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| <b>Project</b>     | <b>Primary Financial Statements</b> |  |
| <b>Paper topic</b> | Feedback summary—Literature review  |  |
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## Introduction

1. This literature review summarises the evidence from academic papers on topics relevant to the questions in the Exposure Draft *General Presentation and Disclosures* resulting from the Primary Financial Statements project (the Exposure Draft). The literature review is based on published and working papers, located via Google Scholar, Social Science Research Network (SSRN) and other databases of academic studies.<sup>1</sup> The literature review includes papers sent from academics who participated in staff’s academic outreach workshops with the Academic Advisory Committee of the Canadian Accounting Standards Board, the Australian Accounting Standards Board, the EFRAG Academic Panel, and the European Accounting Association (EAA). It also includes relevant papers from academic comment letters received from the American Accounting Association (AAA), the University of Brasilia, University of Sao Paulo, and the University of Technology Sydney. The literature review is organised in ten sections, one for each question in the Exposure Draft, with the exception of questions 2, 3, 4 and 5 which are combined in one section. All papers included in the literature review are listed in Appendix A.

<sup>1</sup> Even though the results of working papers may change prior to publication, working papers were included in this review for the purpose of outlining the scope of the primary financial statements related topics that researchers have addressed.

## Overview

2. The paper includes the following sections:
  - (a) Section 1—operating profit or loss (paragraphs 3–16)
  - (b) Section 2—the operating category and the investing category (paragraphs 17–22)
  - (c) Section 3—profit or loss before financing and income tax and the financing category (paragraphs 23–25)
  - (d) Section 4—integral and non-integral associates and joint ventures (paragraphs 26–28)
  - (e) Section 5—disaggregation principles and general requirements (paragraphs 29–33)
  - (f) Section 6—analysis of expenses (paragraphs 34–40)
  - (g) Section 7—unusual income and expenses (paragraphs 41–53)
  - (h) Section 8—management performance measures (paragraphs 54–71)
  - (i) Section 9—earnings before interest, tax, depreciation and amortisation (EBITDA) (paragraphs 72–79)
  - (j) Section 10—statement of cash flows (paragraphs 80–84)
  - (k) Appendix A—list of academic papers
  - (l) Appendix B—questions in Exposure Draft

## Section 1: Question 1—operating profit or loss

### **Summary**

3. Academic research has established that users of financial statements view operating profit as a useful measure of entity performance. Specifically, the academic evidence shows that operating profit is value relevant—associated with stock prices and returns—and has predictive ability for future entity performance. To the extent that it enhances comparability, including operating profit as a subtotal in the statement of profit or loss is likely to benefit investors, analysts, auditors and the reporting entities.
4. The academic evidence discussed below relates to:
  - (a) the usefulness of operating profit as a measure of entity performance; and
  - (b) the benefits of enhanced comparability.

### **Detailed review of the academic evidence**

#### *Usefulness of operating profit as a measure of entity performance*

5. Investigating a sample of 400 IFRS reporting entities from Australia, France, Germany, Hong Kong, Italy, Singapore, Sweden and UK, in 2005, 2008, 2011 and 2013, Clinch, Tarca, and Wee (2018) documented that operating profit, EBIT and EBITDA were value relevant, implying they were useful for investors. The researchers also showed that the disclosure of non-GAAP earnings provided useful information only for entities that reconciled the non-GAAP earnings to operating profit (or EBIT/EBITDA) but not for entities that reconciled the non-GAAP measures to net profit. Clinch et al (2018) further investigated these findings and reported that, for those entities that reconciled the non-GAAP earnings to operating profit (or EBIT/EBITDA), the adjusting items were not associated with price, providing support for their exclusion by managers. For the second group, the researchers found that the reconciliations to net profit were associated with price. In the authors' view, this was consistent with opportunistic motivation of entities to report non-GAAP measures reconciled to net profit because the disclosure of the non-GAAP measure did not provide relevant information for explaining variation in price beyond that already available from the reported GAAP-based net profit measure.

6. Examining the line items and subtotals presented by entities from 46 countries in the period 1996–2005, Barton, Hansen, and Pownall (2010) documented that subtotals near the ‘middle’ of the income statement, such as operating profit, had the strongest association with stock returns. They also reported that subtotals at the top and bottom of the income statement, such as sales and total comprehensive income, had the weakest association with stock returns.
  
7. Chen and Wang (2004) investigated the value relevance of operating income versus items reported below operating income by entities listed on the Chinese stock market in the period 1997–2001.<sup>2</sup> The researchers found that operating income was more persistent and had higher predictive ability than items reported below operating income. However, they documented that the association between items reported below operating income and price was larger than the association between operating income and price. They attributed some of this apparent mispricing anomaly to institutional factors of the Chinese market, such as items reported below operating income being a primary tool of earnings management and frequently accounting for a large percentage of an entity's reported net income. The authors found some evidence that ‘below the line’ items that were purely transitory were not value relevant.
  
8. Analysing a sample of 64 Spanish entities in the period 2001–2008, Cutillas-Gomariz, Sánchez-Ballesta, and Yagüe (2016) reported that operating income was associated with stock price and this association had increased after IFRS adoption. They also showed that operating income was persistent and had predictive ability for future earnings both before and after IFRS adoption.
  
9. Focusing on a sample of Taiwanese entities in the period 1992–1997, Bao and Bao (2004) illustrated that including operating profit in the income statement increased its informativeness<sup>3</sup>. They showed that earnings, disaggregated into an operating and non-operating component, had much higher explanatory power for stock prices and returns than stand-alone earnings.

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<sup>2</sup> The items reported below operating income included: investment income, government subsidy, nonoperating revenues and nonoperating expenses.

<sup>3</sup> Informativeness is a term frequently used by academics. It measures the explanatory power of an item for variation in stock prices or returns. Staff view informativeness as similar to usefulness for investors.

10. Most of the evidence on the usefulness of operating profit or loss for future performance forecasting is based on US data. For example, using a sample of US entities for the period 1963–2013, Ball, Gerakos, Linnainmaa, and Nikolaev (2015) documented that operating profit was more strongly associated with expected returns than other measures of profitability, such as net income or gross profit.
11. Fairfield, Sweeney, and Yohn (1996) provided evidence that reporting operating income separately helped improve forecasts of future profitability. Esplin, Hewitt, Plumlee, and Yohn (2014) showed that operating / financial disaggregation was incrementally useful for forecasting future firm performance relative to a benchmark model incorporating aggregate information.
12. Using a US sample of firms in the period 1989–1997, Brown and Sivakumar (2003) compared non-GAAP operating profit, reported by managers and analysts, and a Compustat measure of operating profit, constructed from information in the 10-Q and 10-K filings. They found some evidence that the operating profit obtained from financial statements was more value relevant than operating profit provided by managers and analysts.
13. An important caveat to consider is that entities’ decisions to report or disclose operating profit in their financial statements depend on regulators or national standard setters’ requirements for presentation of operating profit and on whether entities consider operating profit to be a relevant subtotal when applying IAS 1 *Presentation of Financial Statements*. Therefore, some researchers’ conclusions that operating profit is a useful measure of performance may be influenced by entities’ decisions to present operating profit on the basis of its relevance—operating profit for entities that have not chosen to present it might not be so relevant. Another caveat is that the definition of operating profit varies widely across entities which may have affected the results of the academic studies. Finally, some researchers believe that research on the association of accounting amounts and stock prices and returns offers limited insights for standard setting (Holthausen and Watts, 2001).
14. It is not clear, however, whether the self-selection concerns discussed above negate the conclusions about the usefulness of operating profit as a measure of performance. The evidence provided by the studies examining the value relevance of operating profit attest to the importance of operating profit as a measure that is used by investors in valuing

entities' equity. Furthermore, researchers employ well established techniques for mitigating the effects of econometric issues (such as self-selection) that arise in value relevance studies (Barth, Beaver and Landsman, 2001).

