EVALUESERVE

IASB Refocuses on Transparency and Improved Presentation of Financial Statements

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The International Accounting Standards Board (IASB) published the draft proposal of a new standard – **General Presentation and Disclosures** in December 2019 **–** which is expected to replace the existing IAS 1 – Presentation of Financial Statements. The IASB sought views on the proposal by 30 September 2020. The board met on 15 and 16 December 2020 to discuss the feedback on its Exposure Draft General Presentation and Disclosures. The new standard is still under discussion and is expected to be implemented in 18–24 months, after the finalization and publication of the proposed changes. We believe the new accounting standard should improve transparency and disclosure in the presentation of financial statements and facilitate comparability across companies. The proposed change i.e. better disclosure should help research analysts in analyzing the financial statement of companies.

What is the need for a new standard?

Let's try to understand.

- Firstly, in the absence of a well-defined and mandated financial reporting structure, companies use different ways to present their income statements. For instance, the current International Financial Reporting Standards (IFRS) do not define key financial metrics, such as operating profit, leaving it to companies to determine which financial components they include or exclude in their calculations. This makes the comparison of financial performance a tedious and challenging task.

BT Group and Vodafone Group's financial reporting, highlighted below, show the stark difference in their reporting structure.

Exhibit 1: BT Group and Vodafone Group's financial reporting[1,2]

BT Group plc Annual Report 2020
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Group income statement
Year ended 31 March 2020

	Notes	Before specific items ('Adjusted') £m	Specific itemsa £m	Total (Reported) £m
Revenue	4,5	22,824	81	22,905
Operating costs	6	(19,213)	(409)	(19,622)
Operating profit (loss)	4	3,611	(328)	3,283
Finance expense	27	(796)	(145)	(941)
Finance income		39	5	44
Net finance expense		(757)	(140)	(897)
Share of post tax profit (loss) of associates and joint ventures		6	(39)	(33)
Profit (loss) before taxation		2,860	(507)	2,353
Taxation	10	(536)	(83)	(619)
Profit (loss) for the year		2,324	(590)	1,734
Earnings per share	11			
Basic		23.5p	(6.0)p	17.5p
Diluted		23.3p	(5.9)p	17.4p

Vodafone Group Plc : FY20 Preliminary Results

Unaudited condensed consolidated financial statements

Consolidated income statement

	Notes	2020 €m	2019 €m
Revenue		44,974	43,666
Cost of sales		(30,682)	(30,160)
Gross profit		14,292	13,506
Selling and distribution expenses		(3,814)	(3,891)
Administrative expenses		(5,810)	(5,410)
Net credit losses on financial assets		(660)	(575)
Share of results of equity accounted associates and joint ventures		(2,505)	(908)
Impairment loss	2	(1,685)	(3,525)
Other income/(expense)		4,281	(148)
Operating profit/(loss)		4,099	(951)
Non-operating expense		(3)	(7)
Investment income		248	433
Financing costs		(3,549)	(2,088)
Profit/(loss) before taxation		795	(2,613)
Income tax (expense)/credit	3	(1,250)	(1,496)
(Loss)/profit for the financial year from continuing operations		(455)	(4,109)
Loss for the financial year from discontinued operations		–	(3,535)
(Loss)/profit for the financial year		(455)	(7,644)
Attributable to:			
– Owners of the parent		(920)	(8,020)
– Non-controlling interests		465	376
(Loss)/profit for the financial year		(455)	(7,644)
(Loss)/earnings per share			
From continuing operations:			
– Basic		(3.13)c	(16.25)c
– Diluted		(3.13)c	(16.25)c
Total Group:			
– Basic		(3.13)c	(29.05)c
– Diluted		(3.13)c	(29.05)c

- Secondly, companies disclose unusual (non-recurring) income / expenses to provide information about underlying / core / normalized earnings. However, it is often unclear why an item has been identified as unusual. Furthermore, there is substantial variation in the way different companies provide information on unusual items.
- Thirdly, aggregated reporting, i.e. grouping of certain line items under a single head within a financial statement is another pain point for financial analysts. For example, a company may choose to disclose large 'other expenses', without providing any further information on items clubbed within the 'other expenses.'
- Last but not least, companies do not always explain a) the way their management defines or calculates performance measures, b) how these can be reconciled to sub-totals (as defined by the IFRS), and c) the effect of adjustments on other line items (e.g., taxes). Generally, information about these measures is presented outside financial statements, and not audited.

How does IASB's draft proposal helps?

