Meeting Notes—CMAC Meeting

The Capital Markets Advisory Committee (CMAC) held a hybrid meeting on 17 March 2022, broadcast from the London offices of the International Accounting Standards Board (IASB).

Members discussed these projects:

- IASB update, including:
  - Agenda Consultation
  - ISSB
- Primary Financial Statements (paragraphs [1–24])
- Non-current Liabilities with Covenants (paragraphs [25–33])
- Supplier Finance Arrangements (paragraphs [34-42])

Primary Financial Statements

1. The purpose of this session was to obtain feedback from CMAC members to help the IASB's future discussions on:

   a. the proposed requirements for an entity to disclose operating expenses by nature in the notes if that entity reports operating expenses by function in the statement of profit or loss; and

   b. the definition of 'unusual income and expenses'.

2. The staff provided CMAC members with an overview of:

   a. the proposed requirements in the Exposure Draft *General Presentation and Disclosures* (Exposure Draft) for an entity that reports expenses by function in the statement of profit or loss to disclose an analysis of expenses by nature in the notes. The staff also summarised the feedback on these proposed requirements.

   b. an alternative (partial matrix) approach the IASB could consider and the feedback on this approach. The staff provided an overview of two different versions of a partial matrix:

      i. Partial Matrix 1: the IASB specifies the expenses by nature to be disaggregated by function (for example, how much employee benefits is included in cost of sales); and

      ii. Partial Matrix 2: the IASB specifies the functions to be disaggregated by nature (for example, which expenses by nature are included in cost of sales);

   c. the proposed definition of 'unusual income and expenses', feedback on this definition and the IASB's redeliberations so far. The staff overview focused on two potential objectives for the definition of unusual items:

      i. ensuring all 'unusual' items are identified; or

      ii. preventing recurring items from being portrayed as 'unusual'.

3. CMAC members commented on:

a. disclosing operating expenses by nature in the notes, specifically:

   i. the approach that would provide CMAC members with more benefits (the Exposure Draft proposal or the partial matrix approach) (paragraphs 4–8);

   ii. the version of a partial matrix that would be more beneficial for CMAC members (paragraphs 9–12); and

   iii. other comments (paragraph 13);

b. unusual income and expenses, specifically:

   i. how CMAC members would use the information about unusual income and expenses (paragraphs 14–15);

   ii. the importance of disclosing information in a single note and using the label ‘unusual’ for the defined items (paragraphs 16–17);

   iii. the basis for the definition of ‘unusual income and expenses’ and how information about unusual income and expenses will be used (paragraphs 18–19); and

   iv. other comments (paragraphs 20–23).

Disclosing operating expenses by nature

Approach that would provide CMAC members with more benefits

Exposure Draft proposal

4. One member agreed with the requirements proposed in the Exposure Draft because these would:

   a. enable users of financial statements to compare an entity that reports expenses by function with an entity that reports expenses by nature in the statement of profit or loss; and

   b. provide the totals of depreciation and amortisation necessary to calculate EBITDA.

5. One member explained that they obtain total depreciation and amortisation from the statement of cash flows if an entity uses the indirect method.

Partial matrix approach

6. Most members said having a better understanding of the composition of (some) functions would benefit forecasting and help them to understand an entity’s cost drivers—thus, supported a partial matrix approach. However, they also said that it would be most beneficial if an entity were to give entity-specific material information (a full matrix), rather than the IASB specifying the expenses by nature to be disclosed by function, or the functions to be disaggregated into expenses by nature.

7. Some members acknowledged that a full matrix would be prohibitively costly for preparers, whereas a few members questioned whether the costs would be as high as preparers suggested.

8. IASB members and staff summarised feedback from preparers on the costs of providing a full matrix:

   a. this information is not tracked at the group level;

   b. the costs are charged to cost centres at the entity level, but entities report functional line items to the parent entity for consolidation purposes—hence, it would be necessary for preparers to collect information on expenses by nature manually (for example, through subsidiary reporting packages);

   c. recharging of costs between different entities of a group and within an entity leads to a loss of information on these costs.

Version of a partial matrix that would be more beneficial for CMAC members

9. Overall, CMAC members expressed mixed views about the preferred version of a partial matrix. One member said that the question of which version provides users with more benefits is likely to depend on the entity's business model and the industry in which it operates. (For example, Partial Matrix 1 would be more beneficial when analysing asset-heavy entities whose expenses are mostly depreciation and employee benefits, whereas Partial Matrix 2 would be more beneficial when analysing an entity in the software as a service business whose expenses are mostly costs other than depreciation and employee benefits.)