*Benefits of enhanced comparability*

15. In a comment letter from AAA, academics commented that requiring operating profit as a subtotal is likely to enhance comparability to the extent entities include similar items in the computation of this subtotal. The academic literature has shown that increased comparability benefits:
  - (a) various types of financial statement users—analysts to forecast earnings (De Franco, Kothari and Verdi, 2011), investors to anticipate future firm performance (Choi, Choi, Myers and Ziebart, 2019) and acquirers to make capital allocation decisions (Chen, Collins, Kravet and Mergenthaler, 2018);
  - (b) auditors—to assess client audit risk and lower the cost of audit testing (Zhang, 2018); and
  - (c) the reporting entities—to obtain lower-cost equity and debt financing (Kim, Kraft and Ryan, 2013; Imhof, Seavey and Smith, 2017).
  
16. The AAA comment letter highlights two caveats in considering the evidence on the benefits of enhanced compatibility: that the existing evidence might not be fully relevant to the proposal in paragraph 60(a) in the Exposure Draft because it is based on broad measures of comparability and not on specific measures of line-item comparability; and comparability under IFRS can still be affected by entity-, region-, and country-level initiatives that influence IFRS compliance (Cascino and Gassen, 2015; De George, Li and Shivakumar, 2016).

**Section 2: Questions 2–5—the operating category and the investing category**

***Summary***

17. The academic literature on this topic focuses on the operating-financing distinction. There is agreement the operating-financing distinction in financial reporting is useful for

investors' decision-making as it corresponds to the conceptual distinction between value generation and value distribution activities in the firm.

### ***Detailed review of the academic evidence***

18. Academic research has documented the benefits of disaggregation in financial statements. For example, Jeanjean, Martinez, and Davrinche (2018) examined whether income statement disaggregation influenced investors' ability to predict future cash flows. Using a sample of French listed entities over the period 2007–2015, they investigated the influence on the usefulness of non-IFRS earnings disclosures of the variation in entities' practices to report aggregated income statements (where net profit was presented as the difference between revenues and expenses) and disaggregated income statements (where additional subtotals such as EBITDA were disclosed before deriving the net income figure). They found that entities' non-IFRS earnings were more (less) relevant for predicting future cash flows when firms published disaggregated (aggregated) income statements. In the authors' view, the disaggregated income statement format improved the informativeness of financial statements and helped investors to predict future cash flows.
19. The academic literature has emphasized the importance of reporting operating and financing activities separately (eg Feltham and Ohlson (1995); Nissim and Penman (2001), Penman (2006)). Barker (2010) argued that accounting standards should require the operating-financing distinction both because it is necessary to differentiate conceptually between entities' value generation and value distribution activities but also because the operating-financing distinction is of considerable importance for the typical valuation practice of investors.
20. Barker (2010) examined the merits of defining financing activities by nature versus by function by applying the distinction between nature and function presentation of operating activities in IAS 1 *Presentation of Financial Statements* to financing activities. He argued that although the definition by nature is more objective, reporting by function is preferable in practice. Barker (2010) concluded that defining financing activities by function was entity-specific: depending on the entity's business model, an item might be classified by function as operating for one entity but financing for another. Barker's conclusions are of direct relevance to Question 4 in the Exposure Draft.

21. The above arguments in favour of an operating-financing distinction in financial reporting have been supported by both empirical and experimental evidence. For example, as mentioned in paragraph 11 above, Esplin et al. (2014) investigated empirically whether disaggregating financial statements into operating and financing activities was useful for forecasting profitability. They found that the operating/financing disaggregation improved forecasts of profitability when combined with unusual/infrequent disaggregation.
22. In an experimental setting, Taguchi (2010) examined whether presenting operating and financing activities subtotals on the income statement affected investors' decision making. The researcher examined users' decisions in the form of evaluating a proposal using 3 income statement formats: 1) an income statement presenting only net income; 2) an income statement presenting operating income in addition to net income; and 3) an income statement presenting income from financing activities in addition to net income. The author concluded that investors factored the source of income and expenses into their decision-making, highlighting the importance of the financing-operating distinction.

### **Section 3: Question 6—profit or loss before financing and income tax and the financing category**

#### ***Summary***

23. The academic studies examining the usefulness of earnings before interest and tax (EBIT)<sup>4</sup> show that EBIT is one of the most frequently disclosed measures by managers and features prominently in entities' press releases.

#### ***Detailed review of the academic evidence***

24. Isidro and Marques (2009) investigated the disclosure of non-GAAP financial measures in Europe, using hand-collected data on the reporting and disclosure practices of the largest European entities for the fiscal years 2003 to 2005. Their sample included 321 entities and

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<sup>4</sup> EBIT is calculated in different ways by entities, and sometimes includes some items of interest. The Board therefore decided not to use that term. Instead, the Board thinks the proposed subtotal profit or loss before financing and income tax could play a similar role to EBIT in financial analysis.

571 press releases. Their findings revealed that EBIT, alongside with EBITDA, were the two most frequently reported measures by managers, with each one appearing in half of the press releases (232 out of 571). Comparing these results to Entwistle, Feltham, and Mbagwu (2005)'s findings, who studied a sample of Canadian and US entities in a similar period, Isidro and Marques (2009) noted that EBIT and EBITDA were more frequently reported in Europe. Isidro and Marques (2009) further examined the prominence of the non-GAAP measures in annual earnings announcement press releases and documented the frequency of reporting each non-GAAP measure first in the press releases. EBIT had the highest frequency (22.4%), closely followed by EBITDA (21%), non-GAAP net income (16.2%) and non-GAAP income from operations (10.6%).

25. Researchers have noted that subtotals such as EBIT and EBITDA are frequently termed non-GAAP metrics although they may appear in the income statement. Hitz (2010), therefore, made a distinction between 'earnings before – measures' (EB-measures) and other non-GAAP earnings measures. He investigated the press release disclosures of non-GAAP earnings by the 80 largest German listed entities over the period 2005–2006 (566 press releases). His results indicated that 85% of his sample reported EB measures. Of the EB measures, EBIT was the most frequently reported measure (used in 40% (229 of 566) press releases). Among the non-GAAP measures, adjusted EBIT was also the most commonly used non-GAAP measure (in 28.7% of the press releases including non-GAAP measures and in 15% of the press releases overall).

#### **Section 4: Question 7—integral and non-integral associates and joint ventures**

##### ***Summary***

26. There is some evidence that investors differentiate between investments, based on the level of expected synergies. One study's descriptive evidence shows that some entities regard associate income as closer to operating income than investment income.

