Maintaining and Strengthening Relevance in Financial Reporting, the IASB Way

"I am honoured to provide a contribution to this esteemed journal. As Chairman of the IASB, I have always enjoyed visiting India and been encouraged by the progress you have made towards IFRS Standards. I commend the ICAI for its leadership in this area, and I am pleased to join you in celebrating this Chartered Accountants Day and Platinum Jubilee of the ICAI. My contribution to this special issue of the Journal is focused on the need to maintain and strengthen the relevance of IFRS Standards," says the author, Chairman IASB as he shares IASB plans in that regard in two specific areas, first the primary financial statements project, or PFS, and second the management commentary project. Read on...

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Remaining relevant in a changing world is a challenge for all of us. Whether you work in publishing, finance, transportation, or accounting, remaining relevant means continuing to adapt to a changing world.

In the world of IFRS, change has been a constant, pretty much since we started back in 2001. First, we had to knock the inherited Standards into shape, in time for EU adoption in 2005. Then, we had to deal with our response to the financial crisis, while in parallel completing the major upgrades to the accounting for financial instruments, revenue recognition, lease accounting and most recently, insurance contracts.

Most of that work is behind us, although we now spend a great deal of time supporting consistent application of these major standards. However, just because the big reforms are done, it doesn't mean that change is no longer required.

There is plenty going on around us. There's the changing nature of companies – the knowledge economy driving huge growth in intangibles, for example. There is also the proliferation of non-GAAP measures, greater interest in broader corporate reporting, particularly in the sustainability space. And there is the impact of technology; how it affects the preparation and consumption of financial information.

These are all important developments, but these don't change the fundamental essence of financial reporting. IFRS is

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However, for the reasons I mentioned, we do need to ensure that IFRS remains relevant in this changing world. So, I'd like to share with you our plans to maintain and strengthen the relevance of financial reporting in two specific areas.

First, I will describe what we are doing with the primary financial statements project, or PFS. This is the key project in our work on 'better communication', which is all about improving the structure and the communication effectiveness of financial statements. PFS really could be a game-changer.

Then, I will discuss the management commentary project, which is our main vehicle for considering broader developments in reporting and how they relate to the financial statements.

Primary Financial Statements

The objective of the Primary Financial Statements project is to provide better structure and content in IFRS financial statements, especially in the income statement. Currently, the IFRS income statement is relatively form-free. We define Revenue, we define Profit or Loss, but not all that much in between.

In practice, both preparers and investors like to use subtotals to better explain and understand performance. Our lack of guidance in this respect has had the unintended consequence of stimulating the use of self-defined subtotals, also known as non-GAAP measures.

These measures can be useful to explain different aspects of the performance of a company and we do not intend to root them out. However, their use should come with a health warning, or maybe a wealth warning is a better way to describe these.

Subtotals like Operating Profit and EBITDA are very commonly used, but in practice companies define these subtotals in very different ways. How many investors actually know about these differences?

Our technical staff looked at 60 companies in different countries and industry sectors. About 70% of those companies used an operating profit subtotal, but there were no fewer than nine different versions of that subtotal – even though each subtotal used the same name. Some included investment incomes, others didn't. Some included profits from joint ventures, others didn't. And some excluded various items they consider non-operating or non-recurring.

Moreover, many non-GAAP measures tend to paint a very rosy picture of a company's performance, almost always showing a result that is better than the official IFRS numbers. An interesting study in the US a few years back showed that around 9 out of 10 companies in the S&P500 disclose non-GAAP metrics and 8 out of 10 showed increased net income. The 'core earnings' metric was on average 30 per cent higher than GAAP earnings. While these are numbers for the American market, we see similar challenges in IFRS markets.

So, what are we proposing to do?

First, we will improve comparability by defining some of the commonly used subtotals as IFRS numbers. Second, where management still feel the need to provide additional metrics, we will require increased transparency and discipline around the calculation and presentation of those subtotals.

The first, and most important, subtotal for the income statement we have defined is operating profit.

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around the world, yet it is not defined in IFRS Standards. We have defined operating profit as profit excluding financing, tax and income and expenses from investments. Many investors we spoke to viewed this as a reasonable measure of a company's main business activities.

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The IASB understands that this definition of operating profit does not work for financial entities, such as banks. For this reason, we have decided to require financial entities to include expenses from financing activities relating to the provision of financing to customers in operating profit. We have found similar solutions for insurers and investment companies.

Now, there is nothing to stop companies creating their own adjusted version of the IFRS operating, profit number (as long as they label it clearly). Short of banning non-GAAP, that's just a fact life (more about that later). However, we hope that there will be less incentive to do so than before, because we are providing a definition that is comparable across companies and industries.

A second important subtotal that the IASB has decided to define is what we call Profit before Financing and Tax. As the name indicates, this subtotal excludes expenses from financing activities (such as interest expense on loans or bonds) and tax. Users often want to compare companies' performance before the effects of financing and this subtotal enables that comparison. In other words, the profit before financing and tax subtotal enables comparison of companies with different capital structures. It creates better comparability of the performance of companies independent of their degree of leverage.

Management performance measures

In addition to these new subtotals, the PFS project will introduce greater transparency and discipline to the use of subtotals not defined in IFRS Standards. Traditionally known as non-GAAP, we have decided to call such subtotals 'Management Performance Measures', or MPMs. This definition makes it clear that these are performance measures created by the management of a company.

