CFA Society United Kingdom

30 September 2020

IFRS Foundation
Att.: Hans Hoogervorst, Chairman of the Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD

Via email: commentletters@ifrs.org

Dear Mr. Hoogervorst,

CFA UK response to the IASB's Exposure Draft on General Presentation and Disclosures

The CFA Society of the UK (CFA UK) is pleased to have the opportunity to share its views on this Exposure Draft, which brings proposals to address a number of critical issues at the heart of corporate reporting. CFA UK's mission is to help build a better investor profession for the ultimate benefit of society. Please see Appendix 1 for a brief overview of both CFA UK and CFA Institute.

As users of financial statements, CFA UK welcomes this project to substantially improve the information content and comparability of corporate reports. This will provide investment professionals with deeper insights and in turn increased confidence in their own analysis and investments. This is invaluable in the context of today's increasingly borderless capital markets. We believe that better corporate reporting ultimately benefits society, with better information leading to better investment decisions and more efficient capital allocation.

To provide a detailed response to the IASB's questions, CFA UK convened a working group of users of financial statements to develop CFA UK's views on the proposals. The group discussed each of the 14 questions contained in the exposure draft over the course of multiple meetings that were dedicated entirely to this important subject. Our responses to these questions are detailed in Appendix II; we would be delighted to discuss and to provide further detail as necessary.

CFA UK strongly endorse the IASB's efforts to impose rigour on the presentation of financial statements and to enhance disclosures, irrespective of an entity's main business activities or structure. We are in favour of the enhanced granularity, clarity, consistency, comparability and auditability of the information that would be disclosed by corporates under the proposed requirements. These changes would not only facilitate single company analysis, but would also support the screening process that investors undertake as a first step towards selecting potential investments from a universe that often comprises hundreds, if not thousands, of individual securities.

Whilst CFA UK is very supportive of the majority of the IASB's proposals, there are some areas where CFA UK believes they could be improved and we wish to highlight:

- First, we believe that most corporates should disclose significant P&L items both by nature and by function, irrespective of the method chosen on the face of the financial statements.

The two sets of information are regarded as highly complementary; in many industry sectors, it would be difficult to take a full view of a company's operations without at least some disclosures about critical inputs both by nature and by function. There are concerns that varying practices within an industry would likely frustrate any efforts on the parts of users to compare the primary financial statements (PFS) of different entities and could make it very difficult to discern any industry-wide trends.

- Secondly, we are slightly disappointed with the IASB's proposal to refrain from defining EBITDA. Whilst we are acutely aware of the operational challenges associated with such an undertaking, we feel strongly that these challenges should not be an impediment and opined that even an imperfect EBITDA-like metric would be preferable to a void, as it would at least impose some level of discipline and comparability which the market could then work with. EBITDA is a cornerstone of financial analysis and features prominently in numerous applications ranging from equity valuation techniques to banking covenants. In the absence of any efforts by the IASB to impose minimum standards, rigor and transparency on this important metric, it will remain highly subjective and obfuscated, with the inclusion and exclusion of crucial components such as impairments largely subject to management's discretion. In this context, we welcome the IASB's proposals in relation to OpDA (Operating profit before depreciation and amortization) as an alternative metric, but note that this metric is unlikely to replace EBITDA unless it is widely reported on the face of the financial statements of industrial companies. This is not a given, as reporting of OpDA in this manner looks set to be voluntary for companies that report expenses by nature and prohibited for companies that report expenses by function.

- Thirdly, CFA UK has a strong desire for consistency across the primary financial statements, both over time and – where possible – between companies. For example, we believe that, if the IASB goes ahead with its proposal to separate integral from non-integral associates and joint ventures, this separation should also be presented on the face of the balance sheet also.

- Fourthly, we would like to see the proposed separation between the investment and financing category in the P&L mirrored in the cash flow statement.

- Fifthly, measures should be taken to avoid the frequent reclassification of individual items between categories. When reclassification does occur, it should be accompanied by an adequate explanation.

- Sixthly, as always, disclosures – whether on the face of the financial statements or in the notes – are foremost on the minds of the users of corporate reporting. In light of the continuously rising complexity of business structures and transactions, it is impossible to capture all of the information required by analysts and investors in respect of any one economic item in a single number shown on the face of the financial statements. Extensive disclosures of material information in the notes are often of paramount importance in the analytical process. For example, we would wish to see a comprehensive description of each associate and joint venture, irrespective of where the structure "sits" in the P&L. Against this backdrop, we would encourage the IASB to conduct the post-implementation reviews of relevant accounting standards (IFRS 10/11 and disclosure standard IFRS 12) in such a

manner as to optimally support the goals of the General Presentation and Disclosures project.

- Finally, we urge the IASB to specifically consider the effects that this project may have on the presentation and disclosures of supply chain finance arrangements, in coordination with the IFRS Interpretations Committee's recent Tentative Agenda Decision. We cover this in more detail in our response to Question 14.

