

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG-CFSS. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG-CFSS. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Primary Financial Statements Issues Paper

Objective

- 1 The objective of the session is to:
 - (a) to provide EFRAG TEG-CFSS members an overview of the IASB's tentative decisions to date;
 - (b) ask for advice on the next steps of the IASB's project, including whether the IASB should move its project from research to standard-setting programme; and
 - (c) discuss the Accounting Standards Board's (AcSB) paper *Draft Framework for Reporting Performance Measures*.

Agenda Papers

- 2 In addition to this issues paper, the following agenda papers have been made available for EFRAG TEG and EFRAG CFSS members as background material:
 - (a) Agenda paper 11-02 – *PFS Moving to Standard setting* – an ASAF Agenda Paper provided by the IASB Staff;
 - (b) Agenda paper 11-03 – *Draft Framework for Reporting Performance Measures* – a paper provided by AcSB for the ASAF discussion; and
 - (c) Agenda paper 11-04 – Slides *Draft Framework for Reporting Performance Measures* – a presentation of the AcSB.

Overview on the IASB's tentative decisions to date

- 3 The Primary Financial Statements project is part of the IASB's work on *Better Communication in Financial Reporting*. The objective of this research project is to exam potential target improvements to the structure and content of the primary financial statements.
- 4 At an early stage of the project, the IASB tentatively decided to focus on targeted improvements to the statement(s) of financial performance and to the statement of cash flows.
- 5 For the **statement(s) of financial performance**, the IASB tentatively decided to explore the following topics:
 - (a) introducing additional subtotal(s) in the statement(s) of financial performance to increase comparability¹:
 - (i) profit before finance income/expenses and tax (EBIT);

¹ Including guidance on the calculation of the new subtotals, definition of a new investment and finance category and additional line items related to finance income or expenses.

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- (ii) profit before investing, financing and tax (proxy of operating profit); and
 - (iii) new subtotal above the new separate line item 'share of profit or loss of integral associates or joint ventures' (proxy of operating profit of consolidated entities);
- (b) providing guidance on use of management performance measures, including reconciliation of the MPMs with those specified in paragraph 81A of IAS 1 *Presentation of Financial Statements*, clear labelling and specific disclosures on them²;
 - (c) removing some of the options for presentation of income and expenses in existing IFRS Standards (for example, presentation of net interest cost on a net defined benefit liability); and
 - (d) renaming the two categories in the OCI and removing presentation options related to tax effects reclassification adjustments.
- 6 For the **statement of cash flows** the IASB tentatively decided to explore the following topics:
- (a) elimination of options for the classification of the cash effects of interest and dividends in the statement of cash flows;
 - (b) non-alignment of the operating section across the statement of cash flows and the statement(s) of financial performance; and
 - (c) requiring a consistent starting point for the indirect reconciliation of cash flows, which should be 'profit before investing, financing and income tax'.
- 7 The IASB also tentatively decided to:
- (a) consider the development of principles and guidance for aggregating and disaggregating items in the financial statements;
 - (b) consider the development of templates for the primary financial statements for a small number of industries; and
 - (c) not to consider targeted improvements to the statement of financial position unless work on other areas of the primary financial statements identified possible improvements to that statement.
- 8 In order to simplify the discussion of topics within the scope of the project, the IASB has initially focused on the presentation of information in the primary financial statements of non-financial entities.

Moving from the Research agenda to Standard-setting

Background

- 9 At this stage, the IASB has not yet decided whether the outcome of this project will be the publication of an Exposure Draft or a Discussion Paper. The IASB staff is planning to ask the IASB to decide on this later this year.
- 10 However, as the Primary Financial Statements project is part of the IASB's research agenda, the IASB will only be able to publish a Discussion Paper as long as the project remains within the IASB's research agenda³. The IASB staff noted that if the project is reclassified to the standard-setting agenda, the IASB will be able to publish either a Discussion Paper or an Exposure Draft⁴.

² it does not affect the presentation of additional subtotals in the statement(s) of financial performance in accordance with paragraphs 85–85A of IAS 1

³ in accordance with paragraph 4.12 of the IASB Due Process Handbook

⁴ in accordance with paragraph 5.5 of the IASB Due Process Handbook

- 11 Considering this, IASB staff is planning to ask the IASB whether it wishes to move the project from its research agenda to a standard-setting agenda. A formal prerequisite to move a project from the research agenda to the standard setting agenda is to consult with Accounting Standards Advisory Forum (ASAF) before making a decision.