##### ***Detailed review of the evidence***

27. The academic literature has emphasised the importance of synergies in distinguishing between value creating and value diminishing joint ventures and alliances. For example,

Chen, King, and Wen (2015) investigated whether joint ventures and strategic alliances created value for bondholders by examining the bond market's reaction to 2,964 announcements from 1985 to 2011. They documented that the synergy effect was one of the determinants of positive market reaction to the announcements of joint ventures and alliances. Mohanram and Nanda (1998) analysed a sample of 253 joint venture announcements and also documented positive abnormal returns around the announcement date. They identified strategic considerations, ie pooling of complimentary resources, as one of the main drivers for the favourable market reaction. To the extent that the distinction between joint ventures and alliances with synergies and those without synergies bears a resemblance to the distinction between integral and non-integral investments in the Exposure Draft, the evidence from the above studies could be interpreted that investors appear to differentiate between the two types of investments.

28. Based on a sample of 154 of the largest 200 listed entities on the Australian stock exchange in 2015, Bradbury, Laura and Scott (2020) examined reporting for associates. They documented a wide diversity in the presentation and disclosures of information related to associates. Of the 154 entities with investments in associates, 129 (84%) entities presented information on associates in the income statement and the rest of the entities disclosed the information in the notes. Of the 154 entities with investments in associates, 87 (56%) included the share of associates' profits before EBIT; 53 entities (34 %) included the share of associates' profits after EBIT; and the rest of the entities did not report EBIT. Entities that reported the share of associates' profits before EBIT were larger, had more debt, had larger number of board members, had lower ownership in the associates and their associates were listed.

## **Section 5: Question 8—disaggregation principles and general requirements**

### ***Summary***

29. The academic evidence reveals that more disaggregation increases the informativeness of financial statements. In addition, disaggregation increases the reliability of the resulting financial statement subtotals. Managers' disaggregation choices become less opportunistic when managers face pressures to report transparently.

**Detailed review of the evidence**

30. Evidence exists on the benefits of disaggregation for improving the information available to analysts and lowering the cost of equity financing. Using a large sample of US entities for the period 1973–2011, Chen, Miao, and Shevlin (2015) examined the link between greater disaggregation in accounting line items in annual reports and analyst forecast properties (accuracy and forecast dispersion), bid-ask spreads and cost of equity. They interpreted higher disaggregation to be representative of higher disclosure quality and documented that more detailed disaggregation improved the information available to investors. Their finding is consistent with academic evidence that more detailed disclosure gives users more information for valuation (Fairfield et al, 1996) and a higher level of disaggregation enhances the credibility of entities' financial reports (Hirst, Koonce, and Venkataraman, 2007), D'Souza, Ramesh, and Shen, 2010)).
31. In a theoretical model, Ebert, Simons and Stetcher (2017) showed that because aggregating information resulted in offsetting good news with bad news, the managers of entities with weak performance had an incentive to disaggregate so that investors could price their entity higher than even worse performing entities. On the other hand, managers of entities with strong performance had an incentive to aggregate and thus disguise themselves from entities with even stronger performance. Accordingly, investors would overprice the weaker entities among the stronger performing ones. Ebert et al (2017)'s study applies to a voluntary disclosure setting and is based on an assumption that investors do not know the extent to which the manager has aggregated or disaggregated amounts. A standard that required disaggregation in specified circumstances (which would be audited) would give investors reasonable assurance that appropriate disaggregation had been applied and hence would help correct the potential mispricing problem identified in the paper.
32. Libby and Brown (2013) provided more directly relevant evidence by examining whether disaggregation increased the reliability of income statement numbers by decreasing the amount of misstatement that auditors tolerated. In an experimental setting, they showed that disaggregating expense items reduced the error auditors allowed, thus increasing the reliability of the disaggregated amounts and of the resulting statement subtotals and totals. The researchers found that the effect was weaker when the disaggregation occurred in the notes.

33. Academic studies have examined the factors that drive managers’ aggregation and disaggregation decisions. Some of the identified determinants include the persistence and materiality of items (Edward and Srinivasan, 2010) and proprietary costs (Harris, 1998)<sup>5</sup>. A more recent experimental study by Bonner, Clor-Proell, and Koonce (2014) documented that managers’ disaggregation preferences varied as a function of the size and relative magnitude of the income statement items. Specifically, managers chose to combine or report items separately, based on the option that gave them the highest utility (behaviour consistent with what is known as ‘mental accounting’)<sup>6</sup>. However, the researchers found that when managers were faced with pressures to report transparently (ie given explicit information about the valuation benefits of transparency), their presentation choices became less opportunistic. Bonner et al (2014) interpreted their findings in support of standard setters providing more guidance on aggregation/disaggregation of income statement items.

## **Section 6: Question 9—analysis of expenses**

### **Summary**

34. The evidence on entities’ choices between the function of expense and nature of expense method shows that these choices are mainly driven by country, industry, auditor type and degree of international exposure (eg foreign listing, international auditor, international sales). There is wide variation in the methods used by entities which potentially reduces the comparability of their financial statements.
35. The academic evidence summarised below relates to:
- (a) entities’ choices between analysis of expenses by function versus by nature and determinants of these choices; and

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<sup>5</sup> Proprietary costs arise when the disclosure of information “provides commercially valuable information to competitors that is not available elsewhere” (Harris, 1998, p. 111).

<sup>6</sup> Managers’ utility is determined by managerial preferences for salary, job security, power, status, dominance, prestige and professional excellence. Bonner et al (2014) show that the preferred presentations of managers result in the highest firm valuations from investors, indicating that investors also rely on mental accounting.

- (b) investors' reaction to information presented on the face versus information presented in the notes.

### ***Detailed review of the academic evidence***

#### *Entities' choices between analysis of expenses by function versus by nature*

36. The empirical evidence on entities' choices between the function of expense and nature of expense method is limited and mainly descriptive. Balshaw and Lont (2010) provided evidence on the level of compliance with operating expenses disclosure requirements by a sample of 94 New Zealand GAAP reporting entities and 37 voluntary IFRS adopters in the period 2002–2007 in New Zealand. For the sample of IFRS voluntary adopters, the authors documented that the choice of function or nature of expense method was influenced by industry. In addition, larger listed entities were more likely to use the nature of expense method.
37. Cole, Branson, and Breesch (2013) analysed accounting choices, including the choice to report expenses by function or by nature, of 197 industrial, financial and technology entities from Belgium, Denmark, Finland, France, Germany, the Netherlands and the UK in 2009 to assess comparability of European IFRS financial statements. The authors documented that, on average, 41% of the entities reported expenses by function and 52% reported expenses by nature. The choice was influenced mainly by country of origin, industry, and to some degree, by auditor firm. The percentage of entities reporting expenses by function and by nature is summarised in the table below:

| Country              | % of entities reporting expenses by function | % of entities reporting expenses by nature | % of entities reporting a mixture of expenses by function and by nature |
|----------------------|--|--|---|
| Netherlands          | 38%  | 62%  | 0%  |
| Belgium <sup>7</sup> | 34%  | 55%  | 10%   |
| UK <sup>8</sup>      | 83%  | 13%  | 3%  |
| Germany              | 43%  | 57%  | 0%  |
| Finland              | 24%  | 76%  | 0%  |
| Denmark              | 35%  | 65%  | 0%  |
| France               | 27%  | 63%  | 10%   |

38. The researchers concluded that, with the country of origin being the main determinant of accounting policy choices (including the analysis of expenses), there was scope for improving the comparability of IFRS financial statements.
39. Ding, Jeanjean and Stolowy (2008) examined the choices of 199 entities from the French SBF 250 index in 2002 to report using the traditional ‘by nature’ financial statement format in continental Europe (including Belgium, France, Germany and Switzerland) versus the ‘Anglo-American’ ‘by function’ income statement or ‘by term’ balance sheet format. They documented that 131 entities (65.8%) published financial statements using the traditional French ‘by nature’ format, 36 entities (18.1%) adopted the ‘by function’ approach for both the balance sheet and the income statement, and 32 entities (16.1%) followed a mixed strategy where either the income statement or the balance sheet was presented using the traditional ‘by nature’ approach. The researchers showed that the main drivers of the entities’ reporting choices were the degree of entity’s internationalization:

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<sup>7,8</sup> The authors do not provide an explanation why the percentages for Belgium and the UK do not add up to 100.

entity size, use of an international auditor, the decision to apply alternative accounting standards (such as IFRS/US GAAP), foreign listing and sales internationalization.