CFA UK welcomes the IASB's call for input on these important, nuanced and detailed matters and appreciates this opportunity to share its views.

Should you have any questions or points of clarification regarding this letter, please contact Andrew Burton (aburton@cfauk.org) in the first instance.

Yours sincerely,

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With thanks to contributions from:

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Appendix 1: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.
- For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.

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Appendix II: RESPONSES TO QUESTIONS

Operating profit subtotal

Question 1 - ***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 fully agree with the IASB's proposal. Whilst we acknowledge that it is impossible to capture a company's position and prospects in a single metric, the assessment of a company's operating profitability in both absolute and relative terms, over time and in relation to peers is an integral component of and often a starting point for financial analysis and the screening of investment opportunities.

Many analysts and investors do not realise that the "operating profit" or "EBIT" figures reported by many corporates are not IFRS-defined metrics and are subject to wide discretion by management with respect to the inclusion and exclusion of income and expense items. We welcome the IASB's proposal to impose rigour on this metric and to enhance the comparability over time and between business entities. A clear, consistent subtotal that is subject to audit is very welcome.

Operating category definition

Question 2 - ***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 support the IASB's pragmatic proposal and concur that any item pertaining to an entity's (company's) continuing operations that does not meet the criteria to be considered as a non-operating item, such as a financing, investment or taxation charge or income, must by definition be an operating item.

The IASB's indirect approach to defining the operating category as a residual appears straightforward, more comprehensive and less ambiguous than any potential direct definition of the operating category. In light of the significant heterogeneity of operations and the emergence of increasingly innovative business models, drawing up a comprehensive list of all items that may be considered to be operating is not practical. Such a list would inevitably be incomplete, creating ambiguity with respect to the presentation by preparers. This could potentially lead to the mis-classification of any operating income or expenses that are not explicitly included in an operating category definition or even to the omission of such items from all categories, which could potentially distort subtotals and confuse users.

We are particularly concerned that if the IASB had chosen a direct approach to defining the operating category, preparers might omit some expenses that they did not care to explain based

on either their magnitude or their nature. Recent questions by preparers as to whether amortization & impairment or certain hedging losses should be classified in the operating category are a case in point: under the proposed rules, these items are included in the operating category by default, whereas confusion might arise under a direct approach to defining operating profit as to whether the operating category criteria are met. We are generally in favour of limiting management discretion to ensure consistency and comparability wherever possible. Management then still retain the discretion to break-out any items they wish in the notes, but at least we are ensured that they are all included in the sub-total.

For these reasons, we welcome the IASB's indirect approach to defining the operating category, as this will ensure that all operating expenses will have a greater likelihood of ensuring that the types of expenses we as users would consider to be operating will be captured and included in this subtotal.

Investments in the course of an entity's main business activities

Question 3 - 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 are philosophically aligned with the IASB in so far as we take the view that any income and expenses derived directly from an entity's main business activities should be categorized as "operating".

We concur with the IASB's reasoning that the removal of investment income and expenses from the operating category would result in meaningless operating profit or loss numbers for insurance or investment companies, as they would primarily capture *expenses* related to the main business activities while excluding much of the *income* resulting from the same main business activities.

However, we are wary that circumstances may arise where it may be difficult to separate investments made in the course of a general corporate entity's main business activities from investments made for other purposes. We would therefore encourage the IASB to provide clear guidance to preparers on how to do this and require disclosure in the notes where the income or expenses related to any investment may have been reclassified between the operating and the investing category - for example, the gradual exit strategy from a previously consolidated activity.

Customer financing as a main business activity

Question 4 - 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?

As stated above in our response to Question 3, we concur with the IASB's general approach to classifying all income and expenses that are generated in the course of an entity's main business activity as operating.

As also stated above in our response to question 3, in the case of financing entities we also agree with the IASB's observation that any allocation of expenses between customer financing activities and other financing activities may be arbitrary to the point where the distinction becomes meaningless, making the proposed policy choice the only viable option. Where an entity is unable to separate customer financing activities from non-customer-related financing activities, we would recommend a requirement to elaborate on the scope of the non-customer-related financing activities in the notes.

We have some concern about the distinction between customer financing as a *main* business activity and customer financing as an *ancillary* business activity – which many companies engage in in an effort to render their products and services affordable. This distinction can be subtle, with scope for confusion as to which financing activities are captured in the operating versus financing section of the income statement, although we appreciate that this may be linked primarily to revenue recognition.

One of our working group members provided an example of a construction company that provided financing to customers who purchased a new home over a ten-year horizon. Since it only took two years on average to build the house, the interest income would likely be deemed to be financing income during the two-year construction period, but operating income during the subsequent eight years. The capture of income from a single contract in different line items over time presents analytical challenges for users, given that numerous transactions are aggregated in each line.

Investments outside of an entity's main business activities

Question 5 - 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 that investment income and expenses should be separated from operating income and expenses arising from an entity's main business activities.