Partial Matrix 1

10. Most members said that disaggregated information on depreciation, amortisation and employee benefits by function was useful, but some expressed concerns about a loss of material information because Partial Matrix 1 would result in some entities not disclosing material information (that is, for some entities, disclosing only depreciation, amortisation and employee benefits by function would lead to functions not being sufficiently explained).

11. A few members said that having as much information as possible on depreciation, amortisation, and employee benefits is important to them—thus, they preferred Partial Matrix 1. One of these members explained that they want to strip out depreciation, amortisation and employee benefits when modelling functions.

Partial Matrix 2

12. Many members said Partial Matrix 2 has important benefits, including:

   a. it is similar to the models that analysts use for forecasting (members explained that analysts forecast functions, but lack information on the expenses by nature included in these functions).

b. it would allow users to better understand the composition of functions. Members emphasised that:

   i. there is diversity in practice with regards to what entities include in cost of sales and understanding the composition of cost of sales is important—for example, when forecasting an entity's gross margins or comparing various entities' gross margins (because information on the composition of functions allows users to adjust gross margins); and

   ii. more granularity on selling, general and administrative costs/expenses (SG&A) would also be helpful (one member said that separating ongoing general and administrative costs/expenses from advertising and marketing costs/expenses that relate to future sales was important).

c. it would make digital consumption easier because disaggregated items would add up to the total (functional line item).

d. it would give insights into changes in cost drivers (for example, changes in cost drivers could lead to an entity having to disclose specific (material) expenses by nature that were previously not disclosed due to them being immaterial).

Other comments

13. A few members said that narratives could complement quantitative information, but that quantitative information is crucial for users (in particular, when calculating metrics). One member explained that it would be enough for users if narrative information came with estimations rather than precise amounts (for example, if an entity discloses the percentage of depreciation in cost of sales). One IASB member said that entities would be reluctant to disclose estimations due to the management's legal responsibility for the information in financial statements.

Unusual income and expenses

Using information about unusual income and expenses

14. CMAC members described various ways they would use information about unusual items, including:

   a. as an input for their forecasts;

   b. to help them better understand the entity's performance; and

   c. as a screening tool to help them to assess the quality of earnings.

15. Many members commented on the importance of a narrative description of the unusual income or expenses, especially an explanation of why the item was unusual and whether (and, if so, when) it had occurred in previous periods.

Importance of disclosing information in a single note and using the label 'unusual' for the defined items

16. All members agreed that the information should be disclosed in a single note. If the information were included in varied locations, it could be hard to find, and comparing various entities' information could be difficult.

17. Some members commented that it was important that entities were disciplined in using the label 'unusual'. Describing income and expenses that recur routinely as unusual could be misleading.

Basis for the definition of 'unusual income and expenses'

18. Some members preferred a broad definition that would capture a wide range of non-recurring items. They wanted information about such items, not just a narrow set of highly exceptional items. Users are also looking for information about varied things, depending on their needs. A broad definition would enable users to choose which items they would exclude from an ongoing earnings calculation. However, a few members would prefer the definition to focus on preventing recurring items from being portrayed as 'unusual'.

19. On the specific topics raised by the IASB staff:

    a. some members said the definition should include income and expenses that have occurred in the past (as proposed in the Exposure Draft). A member gave an example of natural disasters that might have occurred in a recent annual financial reporting period, but should still be deemed to be unusual if they occurred again in the current period.

    b. most members said the definition should include income and expenses that occur in a few annual periods (rather than just the current period, as proposed in the Exposure Draft). Some members said information about when such items had occurred in the past and for how long they were expected to continue in the future would be important.

Other comments

20. Some members commented on the relationship between unusual income and expenses as defined by the IASB and items excluded from management performance measures:

    a. one member said that there would not be a loss of information if the IASB establishes a narrow definition of unusual items because items not defined as 'unusual' would be identified in the management performance measures.

    b. other members did not want to rely on items being picked up by management performance measures because those measures were decided by the entity, and information about unusual income and expenses could be lost if the entity did not use management performance measures to report on them.

    c. other members said that useful information was provided by comparing unusual income and expenses as defined by the IASB and items excluded from management performance measures.

21. A few members stressed the importance of applying the definition consistently in different accounting periods.

22. One member suggested a more restrictive definition for ‘unusual expenses’ and a broader definition for ‘unusual income’.

