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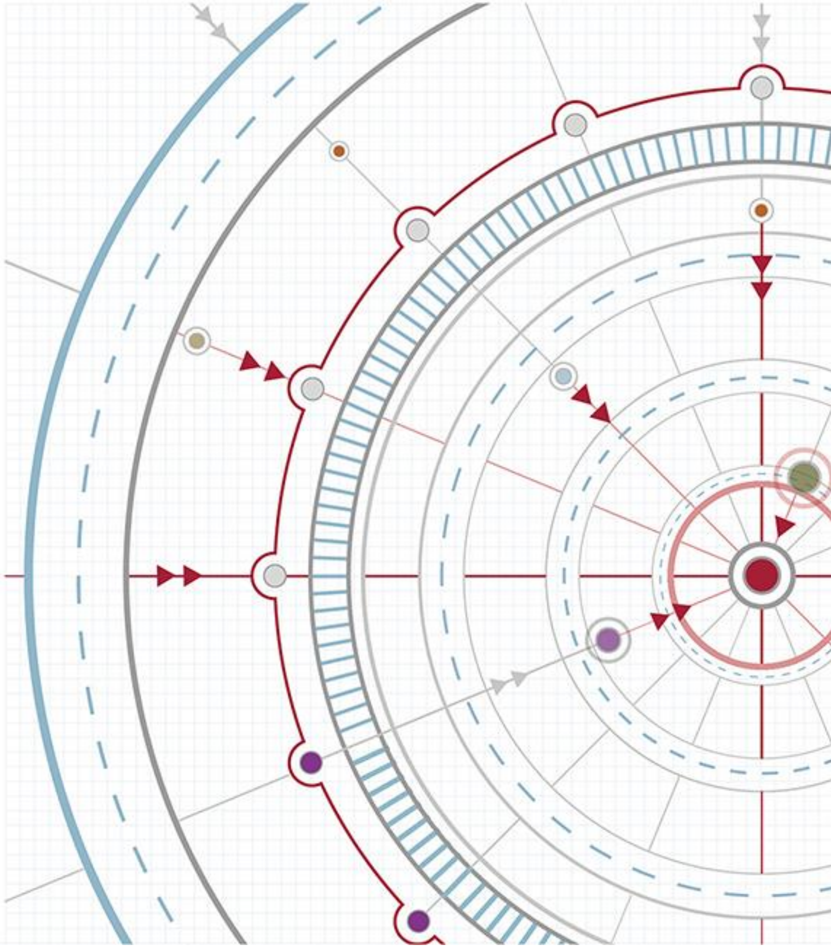

Joint CMAC-GPF meeting, 14-15 June 2018

Agenda Paper 3

Primary Financial Statements (session 1)

EBITDA and unusual or infrequently occurring items

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Overview

EBITDA

Earnings before interest, tax, depreciation and amortisation

EBITDA—Background

- In the Primary Financial Statements project the Board has tentatively decided to define a 'profit before financing and income tax' subtotal, which is similar to EBIT.
- At a future meeting the Board will consider whether it should also develop guidance on and/or define EBITDA, because:
  - some stakeholders have requested this.
  - under the current proposals, EBITDA would be considered an entity-specific management performance measure (MPM), rather than an IFRS-defined measure. However, the proposed disclosures for MPMs may not be useful for EBITDA (see slides 25-26 in Appendix for background)

EBITDA—Key considerations

- **Two key questions** for the Board to consider when deciding whether to develop guidance on and/or define EBITDA:

Is EBITDA a useful measure for assessing an entity's financial performance?

Is there diversity in how EBITDA is calculated in practice, which could be misleading?

EBITDA—Preliminary findings

Usefulness of EBITDA?

