items, avoiding line items such as 'other expenses'. Entities would be required to provide information in the notes about the content of such groups if it is not possible to avoid in the primary financial statements. A disclosure indicating that an aggregated item consists of several unrelated immaterial amounts and indicating the nature and amount of the largest item would according to the IASB be sufficient to disclose.

Unusual income and expenses

The IASB introduced a definition for unusual income and expenses and requirements for disclosures to achieve a consistent way of presentation, as follows:

> **"Income and expenses with limited predictive value. Income and expenses have limited predictive value 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"**

The below graph provides examples to assist in determining when an income or expense might be unusual. What the graph shows is that past periods are not a decisive factor in determining whether an expense or income is unusual. An entity should look at the current period and their expectation for future periods. An expense that only occurs in the current period and is not expected to reoccur in future periods is categorised as unusual. The same goes for the third example where the amount in the current period is significantly higher than the expected amounts in future periods.

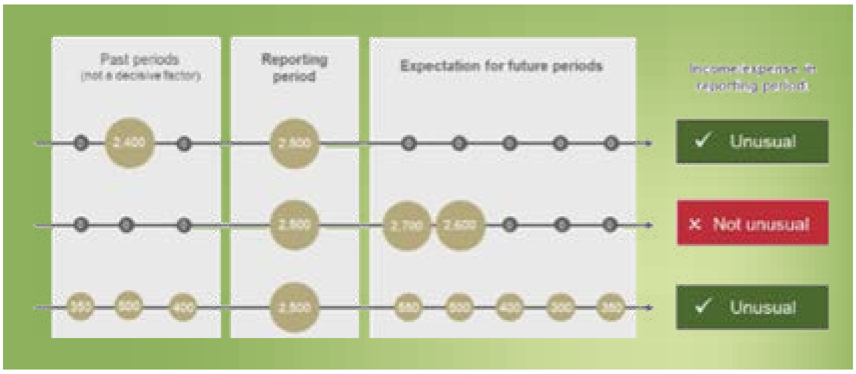


Figure 3.
Graph of examples for unusual items: Exposure Draft General Presentation and Disclosures, IFRS Foundation, July 2020, Retrieved from www.ifrs.org on 1 March 2021.

This brings forward an interesting issue when considering investment funds. How would an investment fund categorise dividend income that can differ significantly from one year to another? Judging from the text in the Exposure Draft, an entity should look into what is reasonably expected due to the nature of an income or expense. If it is usual that a certain type of income (like dividend) is highly volatile from one year to another, this is not expected to be categorised as unusual as long as the amounts are within the lines of what is reasonable. The term reasonable is in this context quite difficult and we expect this could in practice cause discussions as the manager of an investment fund and its auditor might have a different view on what is reasonable. Within the current definition, based on the limited predictive value of unusual items, we expect there will be audit questions and discussion on what falls within the ordinary course of business and what needs to be classified as unusual. For an investment fund the items of income and expenses in general have limited predictive value due to the nature of its business. Unlike the General Model, it seems that for this part of the proposals the IASB did not take the entities strategy into account.

Management performance measures

Many entities provide performance measures, defined by management, in communications with investors. Investors have expressed to the IASB that such measures can provide useful information, but should be used in a more transparent and disciplined way. The measures sometimes differ from one period to another or are communicated through various channels and publications and therefore hard to find. The IASB has proposed to address this issue by introducing a definition of 'Management Performance Measures' (MPMs) and require an entity to disclose them in a single note to the financial statements.

Management performance measures are subtotals of income and expenses that:

- are used in public communications outside financial statements;
- complement totals and subtotals specified by IFRS Standards; and
- communicate management's view of an aspect of an entity's performance to users of financial statements.

Subtotals specified by IFRS Standards are not MPMs. An entity will have to disclose information about any MPM in a single note. This note will have to include:

- A statement that the MPMs provide management's view of an aspect of the entity's performance and are not necessarily comparable with measures sharing similar descriptions provided by other entities.
- A description of why the MPMs communicate management view of performance and:
  o How the MPMs are calculated
  o How the MPMs are providing useful information
- A reconciliation between the MPMs and the most directly comparable subtotal or total specified by IFRS Standards.
- The effect of income tax and non-controlling interests for each item disclosed in the reconciliation and how the effect is determined.
- An explanation of any changes (change, introduction or removal) in MPMs.

With these requirements the IASB aims to address the items raised by users as the MPMs would be located in a single location (notes instead of across public communications) and expected to be in scope of audit as this will be part of the financial statements.

For investment funds, the impact of this proposal is limited. Commonly used performance measures like figures per share are not subtotals of income and expenses and therefore not classified as MPMs. Performance measures as operating income per share are often included as key figures in the annual report outside the financial statements. These items are (sub)totals of income and expense and would be required to be included in the financial statements as MPMs.

Targeted improvements to the Statement of Cash Flows

The IASB proposed to require an entity to use the operating profit or loss subtotal as starting point when using the indirect method to present the Statement of Cash Flows. The IASB also wants to reduce the presentation alternatives currently permitted by IAS 7 and to require entities to present interest and dividend cash flows as shown in table 1.

Cash flow item	Most entities	Specifie entities
Interest paid	Financing	Accounting policy choice, possible location depends on the classification of the related income and expenses in the statement of profit or loss
Interest received	Investing	
Dividends received	Investing	
Dividends paid	Financing	

Table 1. Classification of interest and dividend cash flows

Dividend paid on short positions

Investment funds can have short positions in their portfolio and are therefore obliged to pay dividends for these positions. This should in our view be part of the operating activities of an investment fund. However, Table 1 does not allow any other presentation than Financing activities and therefore this is not possible under the current proposal. This seems odd as it is possible for interest paid to be classified under the operating category for specified entities. In our opinion, the same option for dividends paid should be possible for specified entities like investment funds, where this is part of the main business activities.

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info@solutional.nl
www.solutional.eu