The IASB proposal mandates more disclosure on items included in operating profit, proposes new sub-totals in income statements, requires distinguishing integrated and non-integrated associates and joint ventures (JVs), and proposes detailed disclosure on unusual items. It also defines reporting requirements for management performance measures (or non-GAAP items). The proposal aims to ensure uniformity in terms of the level of financial details disclosed by companies.

In view of its approach, we expect the new standard to improve transparency and ensure uniformity in the presentation of financial statements, as well as significantly improve the comparability of financial statements across different companies.

In this blog, we try to understand the proposed changes and their impact on the financial community.

Current vs proposed disclosure norms

Below is a summary of the current and proposed disclosure norms.

Exhibit 2: Proposed changes aimed at making presentations and disclosures more transparent

	Current norms	Proposed norms
Income statement	• Companies need to present 'revenue' and 'profit / loss' but not specific sub-totals • Companies calculate operating profit in different ways	• Classification of income and expenses into four defined categories – operating, integral associates and joint ventures, investing, and financing. Companies will not explicitly use defined category labels in presentation • Structured presentation format with defined sub-totals, including operating profit or loss
	• Share of profit / loss of associates and JVs are presented at different places, based on a company's discretion • A single line item is used for profit / loss of associates and JVs	• Associates and JVs to be segregated as integral and non-integral • Income and expenses from the integral associates and JVs to be presented closer to operating profit, separately from non-integral associates and JVs
	• Break-down of operating expenses is provided through a mix of nature (e.g., employee benefit and depreciation) and function (e.g., cost of sales, and general and administrative expenses) • Analysis of operating expenses is provided only in the notes, based on a company's discretion	• Operating expenses break-down to be disclosed either based on nature or function, but not as a combination of two • Analysis of operating expenses to be clearly presented on the face
	• Foreign exchange related income/expense are included under finance costs	• Foreign exchange related income/expense to be classified in the four categories as they originate
Balance Sheet	• Investments in associates and JVs are presented together, with no distinction between integral and non-integral associates and JVs • At times, Goodwill is shown either as a separate line item or clubbed with Intangibles	• Integral and non-integral associates and JVs to be disclosed separately • Goodwill to be shown separately
Cash Flow Statement	• Interest and dividends are classified as operating / investing / financing, based on a company's accounting policy	• Classification of interest and dividends, based on pre-defined requirements
	• Companies use 'profit after tax', 'operating profit,' or 'profit before tax' as a starting point for the indirect method of reporting the cash flows from operating activities	• Operating profit to be the single starting point for the indirect method of reporting the cash flows from operating activities
Notes to accounts	• Companies disclose details of 'unusual items' at their own discretion; also, information is provided in varied ways, as there are no explicit guidelines for disclosure	• Unusual items to be separately identified and explained in the notes
	• Quality of disclosure on management performance measures vary; companies do not always explain how measures were calculated, how they can be reconciled to sub-totals in the income statement, their tax impact, etc.	• Management performance measures to be presented in a separate note with explanatory disclosures
		• Entities that provide an analysis of their operating expenses by function in the income statement are required to provide the analysis using the nature of the expense method in the notes

Key takeaways on IASB's draft standard

The IASB recommends the following changes to improve the presentation and disclosure of financial statements:

- Inclusion of new sub-totals in an **income statement**, including i) operating profit ii) operating profit, and income and expenses from integral associates and joint ventures, and iii) profit before financing and income tax)
- Guidelines on disaggregation and aggregation principles to facilitate relevant information disclosure
  - Categorization and aggregation of information based on the shared characteristics
  - Ungrouping of items that do not share same characteristics; rules for immaterial information
  - Aggregation and disaggregation of financial items should not conceal relevant information or result in ambiguity in financial statements
- Disclosure of management performance measures (e.g., adjusted EPS) in a separate note, and reconciliation of management performance measures with sub-totals specified by IFRS Standards
- Consistency in the presentation of items in **cash flow statements** by removing the classification option for dividend and interest and suggesting a basis for classification.
- Use of operating profit / loss as a starting point for the indirect method of cash flow statement, eliminating the option of using different metrics (net profit / loss or profit / loss before income tax)
- Reporting of goodwill and integral and non-integral associates and JVs separately in the **balance sheet**

