European Securities and Markets Authority

The Chair

Date: 30 October 2013
ESMA/2013/1555

Wayne Upton
Chairman of IFRS IC
Cannon Street 30
London EC4M 6XH
United Kingdom

Agenda item request: Issues related to the application of IAS 1 - Presentation of Financial Statements

Dear Mr Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the review of financial statements carried out by national competent authorities and ESMA's co-ordination activities we have identified several issues related to the application of IAS 1 – *Presentation of Financial Statements* which we would like to bring to the attention of the IFRS Interpretations Committee (IFRS IC) for further consideration. We are aware that the IASB discussed during its September and October 2013 meetings some of the issues linked to the ones raised in this letter. We have included them in the letter in order to provide the IASB with a comprehensive overview of the issues identified in practice on the application and/or enforcement of IAS 1.

A detailed description of the issues is set out in the appendix to this letter. Please do not hesitate to contact us should you wish to discuss any of the issues we have raised.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

cc: Hans Hoogervorst, Chairman International Accounting Standards Board (IASB)

APPENDIX – IAS 1 PRESENTATION OF FINANCIAL STATEMENTS

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified several issues concerning presentation in the financial statements and the application of IAS 1.

2. ESMA is concerned that the absence of definitions of some concepts in IAS 1 and the lack of implementation guidance gives a lot of flexibility to entities to present their financial statements in ways that may impair the comparability and understandability of the financial statements.

3. In what follows ESMA provides some examples to illustrate the concerns mentioned above. They are grouped based on the nature of the issues raised:

    a. Presentation of expenses by function
    b. Additional lines, headings and subtotals
    c. Additional statements or columns in the primary statements
    d. Materiality and aggregation

a) Presentation of expenses by function

4. ESMA is concerned about the impact of the wording in paragraph 103 of IAS 1 on the comparability of financial statements. According to paragraph 103 of IAS 1, the classification by function of expenses in the income statement may require arbitrary allocations and involve considerable judgement. ESMA observed that sometimes issuers change the presentation of the income statement when using the analysis by function and present financial indicators that may not faithfully represent the performance of the issuer. The following example illustrates this concern.

a.1) Presentation of impairment losses

5. ESMA has identified two different views in relation to the recognition and presentation of impairment losses on capitalised development costs in an income statement presented by function.

6. The issuer has capitalised development costs in accordance with paragraph 57 of IAS 38. At the reporting date, the issuer recognised amortisation and impairment expenses on capitalised development costs and presented them on a separate line after the “Gross profit” subtotal instead of classifying them as part of “Cost of sales”.

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7. **View 1:** According to paragraph 99 of IAS 38, amortisation of intangible assets used in the production process should be included in the carrying amount of inventories. As the development of new technologies and products is used in the issuer's production process, the amortisation of such development costs forms part of the cost of conversion (paragraph 12 of IAS 2).

8. According to this view, impairment losses are similar to idle costs and should be included as part of Cost of sales. The difference between the amortisation and impairment expenses related to capitalised development costs relates to timing alone, thus the recognition of these costs in the income statement depends on the estimated useful life over which capitalised development costs are amortised. Therefore, the cost of inventories should comprise all costs of conversion including impairment (paragraph 10 of IAS 2). Cost of sales should equal the amount of inventories (at cost) recognised as an expense during the period (paragraph 38 of IAS 2).

9. **View 2**: According to this view, including impairment of development costs in Cost of sales distorts margin analysis and, therefore, it should be presented separately from Cost of sales.

10. According to paragraph 103 of IAS 1 "allocating expenses by function may require arbitrary allocations and involve considerable judgement". Paragraphs 85-86 of IAS 1 require an entity to present additional lines in the profit or loss when such information is relevant for the understanding of the entity's financial performance or necessary to explain the elements of financial performance that derive from activities, transactions and events that may differ in frequency, potential for gain or loss and predictability. Therefore, in this view, an issuer should present separately these expenses below the gross margin as these costs are non-recurring.

a.2) Mandatory or voluntary presentation of components of "Cost of sales"

11. Paragraph 97 of IAS 1 requires material items of income and expenses to be disclosed separately and paragraphs 104-105 of IAS 1 require additional information on the nature of expenses to be disclosed when the classification by function of expense is used.

12. In ESMA's experience, entities do not believe it to be clear whether providing the amount of each component of cost of sales is required in all cases. Entities refer to paragraph 29 of IAS 1 which states that "an entity shall present separately each material class of similar items" and "items of a dissimilar nature or function unless they are immaterial (please refer also to par. 46 in this letter).

b) Additional lines, headings and subtotals

13. Paragraph 85 of IAS 1 requires issuers to present additional lines, headings and subtotals when such information is relevant for understanding an entity's financial performance. This requirement allows issuers to adapt the presentation of the income statement based on the nature of their business, sector or industry.