We have found that:

1. EBITDA is widely used by users of financial statements
2. concerns exist about EBITDA as a measure of financial performance

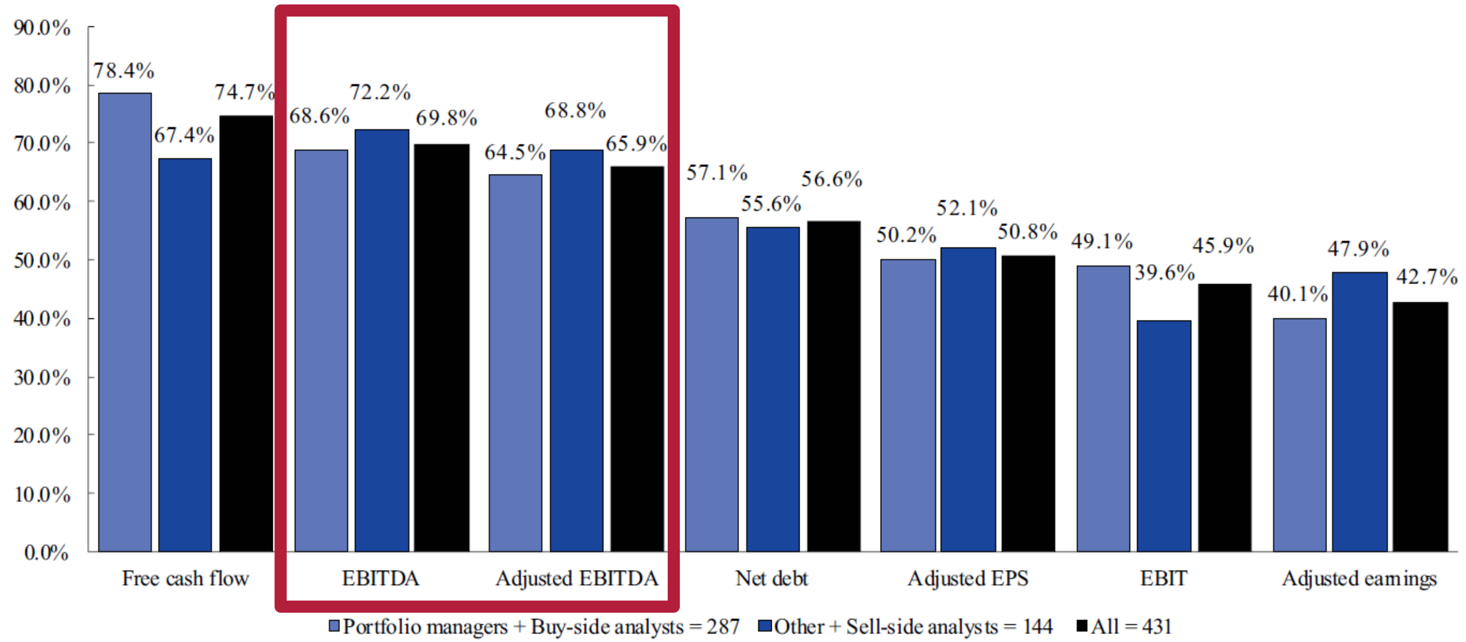
Diversity in practice?

We have found that:

3. there is some diversity in how EBITDA is defined. Some of the causes of diversity also apply to EBIT, but others are unique to EBITDA.

1 Use of EBITDA

Figure 2.4. Investor Use of Different NGFMs



431 respondents

- Source: CFA Institute (2016) *Investor uses, expectations and concerns on non-GAAP financial measures* (Global CFA Institute member survey)
- NGFMs refers to 'Non-GAAP Financial Measures'

1 Use of EBITDA

- Investors, analysts and lenders use EBITDA in similar ways to EBIT, including:

Forecasting	• EBITDA is used as a starting point for forecasting free cash flows

Financial performance comparison	• EBITDA is used to compare the historical financial performance of different entities, eg:
	  • EBITDA margin (EBITDA/Revenue)
	  • EBITDA growth

Debt service capability (solvency)	• EBITDA/Interest expense ratio • Net debt/EBITDA ratio → These metrics are often included in debt covenants
Multiples analysis	• Enterprise Value/EBITDA multiple

- Reasons for using EBITDA, rather than EBIT in the approaches above include:
  - To adjust for non-cash expenses
  - To eliminate distortions caused by differences in depreciation policies

2 Concerns about EBITDA

- We have heard the following concerns:

Forecasting free cash flows	• EBITDA ≠ free cash flow. Further adjustments are required, including adjustments for working capital movements and other accruals.
Debt service capability (solvency)	• Interest coverage based on EBITDA can be overstated because it does not take into account cash needed for capital expenditures.
Multiples analysis	• EV/EBIT multiple is more appropriate than EV/EBITDA when capital intensity varies significantly among the entities being compared.