However, some controversy arose as to whether a clear separation between the investing and financing category in the P&L was necessary and practical. The argument in favour of a separate investing category was made by some panel members who pointed out that the current disaggregation of an entity's non-operating result was inadequate and that a significant positive or negative investment result presented separately from financing activities could potentially serve as an important red flag for investors that are primarily seeking to gain exposure to an entity's operating success and may not be willing or able to accept significant exposure to a company's unrelated speculative activities such as exposure to commodities trading or emerging market real estate.

We agree with the IASB's logic to include the results from non-integral associates and joint ventures in the investment category, provided the IASB follows through with its proposal to separate integral from non-integral associates and joint ventures – a proposal that remains controversial among many users of financial statements. In this context, we note that it would be logical for any income or losses from associates held purely as a financial investment – for example in the context of a gradual exit from a non-core business as a function of the market's absorption capacity – to be treated as an investment result.

However, we do not follow the logic of entering into a joint venture for the sole purpose of generating investment income and thus question whether any income or losses arising from joint ventures should be included in the investment category. For example, we understand that a JV that is entered into on a temporary basis in an effort to keep supply chains intact in the context of the current Covid-19 pandemic would be classified as "non-integral" under the proposed rules; however, we would argue that the purpose of the JV was inextricably linked to the entity's main business activities during pandemic times and would thus disagree with the classification of any income or loss arising from such a structural measure as an "investment" item. *Please refer to question 7 for a more detailed discussion of our views on the merits of the proposed distinction between integral and non-integral associates & JVs.*

Profit before financing and income tax

Question 6

(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.
(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 that a subtotal that encompasses all income expenses from continuing operations with the exception of income and expenses from financing activities and taxation represents, for non-financial entities, a meaningful metric that may be particularly useful when comparing companies with similar operations and profit streams that are financed differently and/or subject to different tax jurisdictions and rates.

In practice, we are wary that some controversies may arise as to which items should be included in the financing result and particularly note distortions that may arise in the context of supply chain finance (SCF) arrangements with or without the use of a financial intermediary. To ensure that this project's proposals address investor needs as completely as possible, we would encourage the Board to focus on the presentation of any changes that may result from any potential future work by the Board work with respect to the accounting requirements in relation to supply chain finance arrangements in its re-deliberations.

Similarly, we support the disclosure of a pre-tax profit figure, but note the risk of mixing taxed and untaxed income, given that the proposed "pre-tax" subtotal would consolidate under the equity method any income or losses from associates and joint ventures on a post-tax basis. *Please refer to our response to Question 7 for our suggestions with respect to the presentation of income and losses from associates and joint ventures on both a pre- and post-tax basis, as well as the clear separation of taxed from non-taxed income in the income statement at all times.*

Separation of integral from non-integral associates & joint ventures

Question 7

(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.
(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.
(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 regard the Board's proposals as a compromise that would allow corporates to emphasize the importance of investments they consider to be directly related, or integral, to their operations while also providing investors with a subtotal of operating income or loss before such activities.

We would urge the IASB to take the following concerns and suggestions into consideration in the context of both this project's proposals and the post-implementation reviews of relevant accounting standards:

- **The distinction between integral and non-integral associates and joint ventures is subjective and somewhat arbitrary.** We do not consider the proposed test (i.e. a set of indicators) to determine whether an associate or JV generates a return "individually and largely independently of an entity's other assets" to be adequate to draw the demarcation lines between "integral" and "non-integral" associates & JVs. The binary nature of the proposed distinction between "integral" and "non-integral" associates &

joint ventures belies the complexity underlying these investments and structures. In practice, there are numerous business, economic, legal, practical and political reasons why a company may opt (or be forced) to forego control (or to exercise control while holding a minority stake due to legal requirements, a phenomenon that is out of scope with respect to the IASB's current project, but which may add substantial complexity for users in practice). A wide range of arrangements is observed with respect to the stake held (and which may vary over time), operational input and governance structures, making an assessment of the nature and extent of any "interdependency" between an entity and an associate or joint venture highly subjective. Moreover, from a practical perspective, the classification of an investment as "non-integral" would likely draw investor scrutiny, with management hard pressed to explain why they are holding on to investments that are not "integral" to their operations. On the other hand, we wonder whether any stake in an entity should ever be considered as "integral" to an entity's operations in the absence of control. Irrespective of the classification chosen, users require extensive disclosures with respect to the nature of and reason for the arrangement, the stake held and the gating factors for its evolution as well as detail with respect to the operational and governance structures. If the IASB were to go ahead with its proposed distinction between integral and non-integral associates and joint ventures, any reclassification between the two categories should be explained by management, with a clear description of those elements of "interdependency" (as outlined in paragraph 20D of p. 75 of the exposure draft) that have grown/declined or ceased to exist from the point of view of management.