Meeting the standard-setting criteria in the Due Process Handbook

- 12 The IASB staff has assessed and concluded that the Primary Financial Statements project meets the necessary criteria to be moved from the IASB's research agenda to its standard-setting agenda based on the evaluation of the following criteria:
- (a) *whether there is a deficiency in current reporting and the importance of any deficiency to users:* In 2014 the IASB added this project to its research agenda in response to a strong demand from users to undertake a project on financial performance. In 2015, respondents to the *2015 Agenda Consultation* asked the IASB to give high priority to this project and reinforced the idea that the project should focus on performance reporting issues. In 2016, the IASB staff conducted research and outreach activities and identified a number of areas that need improvement (e.g. lack of comparability and disaggregation in the statement of financial performance and wide use of non-IFRS performance measures that often lack transparency on how and why they are calculated);
 - (b) *types of entities likely to be affected by the proposals:* Although the initial focus of the project has been on non-financial entities, it is likely that at least some proposals (for example the proposals on disaggregation and management performance measures) will affect all entities;
 - (c) *the pervasiveness of the problem:* the IASB staff research has revealed that problems with presentation in the primary financial statements are pervasive as the structure and content of those statements can vary even among entities in the same industry; there are significant variations in the presentation of information across jurisdictions and the use of alternative performance measures and the quality of disclosures about such measures are dependent on the approach taken by individual regulators; and
 - (d) *the costs and benefits of the proposals:* The IASB staff acknowledge that it is difficult to assess the likely costs and benefits of the IASB's proposals at this stage of the project. However, from early research the IASB staff considers that improvements to the content and structure of the financial statements are likely to be beneficial to users. In regard to the potential costs, the IASB staff noted that the IASB's proposals only affect the presentation and disclosure requirements and are only targeted improvements. Consequently, the IASB staff preliminary assessment is that the benefits of the improvements to financial reporting from this project are likely to outweigh the costs.

EFRAG Secretariat analysis

- 13 EFRAG Secretariat notes that at this stage the IASB's proposals are not a fundamental review of current requirements in IAS 1 and IAS 7 *Statement of Cash Flows*. Therefore, a possible outcome of this project could be an Exposure Draft, which would reduce significantly the timing of this project.
- 14 However, the EFRAG Secretariat is concerned that there are still many issues that need to be discussed and finalised, particularly on how the IASB proposals can be applied to financial institutions and other industries with specific needs. In this case, the EFRAG Secretariat considers that the IASB staff has not yet collected all the evidence on the nature and extent of the perceived shortcomings and assessed potential ways to improve financial reporting. Furthermore, in accordance with paragraph 5.5 of the Due Process Handbook the IASB will need to explain why it decided not to publish a Discussion Paper.

- 15 Therefore, the EFRAG Secretariat considers that the IASB should only move this project to the standard-setting agenda after analysing and finalising its discussions on financial institutions and other industries with specific needs and explaining why a Research or Discussion Paper may not be necessary.

Question for EFRAG TEG and EFRAG CFSS

- 16 What are EFRAG TEG and EFRAG CFSS's views on moving the Primary Financial Statements project from the IASB's research agenda to the standard-setting agenda?

AcSB's Draft Framework for Reporting Performance Measures

Background

- 17 At the July 2018 ASAF meeting, the AcSB will present a paper and accompanying slides regarding its project on *Framework for Reporting Performance Measures*. The objective is to develop guidelines that will help entities, listed and non-listed, improve their use of performance measures outside the financial statements and, consequently, enhance the relevance of financial reporting.
- 18 The AcSB initiated its project in 2016, following the observations that:
- (a) Management often provides financial and non-financial performance measures to complement and supplement their reporting, to tell their stakeholders the story about an entity's overall performance;
 - (b) These performance measures can affect market prices, lending rates, compensation of senior management, directors and employees. Thus, the quality of these performance measures is important; and
 - (c) Users want to better understand and evaluate the performance measures used by the entities. They request better quality performance measures, determined with rigour and explained with transparent disclosures.
- 19 Furthermore, the AcSB observed that users have expressed concerns about the actual quality of performance measures, lack of transparency, consistency, and comparability in reporting, the expectation gap related to provided assurance, and the lack of clarity about how, or whether, the measures affect management compensation.

The Framework

- 20 In response to the concerns, the AcSB discussed and published a draft *Framework for Reporting Performance Measures* (the Framework). The scope of the Framework covers performance measures reported outside the financial statements, prepared in accordance with an accounting framework (e.g. IFRS Standards) and encompass Canadian public and private companies, not-for-profit organisations, and pension plans. It applies to the following measures for which currently there is little guidance:
- (a) **non-GAAP financial measures** which include adjusted GAAP financial measures (e.g. adjusted earnings);
 - (b) **other financial measures**, which are not a GAAP or non-GAAP financial measure (e.g. dollars of order backlog or cost per dollar raised); and
 - (c) **non-financial / operational measures** (physical or non-financial measures).
- 21 The Framework is intended to encourage best practices and to promote reporting of high quality performance measures. Even though its application would not be mandatory, the reporting entities would still be required to comply with regulatory requirements and to consider whether additional disclosures are required to comply with those regulatory requirements.