Proposed Change in Presentation of Financial Statements

Exhibit 3: Proposed structure of income statement

Operating | Integral associates and joint ventures | Investing | Financing

Revenue	347,000
Other income	3,800
Changes in inventories of finished goods an work in progress	3,000
Raw materials used	(146,000)
Employee benefits	(107,000)
Depreciation	(27,000)
Amortisation	(12,500)
Impairment of property, plant and equipment	(8,000)
Impairment of trade receivables	(6,500)
Professional fees and other expenses	(5,530)
Operating profit	***41,270***
Share of profit or loss of integral associates and joint ventures	***(600)***
Operating profit and income and expenses from Integral associates and joint ventures	**40,670**
Share of profit or loss of non-integral associates and joint ventures	***3,380***
Dividend income	***3,550***
Profit before financing and income tax	**47,600**
Expenses from financing activities	(3,800)
Unwinding of discount on pension liabilities and provisions	(3,000)
Profit before tax	40,800
Income tax	(7,200)
Profit for the year	33,600

Income Statement – The proposal requires three specific sub-totals, which are expected to improve transparency and comparability. It also increases the requirements to disaggregate information in the income statement.

Another major amendment is related to the structure and categorization of financial items incurred or earned by entities.

Defining core business activities would be crucial for facilitating the allocation of income and expenses under the four proposed categories:

- Operating
- Integral associates / JVs
- Investing
- Financing

The proposal requires entities to present operating expenses based either on nature (materials, employee, and equipment depreciation) or function (production, sales and marketing, general and administration) of expenses in their income statements and notes.

Additionally, entities are required to segregate integral and non-integral associates and JVs. It also defines integral and non-integral associates and JVs. An associate or JV is deemed to be integral if there is significant interdependence between the underlying business of an entity and that associate/JV.

Some examples of interdependency are as follows:

(a) Having integrated lines of business with an associate or JV

(b) Sharing a name or brand with an associate or JV, so that externally it may appear as one business in relation to the activities of the associate or JV (although the reporting entity may have other, separate businesses)

(c) Having a supplier or customer relationship with an associate or JV that the entity would have difficulty replacing without significant business disruption

Foreign exchange differences, as well as gains and losses on hedging instruments and derivatives, will be classified based on the nature of income and expense (i.e., operating, investing, or financing). For instance, foreign exchange gains / losses on hedging overseas revenue and / or associated operating costs will be included under 'Operating', while foreign exchange gain / loss on an external commercial borrowing will be included under 'Financing'. Foreign exchange differences will be represented as income / expense under financing activities in certain specific situations.

Such segmented classification in under three categories (operating, investing, or financing) in the income statement is expected to facilitate the standardization of financial reporting with improved disclosures to financial investors and analysts.

Cash Flow Statement – While an entity's primary business activity determines the basis for the presentation of income and expense items in an income statement across the four broad categories mentioned above, a similar framework would be adopted to classify interest and dividends in the cash flows. Where the cash flow statement is prepared based on the indirect method, operating profit and loss needs to be the starting point.

Exhibit 4: Classification of interest and dividend cash flows[3]

Cash Flow Item	Most entities	Specified entities[(a)]
Interest paid	Financing	Treatment of interest and dividend income/expenses in cash flow statement to depend on nature of business of the entity
Interest received	Investing	
Dividends received	Investing	
Dividends paid	Financing	

(a) A bank that provides financing to customers as a main business activity will classify income and expenses related to cash and cash equivalents and funding activities under operating category.

Balance Sheet – The proposed change in balance sheet structure requires separate disclosure for goodwill and the breakdown of investments into integral and non-integral associates, as shown below.

Exhibit 5: Presentation of goodwill and integral and non-integral associates and JVs

(in currency units)

Assets	31 Dec 20X4	31 Dec 20x3
Fixed Assets	**3,217**	**2,706**
Property, plant and equipment	2,342	1,910
Intangibles	256	212
Goodwill	180	180
Investment in integrated associates and joint ventures	232	215
Investment in non-integrated associates and joint ventures	95	100
Investment in equity instruments other than associates and joint ventures	112	89
Current Assets	**559**	**628**
Cash and cash equivalents	250	322
Inventory	180	191
Receivables	129	115
Total Assets	**3,776**	**3,334**

What is aggregation and disaggregation principle?

The IASB has proposed the following principles for the aggregation and disaggregation of certain line-items in financial statements:

Exhibit 6: Guidelines of aggregation and disaggregation

Identify

Identify assets, liabilities, equity, income, and expenses that arise from individual transactions or other events

Classify

Classify them into groups, based on shared characteristics, so that line items in primary financial statements comprise items that share at least one characteristic

Separate

Separate line items based on further characteristics, resulting in separate disclosure of material items in notes