- **Profit before and after tax needs to be clearly separated.** In situations where users regard associates and joint ventures as integral to a company's operations, analysing a company's overall operating profitability is currently hampered by the presentation of the profit contributions after tax. The proposed subtotals address this issue only partly, as the company's consolidated pre-tax profit or loss would still mix the pre-tax consolidated operating profit with post-tax equity consolidated results from associates and joint ventures, thus potentially giving rise to confusion with respect to an entity's effective tax rate and underlying profitability. We would prefer that entities clearly separate pre- and post-tax subtotals as well as provide information on the profitability of all associates and joint ventures on both a pre- and after tax basis where such information is available. This would provide analysts and investors with maximum flexibility to calculate their own profitability ratios. Where such information is not currently disclosed under existing accounting standards, we would welcome any potential changes to standards such as IFRS10/11/12 in the context of post-implementation reviews. Whilst we appreciate that many joint ventures may be structured as separate legal entities and that an issuer's legal claim may therefore be limited to the entity's after-tax profits, we note that users of accounts are typically trying to gauge the earnings power associated with an entity's activities irrespective of the legal structures that may have been chosen for a wide range of operational, legal and practical reasons. Margins are a key component of the screening systems many investors apply to their investable universe, and the absence of a "clean" pre-tax number tends to restrict this analysis to the gross and operating margins in practice. Finally, insights into a consolidated group's effective tax rate may be necessary for various analytical purposes; however, the effective tax rate may be obscured by mixing pre-tax and after-tax profits. If this project's proposals aim to maximise the benefits offered to investors by improving how information is communicated in financial statements through the presentation of new subtotals, then we believe the Board

should view providing investors with the most meaningful subtotals possible as a priority. Given that the group tax expense can present one of the largest items of expenditure in a company's consolidated income statement, we believe that having the ability to relate that line item to a relevant pre-tax sub-total would significantly improve how information is communicated in this part of the financial statements.

- **Consistency between the income statement, balance sheet and cash flow statement is highly desirable.** Any distinction between integral and non-integral associates and joint ventures should be mirrored in the balance sheet, as proposed by the IASB, and the inclusion of any P&L items in the operating, financing or investing category should lead to consistent treatment in the operating, financing and investing categories in the cash flow statement. We are concerned that some items, including associates and joint ventures, might be categorized differently in the income statement compared to the cash flow statement, thus giving rise to confusion as to which category they belong in and forcing users to make extensive manual adjustments to satisfy their analytical purposes.

<u>**Disaggregation of information**</u>

Question 8

(a) Paragraphs 20–21 of the Exposure Draft set out the proposed description of the roles of the primary financial statements and the notes.
(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 welcome the IASB's initiative to promote disaggregation, as we strongly believe that more granularity is needed in order to allow analysts and investors to understand the drivers of profitability and to forecast future profits and cash flows on this basis. However, we are concerned that the IASB's proposals may be insufficient to mandate the level of disaggregation that would be meaningful to users.

Our primary concern is that the term "shared characteristics" may be too vague to serve as an appropriate guide in preparers' decisions about whether to aggregate or disaggregate information. For example, many industrial companies currently present Cost of Goods Sold as a single P&L line item, thus lumping together fundamentally dissimilar costs such as manufacturing expenses and royalties to inventors.

It is unclear to us whether the aggregation of such dissimilar costs will necessarily be prevented by the "shared characteristics" test because it could be argued that they all have a purpose of creating the end-product sold. We are especially concerned that many complex entities with global operations may not track the characteristics of expenses in sufficient detail to apply the "shared characteristics" test in a rigorous and consistent manner. For example, entities that report expenses by function may be unable to trace the nature of expenses that were incurred in the preparation of goods or services by subsidiaries, shared services centres or external

suppliers, implying that the only "shared characteristic" of functional expense items would be the department that made the purchase decision.

The subjectivity inherent in the "shared characteristics" test is exacerbated in our view by the absence of a materiality threshold. We appreciate that there is not a single numerical threshold that would be appropriate in all situations. However, we would welcome some numerical guidance with a "comply or explain" approach. A commonly used threshold is 10%; where an income or expense category such as disposal income or royalty payments exceeds 10% of income or expenses, it should be disclosed separately unless there are specific reasons to refrain from doing so. Similarly, some items should always be disclosed based on their nature unless their immateriality can be established. In this context, we note widespread concerns among the users of financial statements that the concept of materiality may not be applied consistently in the context of supply chain finance, notably reverse factoring (*see our response to Question 14*).

Finally, we welcome the IASB's initiative to reduce the amount of expense that can be lumped into the "Other" category. However, based on the above considerations, we are nervous that "Other" may remain the default category for numerous items that management may deem to be immaterial individually, but that represent a significant portion of a company's expenses collectively. Where the "Other" category is large, we would like to see further disaggregation.

Presentation of expenses by nature or by function

Question 9 - 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 with the guiding principles outlined by the IASB which urges entities to choose the method of presentation (by function or by nature) on the face of the financial statements that is more meaningful to the user and consistent with the practice of an entity's peers in the particular sector – two concepts that we regard as flipsides of the same coin, since an industry's principal profit drivers tend to determine users' information needs.