23. One member suggested including information on tax and non-controlling interests for each unusual item.

Next steps

24. The IASB will consider feedback from CMAC members when it redeliberates the proposals at a future IASB meeting.

Non-current Liabilities with Covenants

25. The purpose of this session was to seek CMAC members’ views on the Exposure Draft *Non-current Liabilities with Covenants*, which proposes amendments to IAS 1 *Presentation of Financial Statements*. The staff provided an overview of the Exposure Draft before asking members whether they agreed with the IASB’s proposals on:

    a. *classification of liabilities as current or non-current*—only covenants with which an entity must comply on or before the reporting date would affect a liability’s classification as current or non-current.

    b. *separate presentation*—an entity would be required to present separately in its statement of financial position non-current liabilities subject to compliance with covenants within 12 months after the reporting date.

    c. *disclosure of information about covenants*—an entity would be required to disclose information that enables investors to assess the risk that the liability could become repayable within 12 months, including:

        i. the covenants (their nature and the date on which the entity must comply with them);

        ii. whether the entity would have complied with the covenants at the reporting date; and

        iii. whether and how the entity expects to comply with the covenants in the future.

Feedback on the proposals

Overall support

26. CMAC members generally supported the IASB’s proposals in the Exposure Draft.

Classification of liabilities as current or non-current

27. One CMAC member said that the proposals were an improvement over the existing requirements. Another CMAC member said that the provision of information about covenants in the notes was more important than the classification of liabilities as current or non-current.

Separate presentation

28. A few CMAC members said that separate presentation of non-current liabilities subject to covenants could be helpful, while others said that the proposal might capture too many liabilities (because many liabilities are subject to covenants).

Disclosure of information about covenants in the notes

29. CMAC members supported the proposal to require disclosure of information about covenants. A few CMAC members said that investors need all three specific pieces of information that the Exposure Draft's proposals would require an entity to disclose (see paragraph 1(c) above)

30. A few CMAC members said that the proposed requirement to disclose information about whether and how an entity expects to comply with the covenants in the future would be very helpful. One CMAC member said that entities are expected to provide granular information about how they expect to comply with covenants. Another CMAC member would also want information about an entity's available headroom in meeting its covenant requirements. One CMAC member, however, said that it might be difficult for an entity to say exactly how it expects to comply with its covenants.

31. One CMAC member suggested that providing information about covenants could be commercially sensitive in some cases. Another CMAC member said that it might be necessary to explain that a breach of a covenant would not necessarily result in early repayment, but in a renegotiation of the liability's terms.

32. In responding to the question of whether the proposed requirements should be focused on covenants with a higher risk of non-compliance, one CMAC member said that it would be difficult to specify a risk threshold. However, the member said information about covenants would not be needed if covenant breaches would not have a significant impact on the entity.

Next Steps

33. The staff will consider CMAC members' comments together with the feedback on the Exposure Draft and present a summary to the IASB.

Supplier Finance Arrangements

34. In November 2021 the staff gave CMAC members an overview of the IASB's (then forthcoming) Exposure Draft *Supplier Finance Arrangements* and asked for preliminary feedback from members.

35. The objective of this session was to seek further feedback from CMAC members on whether the proposed disclosures would enable investors to assess the effects that supplier finance arrangements have on an entity's liabilities and cash flows.

Proposed disclosure requirements

36. A few CMAC members suggested that requiring disclosure of a weighted average or distribution of payment due dates would be more useful than a range of payment due dates.

37. A few CMAC members also said that the proposed disclosures would be most helpful if they were provided for multiple years. Such a requirement would, they said, facilitate comparison and meaningful trend analysis of the effect of supplier finance arrangements on an entity's cash flows. One member asked whether the IASB had also considered requiring the proposed disclosures in interim financial statements.

38. A CMAC member suggested that disclosure of the terms and conditions of each arrangement should include information about its total and undrawn capacity and expiry.

Additional disclosure requirements

39. A few CMAC members said that the disclosure requirements should include a roll forward (reconciliation) of the carrying amount of the financial liabilities that form part of the arrangement. One member explained that this information (if it were to identify cash flows paid in the period that would otherwise have been paid in the previous period) would enable an investor to understand the net operating cash flow benefit generated by the arrangement. Another member added that this information enables investors to understand the effect of other transactions—for example, the addition of supplier finance arrangements brought in through a business combination—on the change in the carrying amount of an entity's liabilities.

40. A few CMAC members suggested requiring disclosure of the funding cost of the arrangement, in particular when the interest rate is higher than a standard borrowing rate or the rate would make the arrangement attractive to suppliers.

41. A CMAC member said that an entity should be required to disclose the identity of its finance providers (such as its top five or 10 finance providers) because this information provides insight into the possible nature and risk of the arrangement. The same member also suggested that, in relation to liabilities that are part of an arrangement, an entity should be required to disclose them separately within the maturity analysis required under IFRS 7 *Financial Instruments: Disclosures*.

Next Steps

42. The staff will consider CMAC members' comments together with the feedback on the Exposure Draft and present a summary to the IASB.

Next meetings

The next CMAC meeting will be held jointly with GPF on 16–17 June 2022.