*Investor reaction to information presented in the financial statements versus information in the notes*

40. Related to the proposal to disclose the nature of expense method in the notes if entities choose to present expense by function in the income statement, experimental research suggests that when information is presented in the financial statements, it is reflected in individuals' judgments and decisions to a greater degree than when information is located in the notes (Sami and Schwartz, 1992); Harper Jr, Mister, and Strawser, 1991); Hirst and Hopkins, 1998); Wilkins and Zimmer, 1983).

**Section 7: Question 10—unusual income and expenses**

**Summary**

41. The academic studies on special items show that in the absence of opportunistic motives for misclassifying such items, they are largely transitory in nature, highlighting their important role in forecasting future performance. The evidence on whether investors can differentiate between special items with limited predictive ability for future earnings and misclassified special items is mixed. There is also some evidence that more prominent presentation of special items (in the income statement as opposed to disclosure in the notes) is associated with lower managerial motives to opportunistically classify a persistent item as a special item.
42. The academic evidence on the reporting of unusual income and expenses and their role in forecasting future earnings is mainly US-based. The literature uses different names to refer to unusual items, such as 'special', 'infrequent', 'non-recurring' and 'unusual' items, all denoting items that are transitory in nature and not expected to arise for several future accounting periods. In this paper we refer to these items as special as they may not meet the definition of 'unusual' as defined in the Exposure Draft.

**Detailed review of the academic evidence***The role of special items in forecasting future earnings and market reactions to special items*

43. Consistent with the definition of ‘unusual’, the academic literature has shown that these items have different time-series properties compared to the rest of the earnings components. Absent opportunistic motives for reporting, special items are largely transitory. For example, examining the effect of special items on expected future earnings for a sample of UK firms in the period 1993–2005, Athanasakou, Strong, and Walker (2007) found that exceptional items did not affect core income one year ahead and that removing these items resulted in a more persistent earnings measure than net income.
44. Burgstahler, Jambovolo and Shevlin (2002) found that special items were more transitory than the remaining components of earnings but there were differences in the persistence of positive and negative special items. Their findings showed that positive special items were largely transitory while negative special items were less than completely transitory. Negative special items were followed by earnings of the opposite sign in subsequent quarters, consistent with the idea that negative special items represented a shift of expenses from future periods into the current period that reduced current income but increased future income (eg restructuring charges).
45. Consistent with the notion of special items having a transitory nature, Strong and Walker (1993), Elliott and Hanna (1996) and Fairfield et al (1996) demonstrated that investors placed a lower valuation multiple on such items. The general agreement in the literature is that the share price reactions to income and expenses are positively associated with their recurrence (Beaver, Lambert and Morse, 1980), Kormendi and Lipe, 1987), Easton and Zmijewski, 1989) and Liu and Thomas, 2000).
46. Notwithstanding the evidence that the market recognises the different time series properties of special items, Burgstahler et al (2002) documented that stock prices did not fully incorporate the effect of special items on future earnings. One possible reason emerging from the literature on why stock prices do not completely reflect the transitory nature of special items is that special items are sometimes subject to earnings management.

*Opportunistic reporting of special items*

47. The higher valuation weight attributed to core earnings that exclude special items has motivated some opportunistic managers to engage in so called ‘classificatory shifting’, or the classification of recurring items as special. For example, Doyle, Russel, and Soliman (2003) examined the association of non-recurring items, excluded by managers from non-GAAP earnings, with future cash flows. Contrary to expectations that excluded items should have no predictive value for future cash flows, the researchers found that higher levels of exclusions led to lower levels of future cash flows. McVay (2006) documented that the unexpected component of core earnings (reported core earnings less predicted core earnings) increased with special items and reversed in the following period, consistent with managers classifying core expenses as special items.
48. Fairfield, Kitching, and Tang (2009) examined the association between special items and future profit margins separately for entities with high and low profitability. They showed that while special items had no association with future profit margins for low profit entities, high profit entities appeared to be serially misclassifying special items. For high profit entities, Fairfield et al (2009) reported that negative special items were associated with lower future profit margins.
49. In examining classification shifting through the use of special items, Fan and Liu (2017) investigated which items were likely to be misclassified depending on managerial incentives to achieve specific financial reporting benchmarks (eg a gross profit margin benchmark). They showed that when managers tried to meet a prior period gross profit benchmark, they were likely to misclassify cost of goods sold (COGS) but not selling, general and administrative expenses (SGA) as income-decreasing special items because only COGS misclassification enabled entities to improve reported gross profit margins. They also found that when managers had incentives to increase their reported core earnings, they tended to misclassify both COGS and SGA as income-decreasing special items.
50. The evidence on whether market participants can appreciate the valuation implications of opportunistically excluded special items is mixed. Elliott and Hanna (1996) demonstrated that when a write-off, presented as a special item, was followed by a number of write-offs, implying it was recurring rather than infrequent, the market readjusted the valuation weights it assigned to the permanent and transitory components of reported earnings.

Elliott and Hanna (1996) interpreted this finding as investors having less confidence in their ability to understand the distinction between permanent and transitory components of earnings.

51. Cready, Lopez, and Sisneros (2010) reported that investors placed higher valuation weight on special items and lower valuation weight on unexpected core earnings as the frequency of the special items' occurrence in subsequent accounting periods increased. The researchers' interpretation of the findings was that the market valued "recurring nonrecurring" items more like the other components of recurring earnings. The evidence by Doyle et al (2003), however, suggested that investors could not appreciate the lower cash flow implications of non-GAAP earnings which excluded opportunistically misclassified special items. They documented that a trading strategy based on the excluded expenses yielded a large positive abnormal return in the years following the earnings announcement.

*Separate presentation of special items*

52. Contrary to the view that managers' classifications of special items are driven by opportunistic incentives, some studies showed that these choices are motivated by entities' intention to signal the differential persistence of specific items. Riedl and Srinivasan (2010) examined whether managers' choices to report special items separately in the income statement or aggregate them together with another line item in the notes revealed information about the special items' persistence. Their empirical results revealed that special items presented on the income statement were less persistent relative to those disclosed in the notes. In the authors' view, these findings were consistent with managers reporting special items separately on the income statement when they wanted to signal the differential persistence of these items, ie for informational, as opposed to opportunistic, reasons. Consistently, based on theoretical analysis, Penno and Stetcher (2020) concluded that managers' classifications were more reflective of firms' signalling their performance to the market, rather than deceiving the market.