14. However, the lack of definitions of concepts such as "operating result" or "financial results", and implementation guidance or examples in IAS 1 is likely to increase diversity in how the requirements are applied, which may impair the understandability and comparability of the financial statements. Illustrative examples identified by national enforcers are included below.

b.1) Classification – Operating/Financial Results

15. Although IAS 1 does not define "Results of operating activities", paragraph BC56 of IAS 1 states that "an **entity may elect to disclose the results of operating activities**, or similar line item, even though this **term is not defined**. In such cases, the Board notes that the entity should ensure that the amount disclosed is representative of activities that would normally be regarded as "operating".

16. As indicated in paragraph BC56 of IAS 1, in the IASB's view, it would be misleading and impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly it would be inappropriate to exclude items on the grounds that they do not involve cash-flows, such as depreciation and amortisation expenses".

17. Paragraph 6 of IAS 7 defines "Operating activities" as "the principal revenue-producing activities of the entity and other activities that are not investing or financing activities". However, as shown by recent discussions that took place at the IFRS IC on the definitions of operating, financing and investing cash-flows, distinguishing between these three categories may be challenging, based on the existing IFRS literature.

18. During its March 2013 meeting, the IFRS I Cdecided not to propose that the IASB further clarifies the application of the primary principles in IAS 7 for the classification of cash flows. Moreover, the IFRS IC thought that making amendments to IAS 7 on a piecemeal basis would not be appropriate.

19. ESMA has found cases in which there is diversity in how entities allocate items between the operating and financial result.

b.2) Headings and Subtotals non-recurring items / operating profit

20. During the normal course of business, entities may enter into transactions that do not relate to their daily operating activities. Transactions like business combinations and disposals of businesses or assets may have a significant impact on the income statement; however, these transactions are not necessarily frequent or regular.

21. In accordance with paragraphs 86 and 101 of IAS 1, entities may include additional line items, amend descriptions and the ordering of items in order to explain the elements of financial performance due to various activities, transactions and other events which may differ in frequency, potential for gain or loss and predictability.

22. In order to isolate those effects, entities often group them into separate lines and subtotals so that the recurring result is presented without the effects of the non-recurring transactions. However, the practice of presenting non-recurring items may be interpreted as a way to present “extraordinary items” in the financial statements despite the fact that extraordinary items are not allowed (paragraph 87 of IAS 1), and the items are not identified or classified as such.

23. It can also be argued that additional lines and subtotals, as permitted by IAS 1, may add complexity to the analysis of the financial statements, which may become difficult to understand if entities use subtotals and additional headings to isolate the effects of non-recurring transactions from classes of expense or income.

b.3) Separate line for results of entities accounted for using the equity method

24. Paragraph 82 of IAS 1 states that “As a minimum, the statement of comprehensive income shall include line items that present the following amounts for the period: (...) (c) share of the profit or loss of associates and joint ventures accounted for using the equity method”. IAS 28, IAS 31 and IFRS 11 are silent on the presentation of the “share of profit or loss of associates and joint ventures accounted for using the equity method”.

25. Taking into account the option to include additional lines in the statement of comprehensive income, it can be argued that an issuer may choose to present separately (i) its share of the results of associates and (ii) joint ventures that are accounted for using the equity method.

26. Additionally, it can also be argued that due to the lack of a definition of “Operating result”, an issuer may include in the operating result its share of profit or losses of joint ventures in which it considers the joint ventures’ results to be part of its operating activities.

b.4) Additional income statement lines in the interim financial statements

27. National enforcers have found difficulties in relation to the application of the requirements in IAS 34 - *Interim financial statements* and with the fact that certain aspects of interim financial reporting are not defined. The example below illustrates these difficulties:

28. The issuer is a company with research and development costs only (no production). In the interim condensed financial statements prepared in accordance with paragraph 8 of IAS 34, the issuer recognised impairment losses on a development project. In the income statement, the amount attributable to the impairment on the development project was presented together with amortisation of other intangible assets and no additional disclosures were included in the notes regarding the impairment.

29. Although the issuer considered that the item fulfilled the criteria in paragraphs 97-98 of IAS 1 and therefore required additional lines to be in the annual financial statements, it only mentioned the effect of impairment in the management report in accordance with paragraph 16A, c) of IAS 34. The issuer justified this presentation on the basis that impairment loss was not a recurring event and thus, it should not be presented on a separate line in the income statement in the interim financial statements.

30. **View 1.** The issuer does not need to present impairment as an additional line on the income statement in the interim financial statements. Paragraphs 85-86 of IAS 1, which requires an entity to present additional line items if such presentation is relevant and necessary to explain the elements of financial performance arising from non-recurring activities, transactions and events, do not apply to interim financial statements.

31. Indeed, paragraph 4 of IAS 1 states that the standard "does not apply to the structure and content of condensed interim financial statements prepared in accordance with IAS 34. However, paragraphs 15–35 apply to such financial statements". Consequently, paragraphs 85-86 and 97-98 of IAS 1 are not applicable to condensed interim financial statements.

32. Moreover, paragraph 10 of IAS 34 states that "if an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements shall include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard."

33. This view leads to the conclusion that since the issuer did not include a separate line to present impairment losses in the most recent annual financial statements, the issuer does not need to provide a separate line in the interim condensed financial statements. Moreover, paragraph 16A of IAS 34 allows the impact of significant events and transaction (as required by paragraphs 15-15C of IAS 34) to be

provided elsewhere in the interim financial report. In the absence of a definition of financial report, it can be considered that this refers to the management report in addition to the financial statements.