3 Diversity in calculation of EBITDA

Through our research and outreach we have identified the following causes of diversity so far:

Also applicable to EBIT

- Differences in calculation of **‘I’ (interest)** (eg net interest on defined benefit plans)
- Some include the share of profit or loss of **associates and joint ventures**, others exclude it
- Some adjust for **infrequently occurring and similar items**. This is often reflected in the labelling (eg ‘adjusted EBITDA’) but not always (see example on next slide).

Specific to EBITDA

- As some consider EBITDA a proxy for operating cash flows, additional adjustments for **non-cash items**—other than, but akin to depreciation and amortisation—are sometimes made, eg impairment and fair value gains or losses.
- Some **only** adjust for some **amortisation** expenses (eg only acquired intangibles).

3 Example of adjustments and labelling

Some entities present adjusted EBITDA measures that are labelled ‘EBITDA’.

5.1.1 Consolidated income statement

(in millions of euros)	Notes	2016*	2017
REVENUE	4	1,646	1,937
Operating expense	4	(1,139)	(1,311)
EBITDA	5	506	626
Depreciation, amortization and provision expense		(109)	(134)
EBIT	5	397	492
Share of net profit of associates and joint-ventures	7	6	28
EBIT INCLUDING PROFIT OF ASSOCIATES AND JOINT-VENTURES		403	520
Other income and expenses	8	(96)	(107)
OPERATING PROFIT		307	413
Net financial expense	11	(117)	(54)
Income tax	12	2	51
PROFIT FROM CONTINUING OPERATIONS		193	411
Profit from discontinued operations	3	106	71
NET PROFIT OF THE YEAR		**299**	**481**

In this case, ‘EBITDA’ is before

(i) **provision expenses** (non-cash item), and

(ii) **‘other income and expenses’**, which includes impairment losses, restructuring etc.

Questions for breakout discussion (1)

1. Do you think EBITDA is a useful measure for assessing an entity's financial performance, considering the concerns listed on slide 9?

A.	CMAC members	Do you use EBITDA in your analysis? If so, what do you use it for? Any uses in addition to those listed on slide 8?
B.	GPF members	Do you present EBITDA inside and/or outside your financial statements? Why (not)? Do you use EBITDA internally?

Questions for breakout discussion (2)

2. Is there diversity in how EBITDA is calculated in practice, which could be misleading?

   A. CMAC members — Have you come across:
   - diversity in the calculation of EBITDA?
   - misleading labelling of EBITDA?

   B. GPF members — If you present EBITDA:
   - how do you calculate it?
   - are you aware of peers calculating EBITDA differently?

3. Overall, do you think the Board should define EBITDA? If so, how?

Unusual or infrequently occurring items

What is the issue? (POD DP para. 5.13)

- Isolation of unusual or infrequently occurring items can be helpful to users for forecasting future cash flows.
- However, users have expressed the following concerns:
  - transactions commonly identified as ‘infrequent’ might occur too frequently for that label to be justified
  - classification is used inconsistently by entities over time and in comparison with other entities
  - insufficient information might be provided about the effects of these items, for example, their effect on operating profit might be shown, but not their effect on other line items such as financing expenses or taxation
  - although expenses are often classified as unusual or infrequent, income is rarely classified this way, so such measures can present a biased view of an entity’s financial position or performance.

Examples of income/expenses commonly identified as unusual or infrequently occurring in practice

- Impairment of PPE
- One-off revenue
- Impairment of intangibles, incl. goodwill
- Gains/losses on disposal of PPE
- Litigation expenses
- Gains/losses on disposal of businesses
- Restructuring expenses

Feedback received on the *Principles of Disclosure* Discussion Paper

The Board's **preliminary view** in the DP was that it should develop **definitions** of, and **requirements** for, the presentation of unusual or infrequently occurring items.

Mixed Feedback

- definitions and requirements developed by the Board could make such items more **transparent** and **comparable** across entities and could **reduce opportunistic adjustments**.