*Location of unusual items*

53. In a comment letter by AAA, academics commented that unusual items should be allowed or required to be presented in the statement of profit or loss and, specifically, in the operating category. The researchers expressed a concern that unintended differences might

arise because the proposed operating category is a residual category and highlighted that the persistence of earnings components influenced the weight investors placed on different performance metrics (eg Bradshaw and Sloan, 2002, Bhattacharya, Christensen and Larson, 2003). The academics recognised that entities would be allowed to provide information on unusual items in note disclosures but noted that users assessed information in the notes differently than information on the face of the financial statements (eg Harper, Mister and Strawser, 1987, Barth, Clinch and Shibano, 2003, Clor-Proell and Maines, 2014 and Muller, Riedl and Selhorn, 2015).

## **Section 8: Question 11—management performance measures**

### ***Summary***

54. The academic evidence on non-GAAP measures is generally in agreement that these measures are value relevant, ie associated with stock prices and stock returns (Black, Christensen, Ciesielski, and Whipple, 2018; Marques, 2017). There is evidence that managers disclose non-GAAP measures to better convey the performance of their companies but also for opportunistic reasons. As a result, in the absence of specific guidance on non-GAAP measures' definitions and disclosure, the content of non-GAAP measures varies widely across entities. Discipline, transparency, consistency and full reconciliation to the closest GAAP equivalent are key for the decision usefulness of non-GAAP measure disclosures.

### ***Detailed review of the academic evidence***

55. Research has shown that while some managers report non-GAAP numbers to better reflect core earnings (eg Black et al, 2018; Entwistle et al, 2005; etc.), others may use strategic considerations, based on the direction of GAAP earnings surprises (ie GAAP earnings being higher or lower than expected), as an important determinant of pro forma reporting.<sup>9</sup>

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<sup>9</sup> A non-comprehensive list of relevant studies includes (Bradshaw and Sloan (2002) Lougee and Marquardt (2004); Bhattacharya et al. (2007); Black and Christensen (2009) Bradshaw, Christensen, Gee, and Whipple (2018); Brockbank (2017); Doyle, Jennings, and Soliman (2013); Isidro and Marques (2015); Lopez, McCoy, Taylor, and Young (2016); Marques (2010); McVay (2006), etc.).

56. Lougee and Marquardt (2004) examined the characteristics of entities that included non-GAAP earnings measures in their press releases and whether the usefulness of non-GAAP measures to investors varied with these characteristics. They documented that entities with low GAAP earnings informativeness and negative earnings surprises were more likely to disclose non-GAAP earnings measures. They also found that investors considered non-GAAP earnings measures to be more useful when GAAP earnings were less informative (explained less of the variation in stock prices) or when strategic considerations were absent.
57. Ribeiro, Shan, and Taylor (2019) examined a sample of earnings announcements by 500 Australian entities from 2000 to 2014 and compared the attributes of non-GAAP measures with those of their closest GAAP equivalents. They concluded non-GAAP measures were more value relevant, more persistent, had higher predictive power and were, therefore, more useful for valuation. The authors, however, established that non-GAAP measures were less timely and less conservative, consistent with the idea that a single performance measure could not satisfy the requirements of both the value-relevance and stewardship role<sup>10</sup>. The researchers interpreted these results in support of the IASB’s proposal to introduce multiple measures of earnings by including a set of subtotals in the income statement.
58. Unlike most of the existing studies using manager-defined (or analysts’) measures of core business performance, Rouen, So, and Wang (2019) constructed their own measure of non-GAAP earnings by adding back a number of transitory items (net acquisition expenses, net currency expenses, net discontinued operations expenses, net legal expenses, net pension adjustments, net entity-defined other expenses and net other expenses) to net income. They examined the predictive ability of core earnings for future income and showed that their measure had incremental association with future income over net profit. They showed that analysts took time to incorporate these transitory components of net profit (ie adjustments made to core earnings) in their future forecast revisions. Consistent with investors underappreciating the information about the transitory components in earnings, Rouen et al (2019) documented that a profitable trading strategy by investors

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<sup>10</sup> The researchers measured timeliness by estimating the association between negative returns (a proxy for negative news) and earnings.

that exploited cross-sectional differences in firms' transitory earnings could produce abnormal returns of seven to ten percent.

59. A large number of academic studies illustrate the usefulness of non-GAAP measures for users' decision making. Evidence exists that these measures are used by informed investors (Christensen, Drake and Thornock, 2014), analysts (Elliott, 2006), Andersson and Hellman, 2007), creditors (Christensen, Pei, Pierce, and Tan, 2017), Dyreng, Vashishtha, and Weber, 2017) and compensation committees in evaluating management performance (Black, Black, Christensen, and Gee, 2017; Guest, Kothari, and Pozen, 2020). However, the segment of the market that relies on non-GAAP earnings information is predominantly comprised of less sophisticated individual investors (Miller, 2004; Elliott, 2006; Allee et al, 2007; Bhattacharya et al, 2007; Johnson, Percy, Stevenson-Clarke and Cameron, 2014).
  
60. Academic evidence has shown that more consistently defined non-GAAP measures are more useful for decision-making. Albring, Caban-Garcia and Reck (2010) provided evidence that when non-GAAP measures were explicitly defined by a local regulator, they were significantly associated with equity market values and returns and more value-relevant than the GAAP measures. Additional evidence in support of consistent non-GAAP measure definitions was provided by Venter, Cahan and Emmanuel (2014) who examined the value relevance of earnings components in South Africa where entities are required to report GAAP earnings and non-GAAP earnings and to disclose in detail the items eliminated from GAAP earnings.
  
61. Marques (2017) reviewed the international evidence on the disclosure practices and usefulness of non-GAAP measures and documented varying degrees of informativeness in countries with different levels of guidance concerning reporting and disclosure of non-GAAP measures.
  
62. In the US, where Regulation G issued in 2003 requires entities that choose to disclose non-GAAP measures to provide reconciliations to the most directly comparable GAAP measure, researchers have found that the mandated reconciliation provides valuable information for capital markets (Elliott, 2006; Marques, 2010, Zhang and Zheng, 2011) and the quality of non-GAAP disclosures has increased after the regulation (Kolev, Marquardt, and McVay, 2008; Heflin and Hsu, 2008).

63. In New Zealand, where the Financial Market Authority introduced guidelines to improve entities' practices of disclosing non-GAAP measures, Rainsbury, Carol and Sue (2012) examined the disclosure of non-GAAP earnings in the annual reports of listed entities from 2004 to 2012, and found evidence that entities disclosed these measures to inform investors, but also to influence their perception of performance. Xu, Bhuiyan and Rahman (2016) analysed annual reports from 2006 to 2010 and found that non-GAAP disclosures were positively associated with share liquidity.
64. Research also highlights the importance of complete reconciliation disclosures for the usefulness of adjusted measures. In Australia, Clinch et al (2018) found non-GAAP earnings to be informative, but only for firms basing adjustments and reconciliations on a reported number in the statement of profit and loss. They found reconciliations to operating profit to be most informative. They further documented that the association between non-GAAP earnings and prices was stronger when the disclosures were more complete.
65. Similarly, based on German data, Aubert and Grudnitski (2014) reported that high-quality reconciliations between non-GAAP earnings and GAAP earnings mitigated market mispricing of non-GAAP earnings disclosures. They defined reconciliation quality by the degree to which a non-GAAP disclosure fully articulated the difference between non-GAAP and GAAP earnings. Academic research has also shown that side-by-side reconciliations enhance the transparency of the line items affected by the adjustments and that entities presenting side-by-side adjustments are less likely to engage in strategic disclosure behaviours (Zhang and Zheng, 2011; Brown et al, 2012; Gomez, Heflin and Wang, 2018).
66. Researchers have also concluded that including non-GAAP measures in the financial statements and mandating their reconciliation disclosure is likely to result in improved comparability between non-GAAP measures across entities. Clinch, Tarca and Wee (2019) documented that the type of non-IFRS performance measures disclosed differed by country, likely reflecting prior national practices and positions of security market regulators. Their finding was based on a comprehensive sample of entities including Australia, France, Germany, Hong Kong, Italy, Singapore, Sweden and the United Kingdom.