At the same time, we note that in most cases, at least some information both by nature and by function is required by users in order to develop a full understanding of an entity's key profit drivers and industry trends. We would prefer a "matrix" comprising both approaches on the face of the income statement. For example, where an entity reports expenses by function and splits out Cost of Goods Sold, Research & Development as well as Marketing/Selling & General/Administrative expenses, these categories should be subdivided further by their nature, with Cost of Goods divided into salary costs, depreciation expenses, impairments, restructuring expenses, royalty payments to inventors etc., while SG&A expenses should be divided into field force remuneration, corporate overhead costs, legal expenses, restructuring expenses, revaluation of contingent consideration liabilities etc.

Where the cost of such "matrix" reporting would be prohibitive, an acceptable compromise would be for entities to choose one method on the face of the income statement and to provide information based on the other method in the notes.

Consequently, we welcome the IASB's proposal to require companies that report expenses by function to include information on the nature of these expenses in the notes. Conversely, we disagree with the IASB's proposals to abstain from requiring companies that report expenses by nature to provide a split by function. We understand from discussions with the IASB that this exemption has been proposed primarily for practical and cost reasons. However, we strongly believe that user access to at least some information on expenses grouped by function is vital in many sectors, notably those with significant R&D and marketing activity – and by extension, for many companies that operate in more than one sector, with "by nature" more relevant than "by function" to some of their operations and vice versa for their other operations. Given the usefulness of such information, we do not believe that the incremental cost or complexity would be prohibitive.

In fact, to our knowledge, much information by function is typically available at the subsidiary level, chiefly for purposes of taxation, for example the allocation of expenses to the R&D function where R&D tax credits are claimed. Collating this information for purposes of preparing consolidated financial statements should be feasible at an acceptable cost. In this context, we note that even a rough approximation of expenses by function may already be of significant value to users. For example, it may not be possible to track for every expense item whether it was incurred by the R&D, marketing, or corporate overhead function; however, a split of salaries and related expenses into these categories may be crucial to users who are seeking to understand an entity's core competencies, competitive position and vulnerability to economic disruption. As noted above, we are aware that much information about the nature of expenses may currently be lost in the context of complex global production processes that involve outsourcing as well as internal sourcing from shared service centres; however, we believe that the resulting limited understanding of input costs by analysts, investors and potentially even top management presents a very real risk with respect to both the integrity of and confidence in capital markets and investment decisions by senior management.

We are less certain about our views on the proposed ban of mixed presentation in ED B46. On the one hand, disaggregation of individual functional line items by nature and vice versa– which we understand would still be allowed under this ban – is clearly preferable to mixed presentation. Furthermore, too much latitude with respect to mixed presentation could undermine the comparability of different entities' financial statements, with adverse consequences for all steps in the investment process, from screening of an investable universe based on profit margins to making peer comparisons for purposes of selecting an investment and the discernment of trends across an entire industry. For example, if mixed presentation were allowed but not required, one entity might choose to allocate depreciation to functions, while another entity might separate out depreciation from the functions and show it as a separate line item; this would frustrate any efforts to compare the gross margin of the two entities on a like-for-like basis based on the information contained in the financial statements. Users would effectively be forced to make adjustments to gross profit based on their own assumptions in order to meaningfully compare the two entities' margins, an expensive and likely error-prone process.

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On the other hand, a major concern about an outright ban of mixed presentation is the implicit ban on the presentation of EBITDA on the face of the income statement of an entity that reports by function. As noted in our preamble, EBITDA remains a cornerstone of financial analysis, effectively forcing users to calculate EBITDA where none is provided. The complexity may be manageable in the case of a dedicated sector analyst who covers no more than a dozen stocks, but may significantly increase the cost of screening systems set up to compare hundreds of securities in an initial step, while simultaneously decreasing the reliability of the results.

Unusual income & expenses

Question 10

(a) Paragraph 100 of the Exposure Draft introduces a definition of 'unusual income and expenses'.
(b) Paragraph 101 of the Exposure Draft proposes to require all entities to disclose unusual income and expenses in a single note.
(c) Paragraphs B67–B75 of the Exposure Draft propose application guidance to help an entity to identify its unusual income and expenses.
(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 agree in principle with the IASB's definition of unusual items as being those with "limited predictive value". We would expect there to be less controversy about those items that are considered to be unusual based on their type compared with those items that are considered to be unusual based on their amount. We also welcome the IASB's proposal to disclose all unusual items in a single note to the financial statements, as disclosure on the face of the income statement would likely risk obscuring some of the subtotals.