- developing such definitions would be **difficult** for the Board. Assessing whether items are unusual or infrequently occurring requires significant **judgement** and depends on **entity-specific circumstances**.
- such definitions would be **difficult to audit.**

Many respondents **did not support** the Board prohibiting the use of other terms (eg 'one-off') to describe unusual or infrequently occurring items.

How do PFS proposals to date address unusual or infrequently occurring items?

Proposals on Management Performance Measures

- There are no specific constraints on the MPM calculation.
- Entities may, but are not required to, exclude unusual or infrequently occurring items from their MPM.
- If excluded, those items would be required to be presented in the MPM reconciliation in the notes, together with any other adjustments (see slide 26).

Proposals on disaggregation characteristics

- The Board may consider including 'Persistence' in a list of characteristics that could be used for disaggregating information in the financial statements (no tentative decision has been taken yet).
- IAS 1 para.101 already refers to frequency and predictability in the context of the analysis of expenses.

Questions for the Board to discuss at a future meeting

Should the Board develop any specific requirements for unusual or infrequently occurring items in addition to the PFS proposals to date (see previous slide)?

NO

Stop here. PFS proposals to date (see previous slide) are sufficient

YES

Develop specific requirements for disclosing unusual or infrequently occurring items

Staff has identified two possible approaches (see next slides):

Build on PFS proposals

Separate approach

Possible approaches

Build on PFS proposals

Categorise the items **in the MPM reconciliation** into:

- unusual or infrequently occurring income/expenses; and
- recurring items

Any unusual/infrequently occurring items that the entity does not exclude from its MPM would not be disclosed separately. Some entities may not present an MPM at all.

Separate approach

Disclose all unusual or infrequently occurring income/expenses

Additional considerations

- The Board will need to consider whether to:
  - place constraints on, or define, what items should be classified as 'unusual' or 'infrequently occurring'.
  - provide requirements for location and format

Approach	Definition	Location
Stop—use PFS approach to date	N/A	N/A
Build on PFS proposals	Defined by the Board or defined by the entity?	In the MPM reconciliation in the notes
Separate approach	Defined by the Board or defined by the entity?	Probably in the notes? In a single location?

Questions for breakout discussion
(for both CMAC and GPF members)

4. Do you think it would be useful for the Board to develop specific requirements for disclosing unusual or infrequently occurring items in addition to its proposals in the Primary Financial Statements project to date (see slides 18-19)?

   Please relate the answer to your experience of how this information is disclosed and used in practice today.

   [refer to decision tree on slide 19]

Questions for breakout discussion
(for both CMAC and GPF members)

5. If the Board decides to develop additional requirements for unusual or infrequently occurring items, which approach would be most useful in your view (including the two approaches on slide 20)?

   When considering different approaches, please also discuss if it would be useful to place constraints on definitions and the most useful way to present information on unusual or infrequently occurring items.

   [refer to decision tree on slide 19]

Appendix

Tentative Board decisions on MPMs

Tentative Board decisions on MPMs (1)

All entities shall identify a measure (or measures) of profit or comprehensive income that, in the view of management, communicates to users the financial performance of the entity

Will often be

a subtotal or total specified by IFRS Standards

- Existing subtotals in paragraph 81A of IAS 1
- Proposed new subtotals, eg profit before investing, financing and tax

Will sometimes be

a management performance measure

ie a measure that is not a subtotal or total specified by IFRS Standards, but that would complement those totals or subtotals

Specific requirements for MPMs (see next slide)

Tentative Board decisions on MPMs (2)

Measurement

no specific constraints on the calculation of MPMs

Labelling

should be labelled in a clear and understandable way

Disclosures

- disclose a reconciliation in the notes between the MPM and the most directly comparable subtotal or total specified by IFRS Standards
- disclose the effect of tax and non-controlling interests separately for each reconciling item
- explain differences between MPMs and segment measures
- describe why the MPM provides management's view of performance and how it has been calculated
- disclose sufficient explanation about any changes in the MPM calculation over time
- state that the measure provides management's view of performance and is not necessarily comparable with other entities' measures

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