67. Another issue concerning current disclosures of non-GAAP measures is that they are often non-transparent. For instance, Hitz (2010) showed that even though disclosure of non-GAAP earnings was an established reporting practice on the German capital market, non-GAAP measure reconciliation disclosures did not always explain the nature and amounts of these exclusions. Isidro and Marques (2015) concluded that in environments in which there was more pressure to achieve earnings benchmarks and less opportunity to manipulate GAAP earnings, managers resorted to non-GAAP earnings disclosures more frequently (and adjusted non-GAAP earnings for recurring expenses such as research and development (R&D), depreciation, and stock-based compensation expenses) to meet the benchmarks. Choi and Young (2015) examined the practices of UK entities and concluded that non-GAAP earnings disclosures tended to be informative (opportunistic) when GAAP earnings beat (undershot) market expectations.
68. Credibility is an important feature of non-GAAP measures that existing literature has identified of interest to preparers, auditors and analysts (Jones and Smith, 2019). Based on 23 interviews with preparers, auditors and analysts from the US and the UK, Jones and Smith (2019) reported that managers believed that non-GAAP measures allowed them to convey important information about the business model and its core performance and analysts found the information in the adjustments most valuable.
69. Black, Christensen, Ciesielski and Whipple (2020) examined consistency and comparability of non-GAAP metrics by focusing on all S&P 500 entities in the period 2009–2014. They documented that managers’ changes of non-GAAP definitions were mainly intended to better represent entities’ core performance and that these adjustments enhanced the comparability of earnings metrics across sector peers. Despite the evidence that managers deviated from prior disclosures or sector norms for informational reasons, the researchers documented that these deviations were more likely to occur in aggressive non-GAAP reporting settings, such as beating earnings benchmarks.
70. In a comment letter by AAA, academics commented that including MPMs in the financial statements and notes and bringing them within the scope of the audit function would, as shown previously by the academic literature, enhance their faithful representation (Black and Christensen, 2018); increase their quality (Black et al, 2014) and constrain the use of overly-aggressive adjustments (Chen, Krishnan, and Pevzner, 2012). In addition, academic evidence exists that unaudited non-GAAP measures are more likely to be

affected by opportunistic disclosure behaviours than audited financial statements (Doyle, Jennings and Soliman, 2013).

71. The academics highlighted, however, that, as shown by experimental research, audited MPMs may be perceived by investors as useful when they are not (Anderson, Hobson and Sommerfeldt, 2019). Academic research has shown that investors tend to over-rely on non-GAAP measures that are presented more prominently in financial disclosures (Elliott, 2006, Brown, Christensen and Elliott, 2012) and that investors place more weight on items presented in the primary financial statements and discount information presented in the notes (Davis-Friday, Liu and Mittlestaedt, 2004; Fredrickson, Hodge and Pratt, 2006). However, this could be because amounts presented on the face of the financial statements are of higher quality than amounts disclosed in the notes (Clor-Proell and Maines, 2014).

## **Section 9—Question 12 EBITDA**

### ***Summary***

72. The evidence on EBITDA is that it is widely used and that investors find it relevant. There is evidence that the motivation to disclose EBITDA is related to market pressures and that EBITDA disclosures tend to be more opportunistic in nature than EBIT and EBITA disclosures. In addition, excessive managers' focus on EBITDA is linked to costs such as capital overinvestment and excessive leverage.

### ***Detailed review of the academic evidence***

73. The academic evidence on EBITDA shows that EBITDA is a useful measure to investors (Clinch et al, 2018). Cormier, Demaria and Magnan (2017) showed, for a sample of 233 Canadian firms in the period 2012–2013, that EBITDA reporting was associated with greater analyst following and lower information asymmetry. They also documented that disclosure of EBITDA enhanced the association of GAAP earnings with stock prices and future cash flows.
74. Cormier, Demaria and Magnan (2020) provided similar evidence focusing on adjusted EBITDA, which was derived after including or excluding items that managers considered not to be representative of their entities' gross cash generation ability (Vasconcelos de

Andrade and Murcia, 2019). For a sample of 241 Canadian and 120 French entities in the period 2016–2017, Cormier et al (2020) showed that adjusted EBITDA was value relevant and reduced the information asymmetry between managers and investors.

75. Additional evidence on the usefulness of EBITDA in a US context was provided by Nissim (2019) who compared the ability of three non-GAAP measures—EBIT, EBITA and EBITDA—to explain market values and concluded that EBITDA performed substantially better than the other two measures. In terms of ability to predict stock returns, the three measures performed well, earning positive abnormal returns to a zero-investment strategy in the first part of the sample period (1989–2009). The trading strategy did not perform well in the last decade (2010–2019), suggesting that it had likely been arbitrated away.
  
76. Despite EBITDA being generally useful to investors, some studies have questioned the credibility of EBITDA measures on the basis of their frequently opportunistic disclosures. For example, Bouwens, de Kok and Verriest (2019) provided evidence that EBITDA, and its adjusted measures, are better suited financial measures to provide a more favourable picture of the entity than the underlying GAAP earnings and cash flow measures. The study documented that EBITDA disclosures were more opportunistic in nature than EBIT and EBITA disclosures. The likelihood of EBITDA disclosure was associated with certain firm characteristics, such as: small size, high leverage, greater capital intensity, lower profitability and longer operating cycles.
  
77. In addition, Cormier et al (2020) showed that the presence of institutional investors, along with other market-related pressures such as analyst coverage and CEO power, restrained entities' propensity to report EBITDA-adjusted measures. However, other market pressures such as US cross-listing, free float and entity size were positively related to the decision to report such measures. Cormier et al (2017) showed that the value relevance of EBITDA beyond that of GAAP earnings measures was mainly attributable to a sub-group of their sample entities—those with weak corporate governance—consistent with a substitution effect between corporate disclosure and corporate governance (Cormier and Magnan, 2014).
  
78. Rozenbaum (2019) examined managers' use of EBITDA in 18,082 US entity annual earnings announcements in the period 2003–2011. The researcher documented that EBITDA disclosures increased from 17% to 35% from 2003 to 2011. The propensity to

disclose EBITDA in earnings announcements was positively associated with the use of EBITDA in executive compensation, the prevalence of EBITDA's use by analysts, and the use of EBITDA-based covenants in firms' debt contracts. The study showed that the widespread use of EBITDA may induce managers to focus on it unduly. Since EBITDA excluded various expenses, managers who focused on it unduly tended to underweight the excluded expenses when determining their entities' investments in capital and level of debt. As a result, the study showed that managers who focused on EBITDA overinvested in capital and acquired excessive debt relative to their industry peers. In the author's view, the capital overinvestment and excessive leverage represented a systematic cost to using EBITDA. This evidence is consistent with evidence by Li (2016) who argues that contracting parties choose an EBITDA-related measure, instead of a measure calculated after depreciation and amortization expenses (eg EBIT), to make the performance measure less sensitive to investment activities.