In practice, we would expect the distinction between items that are usual or unusual based on their type to be relatively clear-cut, with only those items declared as unusual based on their nature that are not expected to be expected in the normal course of operations as they may be ascribed to force majeure or other unusual circumstances, irrespective of whether they have occurred in the past, such as a fire at a company's facilities provided as an example in the Exposure Draft. Still, we would recommend mandatory disclosures about whether an item that is unusual by its nature has occurred in the past three to preferably five years, so that users are in a better position to assess the potential risk of recurrence. For example, if a company stockpiles hazardous materials and has experienced fires in the past, investors may wish to question management with respect to safety measures and/or account for the risk of future impairments in their own cash flow forecasts or valuation of an issuer's securities. We would also ask the IASB to pay special attention to the rare items where controversies may arise whether they are unusual by their nature, such as income from non-integral associates or a significant impact from currency depreciation, during its re-deliberations.

We would like to see stronger language to the effect that expenses, charges or impairments may only be classified as unusual if they occur in isolation and are not linked to any other unusual

business developments. For example, in the context of the Covid-19 pandemic, companies that do not normally provide their employees with protective gear or remote working facilities may be forced to do so temporarily, thus incurring expenses that had not arisen prior to the pandemic, nor are they expected to arise thereafter. However, these expenses may largely be offset by savings from reduced business travel by the workforce. If such a company were to classify the incremental expenses associated with purchasing protective gear and providing homeworking support as “unusual”, without classifying the related savings as unusual (an endeavour that would not be practical as the savings from reduced travel cannot be reliably quantified), the overall picture may be misleading, with analysts and investors erroneously expecting profitability to improve in “normal” years when the company no longer needs to purchase protective gear for its employees, but may see a surge in travel costs.

In the absence of guidance with respect to a threshold, the classification of types of items that would be expected to recur regularly as unusual based solely on their amount risks greater controversy and diverse practice by preparers, with some companies potentially declaring for example litigation expenses as unusual if they rise significantly on a relative basis, while others may declare wide swings off a modest base as “usual” and may only report litigation expenses as unusual items when they represent a material proportion of the entity’s overall cost base. We therefore would like to see clearer guidance with respect to the demarcation lines between “usual” and “unusual” amounts in relation to types of expenses that are incurred relatively frequently, such as litigation and restructuring charges or impairments. Furthermore, it is unclear to us from the language in the proposals whether the “unusual” amount disclosed would relate to the full amount of the item incurred in the period, or merely to the excess over the amount that would typically be incurred.

Where items are classified as “unusual”, we would like to see the amounts disclosed not just for the current period, but also for prior periods, where applicable, irrespective of whether the item was considered to be unusual in that period. For example, if a company incurs litigation expenses of $5m in 2XX1 and 2XX2 and does not disclose them separately because it considers the type and mount to be usual, but flags “unusual” litigation expenses of $50m in 2XX3, the notes should contain disclosures to the effect that the expense amounted to $5m in each of the two prior years – provided it is appropriate to flag the higher expenses as “unusual” in the first place.

Furthermore, we would suggest rewording the time limits stated in paragraph B67 of the exposure draft. The paragraph already introduces an element of ambiguity and subjectivity by effectively asking management to predict the future; the term “several future reporting periods” is vague, and could be construed as meaning three years by some preparers or more than three years by others. Some panel members also voiced concern about potential translation issues. The net effect could be that the classification of an item as “unusual” could be highly subjective, with one company classifying an item as “usual” and a peer classifying the same item as “unusual” based on different management teams’ differential assessment of the likelihood of recurrence over time horizons that are not identical. If the time period chosen is left to the preparer’s discretion, then there should be a requirement to explain the rationale for the time period chosen so the user can ascertain the “unusualness” of each item.

We would also like to see a principle of symmetry applied to the classification of income and expenses as “unusual” based on their type and/or amount and welcome the IASB’s proposals in this regard. At present, in the construction of alternative performance measures *(see Q. 11 for a*

more detailed discussion), the hurdle for the removal of expenses often appears lower than the hurdle for removing income. For example, many companies routinely remove significant litigation expenses, restructuring charges and asset impairments in the calculation of "underlying", "core", or "adjusted profits" irrespective of the frequency with which they recur, while including any and all gains from asset disposals in the "clean" profit figure, even in years when the resulting gains are exceptionally large and distort the group profit figure, on the grounds that portfolio pruning is routinely undertaken and gains are not unusual, even if they vary significantly from year to year.