34. **View 2.** The issuer has to include a separate line in the income statement and provide explanations in the interim condensed financial statements. Although the first sentence of paragraph 10 of IAS 34 refers to the most recent financial statements, the issuer should also take into account which line items are expected to be included in the next annual financial statements. Therefore, if there is a material change during the year, the issuer should not only consider previous financial statements but also take into account events that will be presented in the next annual financial statements. The second sentence of paragraph 10 of IAS 34 "additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading" seems to supports this assumption.

35. Therefore, this view leads to the conclusion that the information about impairment should be disclosed in the notes of the interim condensed financial reporting according to paragraphs 10 and 15B (b) of IAS 34. The description in the management report may add information to the disclosures in the notes, but should not replace them. In this view it is considered that "financial reporting" notion in IAS 34 comprise only financial statements but not the management report.

36. We acknowledge that the IFRS IC is currently working on further improvements to clarify the information that may be cross-referred from the interim financial statements and which might have an impact on the matter identified above.

c) Additional statements or columns in the primary statements

37. As part of the review of financial statements, we observed that some issuers provide additional information to the set of financial statements as described in paragraph 10 of IAS 1. For instance, "pro-forma" information is sometimes presented as an extra-column or as a separate statement reconciling information presented as pro-forma with the information presented in the financial statements. Illustrative examples identified by national enforcers are included below.

c.1) Additional statements or reconciliations

38. The issuer presented a reconciliation of the group's operating profit to the result attributable to owners on the same page as the income statement. The issuer indicated that the basis for such presentation is the fact that reconciliation is important for users in understanding how the business is managed.

39. **View 1**: On the basis of the provisions of paragraphs 7 and 10 of IAS 1, the reconciliation should not be presented together with the primary statement as it leads to lack of clarity on the relevance of the different statements presented and un-clear/diffuse information regarding the different earnings statements of the issuer.

40. In this view, only the income statement prepared in accordance with IAS 1 can be presented as a primary statement. Since this reconciliation is not required by IAS 1 it cannot be presented together with primary statements. Reconciliations should either be included in the notes as non-GAAP information or in the management report, with sufficient disclosure to enable a proper understanding of the items included.

41. **View 2:** Although IAS 1 is written on the assumption that only the "primary statements" presented will be those defined in IAS 1, there is no prohibition in of additional statements or additional information being provided on the face of the primary statements.

42. Additionally, it could also be argued that if this reconciliation is not labelled as a "statement" and if it comes after the primary statements defined in IAS 1, even if presented on the same page, it could be viewed as a footnote and not as another statement.

c.2) Additional columns

43. We have observed that some issuers, instead of providing additional lines or notes, present extra columns in the primary statements and justify that approach by providing a better understanding of transactions and simplification of reconciliations. Such presentations often occur when presenting pro-forma information, but may also appear when an issuer wishes to isolate non-recurring items or re-measurements.

44. Issuers justify this practice by making analogies to paragraphs 85-86 of IAS 1 which allow entities to present additional lines, headings and subtotals if they are relevant to understanding financial performance.

45. Whereas, some argue that analogy is possible as the presentation by column provides information that is clearer when the impacts of unusual and infrequent transactions affect more than one line of items of the primary statements, others believe that including columns is not in compliance with IAS 1.

d) Materiality and aggregation

46. Based on our experience, we believe that the wording in IAS 1 (paragraphs 29-30 and 97-98 of IAS 1) allows different level of disclosures depending on whether issuers consider income and expenses as “classes of items” or “items”. The application of those requirements may lead some issuers to disclose material **items** (as mandated by paragraph 29 of IAS 1), but not material **classes of similar items**. The example bellow illustrates this matter.

Materiality and aggregation in operating segment information

47. The issuer’s internal management reporting is based upon four main operating segments. Management assesses the performance of operating segments based on revenue and earnings before interest and taxes (EBIT).

48. EBIT includes an allocation of various expenses (for instance overheads). The effects of non-recurring items such as impairment expenses are excluded from management’s measurement basis. Interest income and expenses and tax are not allocated to the operating segments. Research and development expenses are included in EBIT. Research and development are presented as a separate line item on the face of the income statement, but they are not disclosed separately in the operating segment information.

49. According to paragraph 23(f) of IFRS 8 – *Operating Segments*, an entity shall disclose material items of income and expense disclosed in accordance with paragraph 97 of IAS 1 for each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker (CODM), or are otherwise regularly provided to the CODM even if not included in that measure of segment profit or loss.

50. One view is that, although these material items of income and expenses are presented to the CODM, they form a class of items and not an individually material item. Consequently, entities can avoid a separate disclosure in segment reporting, as paragraph 97 of IAS 1 explicitly refers to material **items** only, disclosure of research and development expenses per segment is not required according to paragraph 23(f) of IFRS 8.

51. The alternative view is that this information should be disclosed separately in the segment information as this information is regularly provided to the CODM and these classes are presented separately in the income statement.