79. Conducting a survey experiment based on face-to-face interviews with investment professionals and a large-scale follow up online experiment, Cascino, Clatworthy, Osma, Gassen and Imam (2020) documented that investors perceived EBITDA, and revenue, as the most relevant performance measures. However, 76% of the respondents in the online experiment replied that they used depreciation, amortisation and interest when given the task of assessing firm performance.

## **Section 10: Question 13—Statement of Cash flows**

### ***Summary***

80. The existing flexibility in the classification choices in the cash flow statement allows managers to make opportunistic classification choices which may adversely impact financial statements' comparability.

### ***Detailed review of the academic evidence***

81. The studies examining the classification choices in the cash flow statement show diversity in the presentation of IFRS-reporting entities' classification of interest and dividend cash flows (Baik, Cho, Choi and Lee, 2016; Gordon, Henry, Jorgensen and Linthicum, 2017;

Kiaupaite-Grusniene and Alver, 2019). Researchers argue that because of the existing flexibility, managers make strategic classification choices.

82. Analysing a sample of 229 large UK firms for the year of IFRS adoption and the prior year, Charitou, Karamanou, and Kopita (2018) examined the determinants of the classification choice of interest paid in the statement of cash flow. They documented that two thirds of the entities classified interest paid in the cash flows from operating activities (CFOA) section and one third in the cash flows from financing activities (CFFA) section. They found that the classification choice was based on strategic incentives. Specifically, they reported that firms reporting losses, firms with a greater proportion of their debt stemming from public sources, firms with CFO-based covenants and greater increases in leverage in the year of IFRS adoption were less likely to report interest payments in cash flows from operating activities (CFOA). They further established that firms facing incentives to inflate their cash flows from operating activities were less likely to classify interest paid in the cash flows from operating activities section of the statement. The authors interpreted these results to be consistent with strategic classification choices.
83. Studying the determinants and consequences of the classification of interest paid, interest received and dividends on a sample of 798 IFRS-reporting firms from 13 European countries in the period 2005–2012, Gordon et al (2017) documented significant variation in classification across industries and most countries. They reported that 76%, 60%, and 57% of the sample classified interest paid, interest received, and dividends received, respectively, in operating cash flow (OCF). Only about 42% of the sample firms that reported all three items opted to classify all three in OCF. Analysing the determinants of the classification choice, Gordon et al (2017) found that firms with a higher likelihood of financial distress as well as those that issue more equity, had higher leverage, and were less profitable, were more likely to make classification choices that had the effect of increasing OCF. Their conclusions on the consequences of the classification choices, examining the market’s assessment of the persistence of OCF and accruals, showed that cash flow classification flexibility within IFRS created a non-comparability that was absent under the more rigid requirements of US GAAP.
84. Drawing from the academic evidence, in a comment letter by AAA, academics argued that eliminating the classification options would reduce the diversity in practice and also eliminate the possibility of strategic classification shifting. They also cautioned that the

proposal would introduce a break in the trend of operating cash flows over time and potentially reduce comparability with other jurisdictions, such as US GAAP.

**Appendix A—List of academic papers**

1. Aboody, D., Barth, M. E., and Kasznik, R. (2004), 'SFAS No. 123 stock-based compensation expense and equity market values', *The Accounting Review*, 79 (2), 251-75.
2. Anderson, S., Hobson, J., and Sommerfeldt, R. (2019), 'Auditing non-GAAP measures: Signalling more than intended', Working paper, University of Illinois at Urbana-Champaign.
3. Andersson, P. and Hellman, N. (2007) 'Does pro forma reporting bias analyst forecasts?', *European Accounting Review*, 16 (2), 277-298.
4. Ahmed, K. and Falk, H. (2006), 'The value relevance of management's research and development reporting choice: Evidence from Australia', *Journal of Accounting and Public Policy*, 25 (3), 231-64.
5. Athanasakou, V. E., Strong, N. C., and Walker, M. (2007), 'Classificatory income smoothing: The impact of a change in regime of reporting financial performance', *Journal of Accounting and Public Policy*, 26 (4), 387-435.
6. Aubert, F. and Grudnitski, G. (2014), 'The role of reconciliation quality in limiting mispricing of non-GAAP earnings announcements by EURO STOXX firms', *Advances in Accounting*, 30 (1), 154-67.
7. Baik, B., Cho, H., Choi, W., and Lee, K. (2016), 'Who classifies interest payments as financing activities? An analysis of classification shifting in the statement of cash flows at the adoption of IFRS', *Journal of Accounting and Public Policy*, 35 (4): 331-351.
8. Ball, R., Gerakos, J., Linnainmaa, J. T., and Nikolaev, V. (2015), 'Deflating profitability', *Journal of Financial Economics*, 117 (2), 225-48.
9. Balshaw, V. and Lont, D. (2010), 'New Zealand operating expense disclosure: The impact of international financial reporting standards on early adopters', *Pacific Accounting Review*, 22 (2), 108 - 23.
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16. Bhattacharya, N., Black, E. L., Christensen, T. E., and Mergenthaler, R. D. (2007), 'Who trades on pro forma earnings information?', *The Accounting Review*, 82 (3), 581-619.
17. Black, D. and Christensen, T. (2009), 'US managers' use of 'pro forma' adjustments to meet strategic earnings targets', *Journal of Business Finance & Accounting*, 36 (3-4), 297-326.
18. Black, D. and Christensen, T. (2018), 'Policy implications of research on non-GAAP reporting', *Research in Accounting Regulation*, 30, 1-7.
19. Bhattacharya, N., Black, E., Christensen, T., and Larson, C. (2003), 'Assessing the relative informativeness and permanence of pro forma earnings and GAAP operating earnings', *Journal of Accounting and Economics*, 36 (1-3): 285-319.
20. Black, D., Black E., and Christensen, T. (2014), 'The effects of executive compensation contracts and auditor effort on pro forma reporting decisions', Working paper, University of Georgia.
21. Black, D. E., Black E. L., Christensen, T. E., and Gee, K. H. (2017), 'The use of non-GAAP performance measures in executive compensation contracting and financial reporting', Working paper, University of Nebraska.
22. Black, D., Christensen, T. E., Ciesielski, J. T., and Whipple, B. C. (2018), 'Non-GAAP reporting: Evidence from academia and current practice', *Journal of Business Finance and Accounting*, 45 (3/4), 259-294.
23. Black, D., Christensen, T. E., Ciesielski, J. T., and Whipple, B. C. (2020), 'Non-GAAP earnings: A consistency and comparability crisis?', Working paper, University of Nebraska.

24. Bonner, S. E., Clor-Proell, S. M., and Koonce, L. (2014), 'Mental accounting and disaggregation based on the sign and relative magnitude of income statement items', *The Accounting Review*, 89 (6), 2087-2114.
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26. Bradbury, M., Laura, M., and Scott, T. (2020), 'The use of equity accounting in Australia', Working paper, Massey University.
27. Bradshaw, M.T. and Sloan, R. G. (2002), 'GAAP versus the street: An empirical assessment of two alternative definitions of earnings', *Journal of Accounting Research*, 40 (1), 41-66.
28. Bradshaw, M. T., Christensen, T. E., Gee, K. H., and Whipple, B. C. (2018), 'Analysts' GAAP earnings forecasts and their implications for accounting research', *Journal of Accounting and Economics*, 66 (1), 46-66.
29. Brockbank, B. G. (2017), 'Do non-GAAP exclusions impact the extent to which current returns reflect future earnings information?', Working paper, University of Oklahoma.
30. Brown, N., Elliott, W., and Grant, S. (2019), 'Gaming regulation with image-based tweets', Working paper, University of Illinois at Urbana-Champaign.
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34. Cascino, S., Clatworthy, M., Osma, B. G., Gassen, J., and Shahed, I. (2020), 'The Usefulness of financial accounting information: Evidence from the field', Working paper, London School of Economics.
35. Charitou, A., Karamanou, I., and Kopita, A. (2018), 'The determinants and valuation effects of classification choice on the statement of cash flows', *Accounting and Business Research*, 48 (6), 613-650.
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37. Chen, J., King, T. D., and Wen, M. (2015), 'Do joint ventures and strategic alliances create value for bondholders?', *Journal of Banking and Finance*, 58, 247-267.
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## Appendix B—Questions in Exposure Draft

- B1. Below are the questions included in the Exposure Draft for which we sought academic evidence. The Exposure Draft also included question 14, on other topics, for which we did not seek specific academic evidence.