It is clear from the IASB's definition of "unusual" that unusual items are not synonymous with "lumpy" items. We see a risk that lumpy items of significant interest to users of financial statements may either not be disclosed at all, or disclosed with too little transparency. An example of the latter might occur by presenting the expense as an adjusting item in the reconciliation of management performance measures, despite it not being disclosed either as a line item in the financial statements or in a detailed expense breakdown in the notes (with potential risks to the auditability of such items, if adequate procedures to ensure their auditability were not put in place by the company and its auditors). In such cases, adequate labelling and description of the reconciliation items as proposed by the IASB would be vital, particularly where there is risk of confusion with other items disclosed separately (e.g. in the case of the restructuring expenses removed in the calculation of MPMs differing from restructuring expenses that may be disclosed elsewhere in the financial statements). For example, a company may implement a multi-year, multi-billion-dollar major restructuring plan. The bulk of the restructuring charges may be incurred in the early years. Analysts and investors have a significant interest in the disclosure of these large and "lumpy" restructuring charges that would distort profit figures in the early years. However, they might not meet the definition of "unusual" if restructuring charges are expected to remain high for "several" years and may thus remain undisclosed if the amount is deemed to remain below other materiality thresholds. By contrast, charges in the final year of the programme may be much lower than in previous years, but would still be considered to be "unusual" as the amount is much higher than that expected in subsequent years, when restructuring charges return to modest baseline levels following the completion of the programme. With respect to the presentation of the alternative performance measures many companies have disclosed for many years in the absence of IFRS-defined MPMs, it is currently common practice for companies to remove all large and "lumpy" items when disclosing adjusted profit sub-totals, with any significant restructuring charges in all years being excluded from those profit sub-totals labelled "underlying".

Management performance measures

Question 11

(a) Paragraph 103 of the Exposure Draft proposes a definition of 'management performance measures'.

(b) Paragraph 106 of the Exposure Draft proposes requiring an entity to disclose in a single note information about its management performance measures.

(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 welcome the IASB's proposals with respect to management performance measures (MPMs). We believe that such measures can provide valuable information to analysts and investors in addition to the totals and sub-totals prescribed by IFRS on the face of the financial statements.

In many sectors, alternative performance measures (APMs) as defined by company management are routinely provided outside of the financial statements and used extensively by the users of financial statements. They help users understand an entity's underlying earnings power and to improve forecasting accuracy, with many lumpy items that vary over time and are difficult to forecast on a quarterly basis, such as restructuring expenses, often removed in the construction of such APMs. However, APMs have on many occasions been plagued by a lack of rigour, transparency, auditability (since they are outside of the scope of audit) and, consequently, have been frequently regarded by investors with mistrust, despite some ground rules laid down by regulators with respect to the explanations and reconciliations to be provided. Moreover, their presentation outside of the financial statements can be confusing to investors, and it is also unhelpful when different companies use different terms such as "core", "adjusted" or "underlying" to denote APMs.

We believe that the approach to disclosure of MPMs proposed by the IASB will provide users with the benefits of APMs while mitigating some of its drawbacks. Mandatory reconciliation to other sub-totals will increase transparency, and the reconciliation items will be subject to audit, which provides reassurance with regard to the MPMs. This is arguably the greatest difference from APMs disclosed today. The IASB might wish to consider issuing a practice statement aimed at ensuring the rigorous and consistent application of this aspect of the proposed standard.

We particularly welcome the IASB's suggestion that MPMs should be disclosed in a single location in the notes. This addresses one of the biggest practical challenges users face currently with APMs, which may be presented in multiple locations or documents. In addition to a clear-cut justification and explanation of the methodology chosen to calculate MPMs and the rationale for any changes, we believe that MPMs should be shown for at least two, preferably three, prior years using the company's current methodology for calculating MPMs. A transparent time-series would enhance the usefulness of MPMs to investors and support their efforts in assessing performance over time, and the stewardship of management.

With respect to the presentation of reconciliation items, we would welcome a format that allows users to easily calculate "alternative MPMs" based on their own requirements as needed, since different analytical purposes require the inclusion or exclusion of different income and expense items, and many users try to standardize key metrics across different companies. We would like to stress the importance of disclosures pertaining to the tax and NCI effect of individual reconciliation items, and express our support for this proposal in the Exposure Draft.

We appreciate that companies may wish to disclose alternative performance measures that do not meet the definition of MPMs. Nothing should preclude them from doing so; however, these should be clearly marked as non-MPM measures in annual reports, quarterly earnings releases as well as any and all written and verbal communications by companies, so as to enable

investors to easily distinguish between those that prepared in accordance with IFRS Standards and those that are not. We acknowledge that the requirement for a clear distinction between IFRS and non-IFRS metrics outside of the primary financial statements falls within the jurisdiction of local capital markets regulators and is outside of the scope of IFRS.

No requirements relating to EBITDA

Question 12 - 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 are disappointed with the IASB's decision to refrain from defining EBITDA but welcomes proposals for a similar metric that could be used in lieu of EBITDA, such as operating profit before D&A. Despite its many shortcomings, EBITDA is and will continue to be used widely by the financial community; according to the IASB's own research, 70% of companies report EBITDA. By refraining from defining EBITDA or proposing an alternative metric, the IASB is unlikely to change this practice, and is missing out on a valuable opportunity to impose some rigor and standardization on this metric.

Whilst we concede the IASB's point that there is no consensus among users on what EBITDA represents analytically or how it should be calculated, we strongly believe that an IFRS-defined metric, however imperfect, would represent a more useful starting point for any analytical task than starting from scratch by piecing together the components of EBITDA from various disclosures across the financial statements, or trying to unpack management's version. Differences of opinion regarding that presentation can then be brought into the public domain thereby improving the transparency around those companies adopting more controversial presentations and treatments.