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We aim to improve transparency around management performance measures by requiring companies to locate MPMs and the information explaining these measures within a single note in the financial statements. This will make it much easier for investors to find the information. Currently, they often need to search around for this information in- and outside the annual report.

Some may worry that bringing MPMs into the financial statements enhances the status of non-GAAP. However, the presentation of the MPM's will be subject to much of the discipline that many market regulators around the world already require. Management will need to explain how the MPM is calculated and why it is important. Consistent recognition and reporting will be required from one period to another, and if a

company decides to change its performance measures, it will have to explain why.

Discipline also comes from requiring companies to provide a reconciliation between their own performance measures and the closest IFRS-defined subtotal. This will help investors to better understand how the company arrived at a particular number, and perhaps more interestingly, why management apparently thinks that an IFRS subtotal was insufficiently clear about the company's performance.

Moreover, by bringing the MPMs into the notes, they will have to be in line with the 'fair presentation' requirements set out in IAS 1. This should help weed out MPMs that are clearly unbalanced. The MPMs will also be brought into the scope of audit, something which will further strengthen discipline. While we recognise that MPMs are here to stay, we see our role as helping investors in their analysis by shining a brighter light on them.

Disaggregation and unusual items

We have also developed guidance that will improve disaggregation. Many components of the income statement are lumped together in 'other income or expenses'. We have seen cases where this item comprises more than 50% of total expenses! For many investors this is a big source of frustration. Our improved guidance in this respect will make excessive aggregation much more difficult.

Companies will also be required to disclose in the notes any items of income or expenses that are 'unusual', either by size or frequency. Clearly, this is important information for investors in their efforts to predict future cash flows. But there is a lot of variation today in how companies decide what is unusual and how they present the information.

Adjustments for unusual items are common in the realm of non-GAAP. It is also one of the areas of non-GAAP where a lot of cherry picking is going on. Unsurprisingly, companies tend to focus on what they see as unusual expenses rather than unusual income. This is one of the reasons self-defined measures often show better performance results than the IFRS numbers. Investors would certainly benefit from greater symmetry between unusual expenses **and** unusual income.

While it may never be possible to define unusual items perfectly, we will provide guidance as to how to do so. We will stipulate that items can only be categorised as unusual if they have limited predictive value – i.e. it should be reasonable to expect that the same item will not appear again for several years.

I believe the aggregate impact of our proposals on the quality and usefulness of the income statement will be quite substantial. The PFS-proposals will create much more structure in the income statement and will definitely enhance comparability. The improved structure will make it much easier for users to find the components for the analysis that they prefer. It will also facilitate digital consumption of financial information.

Moreover, over time users might start using the subtotals that we have defined—Operating Income and Profit before Finance and Tax—as building blocks for their own analyses. Preparers might find our definitions preferable to their own subtotals, whether EBIT or EBITDA or others, and they might wish to reduce the need for reconciliation.

The increased discipline around MPMs and unusual items will decrease the room for unbalanced presentation. The increased transparency around the adjustments that companies make in their non-GAAP measures will provide the investor with a lot of information about the underlying strategy of management. Do these adjustments reflect a credible strategy for long-term value creation, or do they seem inspired by a wish to embellish results? While we accept that non-GAAP is here to stay, we hope its use -and certainly its abuse- will likely diminish over time.

Management Commentary

So far, I have discussed relevance within the context of the financial statements and the notes. Let's now take a step back and look at other developments in financial reporting.

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They also do not contain information about all the intangible resources and relationships that drive business success. This information is excluded from the financial statements for good reasons. Trying to capture the value of intangibles is a hugely subjective exercise and would pose enormous recognition and measurement challenges.

The financial statements also contain limited forward-looking information, including information on emerging sustainability issues. This makes it very difficult for investors to see whether a company is prioritising short-term financial targets at the expense of longer-term value creation that is not immediately recognised in the financial statements. That can lead to capital being diverted from companies pursuing long-term strategies in favour of those prioritising short-term earnings.

Responding to this need, in 2010 we published what we call our Management Commentary Practice Statement—basically a non-mandatory guide for how to write the front of an annual report. It should help management provide a broader context for the financial statements, which is why I like to refer to broader financial information.

Since 2010, a lot has happened in this space. As the technology giants have taken off, there is much more interest in the impact of intangibles. Clearly, the increasing importance of intangibles, which escape recognition in the financial statements, is a very important reason for this widening gap. We see the annual report as a proper vehicle for providing information on intangibles.

Moreover, there have been other developments in corporate reporting. The International Integrated Reporting Council launched its <IR> Framework. And of course, many advances have been made in the environmental, sustainability and governance (ESG) reporting space, none of which was anticipated by our own Practice Statement. However, we continue to hear concerns from investors over the quality and focus of information that they are receiving.

Conclusion

For the IASB, strengthening relevance of financial reporting means finding a way to help investors better understand the impact of these developments on the financial statements. The way we will achieve this is through a major overhaul of the Practice Statement. The updated Practice Statement will remain primarily focused on the broader financial information needs of investors. We want companies to report on what is strategically important to them, including how remuneration policies align with their long-term objectives. There will be more focus on intangibles. And of course, companies would be expected to tell how sustainability issues, including climate change, may impact their business if that impact is material.

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I thank the leadership of the ICAI for the opportunity to contribute towards this esteemed journal and wish you all a very happy and successful Chartered Accountants Day! ■

The truest test of civilization, culture and dignity is character and not clothing. - Mahatma Gandhi