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| <b>Question 1—operating profit or loss</b> |
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| Paragraph 60(a) of the Exposure Draft proposes that all entities present in the statement of profit or loss a subtotal for operating profit or loss. |
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| Paragraph BC53 of the Basis for Conclusions describes the Board’s reasons for this proposal. |
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| Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why? |
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| <b>Question 2—the operating category</b> |
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| Paragraph 46 of the Exposure Draft proposes that entities classify in the operating category all income and expenses not classified in the other categories, such as the investing category or the financing category. |
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| Paragraphs BC54–BC57 of the Basis for Conclusions describe the Board’s reasons for this proposal. |
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| Do you agree with this proposal? Why or why not? If not, what alternative approach would you suggest and why? |
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| <b>Question 3—the operating category: income and expenses from investments made in the course of an entity’s main business activities</b> |
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| Paragraph 48 of the Exposure Draft proposes that an entity classifies in the operating category income and expenses from investments made in the course of the entity’s main business activities. |
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| Paragraphs BC58–BC61 of the Basis for Conclusions describe the Board’s reasons for this proposal. |
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| Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why? |
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**Question 4—the operating category: an entity that provides financing to customers as a main business activity**

Paragraph 51 of the Exposure Draft proposes that an entity that provides financing to customers as a main business activity classify in the operating category either:

- income and expenses from financing activities, and from cash and cash equivalents, that relate to the provision of financing to customers; or
- all income and expenses from financing activities and all income and expenses from cash and cash equivalents.

Paragraphs BC62–BC69 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

**Question 5—the investing category**

Paragraphs 47–48 of the Exposure Draft propose that an entity classifies in the investing category income and expenses (including related incremental expenses) from assets that generate a return individually and largely independently of other resources held by the entity, unless they are investments made in the course of the entity's main business activities.

Paragraphs BC48–BC52 of the Basis for Conclusions describe the Board's reasons for the proposal.

Do you agree with the proposal? Why or why not? If not, what alternative approach would you suggest and why?

**Question 6—profit or loss before financing and income tax and the financing category**

- (a) Paragraphs 60(c) and 64 of the Exposure Draft propose that all entities, except for some specified entities (see paragraph 64 of the Exposure Draft), present a profit or loss before financing and income tax subtotal in the statement of profit or loss.
- (b) Paragraph 49 of the Exposure Draft proposes which income and expenses an entity classifies in the financing category.

Paragraphs BC33–BC45 of the Basis for Conclusions describe the Board's reasons for the proposals.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

**Question 7—integral and non-integral associates and joint ventures**

The proposed new paragraphs 20A–20D of IFRS 12 would define 'integral associates and joint ventures' and 'non-integral associates and joint ventures'; and require an entity to identify them.

Paragraph 60(b) of the Exposure Draft proposes to require that an entity present in the statement of profit or loss a subtotal for operating profit or loss and income and expenses from integral associates and joint ventures.

Paragraphs 53, 75(a) and 82(g)–82(h) of the Exposure Draft, the proposed new paragraph 38A of IAS 7 and the proposed new paragraph 20E of IFRS 12 would require an entity to provide information about integral associates and joint ventures separately from non-integral associates and joint ventures.

Paragraphs BC77–BC89 and BC205–BC213 of the Basis for Conclusions describe the Board's reasons for these proposals and discuss approaches that were considered but rejected by the Board.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

**Question 8—roles of the primary financial statements and the notes, aggregation and disaggregation**

- (a) Paragraphs 20–21 of the Exposure Draft set out the proposed description of the roles of the primary financial statements and the notes.
- (b) Paragraphs 25–28 and B5–B15 of the Exposure Draft set out proposals for principles and general requirements on the aggregation and disaggregation of information.

Paragraphs BC19–BC27 of the Basis for Conclusions describe the Board’s reasons for these proposals. Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

**Question 9—analysis of operating expenses**

Paragraphs 68 and B45 of the Exposure Draft propose requirements and application guidance to help an entity to decide whether to present its operating expenses using the nature of expense method or the function of expense method of analysis. Paragraph 72 of the Exposure Draft proposes requiring an entity that provides an analysis of its operating expenses by function in the statement of profit or loss to provide an analysis using the nature of expense method in the notes.

Paragraphs BC109–BC114 of the Basis for Conclusions describe the Board’s reasons for the proposals.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

**Question 10—unusual income and expenses**

- (a) Paragraph 100 of the Exposure Draft introduces a definition of ‘unusual income and expenses’.
- (b) Paragraph 101 of the Exposure Draft proposes to require all entities to disclose unusual income and expenses in a single note.
- (c) Paragraphs B67–B75 of the Exposure Draft propose application guidance to help an entity to identify its unusual income and expenses.
- (d) Paragraphs 101(a)–101(d) of the Exposure Draft propose what information should be disclosed relating to unusual income and expenses.

Paragraphs BC122–BC144 of the Basis for Conclusions describe the Board’s reasons for the proposals and discuss approaches that were considered but rejected by the Board.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?

**Question 11—management performance measures**

- (a) Paragraph 103 of the Exposure Draft proposes a definition of ‘management performance measures’.
- (b) Paragraph 106 of the Exposure Draft proposes requiring an entity to disclose in a single note information about its management performance measures.
- (c) Paragraphs 106(a)–106(d) of the Exposure Draft propose what information an entity would be required to disclose about its management performance measures.

Paragraphs BC145–BC180 of the Basis for Conclusions describe the Board’s reasons for the proposals and discuss approaches that were considered but rejected by the Board.

Do you agree that information about management performance measures as defined by the Board should be included in the financial statements? Why or why not?

Do you agree with the proposed disclosure requirements for management performance measures? Why or why not? If not, what alternative disclosures would you suggest and why?

**Question 12—EBITDA**

Paragraphs BC172–BC173 of the Basis for Conclusions explain why the Board has not proposed requirements relating to EBITDA.

Do you agree? Why or why not? If not, what alternative approach would you suggest and why?

**Question 13—statement of cash flows**

- (a) The proposed amendment to paragraph 18(b) of IAS 7 would require operating profit or loss to be the starting point for the indirect method of reporting cash flows from operating activities.
- (b) The proposed new paragraphs 33A and 34A–34D of IAS 7 would specify the classification of interest and dividend cash flows.

Paragraphs BC185–BC208 of the Basis for Conclusions describe the Board's reasons for the proposals and discusses approaches that were considered but rejected by the Board.

Do you agree with the proposals? Why or why not? If not, what alternative approach would you suggest and why?