If the IASB will not define EBIT and, by extension, EBITDA, we strongly encourage the Board to use operating profit as a starting point for a metric that would be obtained by adding back D&A. The various subtotals in the income statement, including operating profit, have been proposed with a full understanding that they are imperfect measures taken individually and that investors may additionally wish to review and/or construct their own adjusted profit sub-totals based on supplemental disclosures such as unusual items and the MPMs presented by management. Therefore, an EBITDA-like metric derived from operating profit might also be included as a metric that does not fulfil a major analytical goal in isolation but may be viewed by a user as a starting point for their own calculations. Analysts could use such a metric as a starting point for various analytical purposes and could, for example, add the results from any associates or joint ventures they deem to be relevant to their analysis. Alternatively, a fuller operating profit figure that would include profits or losses from associates and JVs could be used to calculate an EBITDA-like metric. So long as the definition proposed by the Board is clear, a lack of universal applicability should not represent an impediment, in our view.

Beyond determining the ideal starting point for a definition of EBITDA, there is some debate among users about whether or not to add back impairment charges when defining an EBITDA-like metric, and about the appropriate circumstances that might support adding back those charges. While users believe that impairments are part and parcel of any business operations and should not be added back, others suggested only adding back those impairments that were

demonstrably “non-core” to the operations. Again, an imperfect approach that might lead users to make their own adjustments (such as adding back impairments under specific circumstances) is preferable to refraining from defining an EBITDA-like metric altogether on the grounds that there was a lack of consensus with respect to its construction.

We also note a practical point relating to covenants, which are often tied to EBITDA. The definition of EBITDA in covenants may vary from lender to lender and is often not disclosed to external users. If the IASB were to define an EBITDA-like metric such as OpDA, this could potentially replace proprietary definitions in some loan agreements over time, allowing external analysts and investors to form an educated guess whether a loan agreement may or may not have been breached, with potentially significant ramifications for a company’s operations, equity value and ability to repay its debt in the context of an economic and debt crisis that may be unfolding.

We note that the practical utility of any EBITDA-like metric, such as OpDA, would likely hinge on its widespread adoption. Should disclosure remain voluntary and even be prohibited in some cases, e.g. where expenses are presented by function on the face of the income statement, this would likely defeat the purpose of defining such a metric, as inertia would likely prompt users to carry on using the non-standard EBITDA metrics that are presented by many companies and provided by many data aggregators, using diverse definitions.

Cash flow statement

Question 13
(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.
(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 with the IASB’s proposals with respect to the cash flow statement in general and particularly welcome the IASB’s efforts to align the assignment of items to a category in the cash flow statement with the categories in the income statement, since users generally desire consistency across the primary financial statements. However, we would like to make one suggestion. The Board suggests a lump-sum classification of all interest received as investment cash flows, whereas interest revenue from cash and cash equivalents is classified in the financing category in the P&L statement. Why not follow similar paths in the cash flow and P&L statements? If a distinction is made in the P&L classification, it should be easy to follow it in separating cash flows.

CFA Society United Kingdom

Other comments

Question 14 - 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?

We strongly encourage the IASB to revisit the presentation and disclosures in relation to supply chain finance arrangements (such as reverse factoring) in the context of the General Presentation and Disclosures project and/or potential future projects in relation to the Cash Flow statement. These arrangements are commonly used in major economies around the world, yet disclosures are often inadequate from the point of view of users, with scant information typically available on factoring arrangements. Disclosures about reverse factoring or arrangements that do not involve a financial intermediary appear virtually non-existent.

We therefore support the IFRS Interpretations Committee's Tentative Agenda Decision to clarify existing disclosure requirements in IFRS Standards with respect to these arrangements and its potential recommendation that the IASB develop additional disclosure requirements.

The analysis of these arrangements both at the individual company level and across the supply chain is turning into a priority for many users against a backdrop of high and rising indebtedness of corporations, individuals, governments and institutions globally. This is exacerbated by coronavirus-related supply chain disruptions, as this gives rise to heightened counterparty risk and the possibility of systemic default. These arrangements therefore may influence the decision making of users of financial statements and having sufficient information is critical. This is the case whether an entity's supply chain finance arrangements appear modest when viewed in isolation and may be eclipsed by financial debt and other liabilities, making companies and auditors wrongly conclude that these arrangements are immaterial and therefore are not adequately disclosed.

To ensure that users' information needs with respect to this important area are addressed, ideally both on the face of the financial statements and (at the very least) in the notes, we ask that the IASB require companies that enter into supply chain financing arrangements to disclose information about the nature and scope of any arrangements entered into by the company, even if the scope is deemed to be modest and unlikely to affect the specific entity's credit or counterparty risk. Technically, this is already covered by the concept of materiality; however, we are wary that materiality may not always be applied consistently by preparers.