- 22 The Framework explains that the objective of performance measure reporting is to provide information that is useful to the users in making their financial decisions, and that the management may choose to report a performance measure when it provides useful and transparent information about how the entity creates and realises value, based on its strategy and objectives.
- 23 Finally, the AcSB's Framework is a model that includes a foundation with four pillars topped with an effective communication principle:
- (a) **Setting the foundations:** entity looking to its strategies, goals and objectives to identify key activities it has undertaken to generate value in the short and long term and decide what information it may want to report externally;
- then four pillars:
- (b) **Pillar 1: Selecting a relevant performance measure that can be faithfully depicted** - which includes assessing whether the measure's label, amount and related information reflect the underlying economic and operational characteristics of the information, and is complete, neutral and free from material error.
 - (c) **Pillar 2: Applying materiality and the cost benefit constraint** - which includes assessing whether misstating a performance measure could influence decisions that users make based on that information, and whether the cost of developing a performance measure is justified by the benefits of reporting it.
 - (d) **Pillar 3: Establishing policies, controls and procedures** - which ensures compliance, consistency of preparation, data quality, accuracy, and transparency;
 - (e) **Pillar 4: Reinforcing with governance practices** - including assessment of the appropriate extent of governance practices (directors and audit committees) that should be considered as part of overseeing the development and reporting of a performance measure;
- and, finally,
- (f) **Communicating effectively** – which requires the measures to be transparently disclosed and available to users in time to influence their decisions.
- 24 The graph presenting the structure of the framework is reproduced in the Appendix to this paper.
- 25 The key concerns of the AcSB, related to the Framework, comprise the following:
- (a) **Practicality;** whether industry specific guidance is needed to affect practice;
 - (b) **Applicability issues:** including distinguishing between financial and operating measures, and whether the application of the Framework should be mandatory;
 - (c) **Regulatory compliance:** consistency with regulatory requirements; and
 - (d) **Verification:** whether the Framework provides an adequate basis for assurance.

EFRAG Secretariat analysis

- 26 The EFRAG Secretariat's outreaches and research on the use of non-GAAP performance measures showed that these measures, including those that are presented outside the financial statements, often lack clarity, comparability (between years, and within industries) and may be misleading. Those observations are also reported by other organisations such as the Mazars' study published in 2016.

- 27 The EFRAG Secretariat agrees with the AcSB that more guidance is needed on presentation of non-GAAP performance measure and regarding related disclosures. Therefore, we support the AcSB initiative to develop a framework for the presentation of performance measures that would complement accounting standards, encourage best practices, and promote reporting of high quality performance measures.
- 28 However, the EFRAG Secretariat notes that, in Europe, ESMA has already provided guidelines on the use of alternative performance measures included in prospectus and other regulated information e.g. Market Abuse Regulation and Transparency Directive. Moreover, in order to promote common supervisory approaches and practices in the application of the guidelines and to enhance enforcement, ESMA introduced a Q&A mechanism and regularly updates and publishes its *Questions and Answers on ESMA Guidelines on Alternative Performance Measures (APMs)*. Considering that they are already covered by the applicable financial reporting framework, ESMA has excluded the presentation of APMs within the financial statements from the scope of the guidelines.
- 29 The EFRAG Secretariat also notes that the IASB is currently considering developing guidance on the use of management performance measures within the financial statements.
- 30 Nevertheless, the EFRAG Secretariat considers that the Framework may provide a suitable basis for providing assurance on the quality of performance measures presented. However, we have similar concerns to AcSB, regarding applicability of such a framework.
- 31 We think that enhancing comparability of performance measures between industry participants may require some industry-specific, rather than general, guidance. Our view may be supported by, for example, the recent findings of EFRAG's insurance team research and Mazar's study which reveal that performance measures may vary significantly from industry to industry, including the definitions, labels and calculation.
- 32 We note that the AcSB proposes that application of the Framework should be voluntary. Moreover, the AcSB recognises that securities and market regulators issue their own regulations, what includes regulations regarding performance measures. Consequently, we think that the Framework's guidance need not overlap with, or contradict, the existing guidance and requirements issued by market and security regulators. Furthermore, we think that the AcSB, or other national standard setters that decide to introduce such guidance would need to consider how to support widespread use of the Framework.

Questions for EFRAG TEG and EFRAG CFSS

- 33 Do you have comments and suggestions on the AcSB's draft Framework?
- 34 Do you think a similar framework could be helpful in your jurisdiction? Why or why not?
- 35 How would a similar framework interact with your local securities law and regulations?

Appendix 1: Overview of the Framework

- 1 The following graph, reproduced from the AcSB paper, presents the key Framework's elements for consideration:

