Better disclosure- how to judge material items on IFRS Financial Statements?

Responding to IASB research project “Disaggregation-aggregation material”

IFRS Digital Reporting Workshop 13th

Date and time：5 Mar 2018, 18:30-20:00 (Tokyo time)

& **2nd User Workshop for IFRS financial statements**

Mar 12th 2018, 16:00-17:30 (Hong Kong)

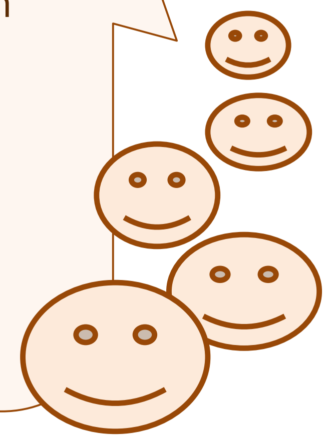
Why IFRS financial statements have disaggregation issue?

The IASB plans to conduct research on issues of aggregating accounting items without necessary detail (disaggregating) disclosure on financial statements. This is the theme that we have mostly dealt with in the past workshops. Not only in Japan, the first user workshop in Hong Kong last year, the issue of “'other operating expenses‘ being too large without detail in footnotes” was discussed. At that time attendees discussed various potential causes, such as IAS1, practice guideline, templates, numerical threshold etc... However the gap in understanding "what is material" between companies and investors is a big issue.

We have seen cases where information necessary for analysis are not disclosed in the breakdown of operating expenses, and a big number is disclosed, without its breakdown table in the footnote, as accounting item named "other“.

In the past workshops we discussed about them and sent messages to the IASB. There is a disclosure option in expenses disclosure in IFRS, and companies think that they can choose one. By Function and By Nature, or their mixed, disclosed as one detailed table from the sum of SGA. In this case, it becomes difficult to understand detailed table, and "the other" becomes big number. We also sent an opinion that threshold should be introduced to make disclosure more granular, and specific accounting items should be added on IAS 1. What surprised us is that IASB's new research is trying to solve them!!

However, at the same time, some investors believe that most important disclosure should be focused on what is material for company, not threshold, not certain items.



Attendees	13th workshop in Tokyo	2nd workshop in Hong Kong
Categories	12 Investors, 7 sell-side analyst/ Information provider/Media/Researcher, 6 CPA, 4 Company side, 1 Academic, 3 Regulator/Accounting setter/Analyst organization. Some oversea attendees via phone	6 investor, 2 information provider, 3 analyst organization, 5 accounting setters Some oversea attendees via phone

Discussion in past workshop in Tokyo

- At previous workshop, we discussed the company which adopted IFRS two years ago. In the first year expense details were disclosed by Function. However in the second year it switched to by Nature, and **"Other operating expenses" became big** number. The detailed disclosure **by Nature is not connected** to each account items on PL. The total is the sum of several account items. So even if detailed account items are disclosed, we cannot distinguish them corresponding to each items on PL. As a result, **SG & A and COGS cannot be separated**. Besides, all other numbers are gathered to "other operating expenses".
- Even if IFRS is applied, information providers need to set data as same as J-GAAP so that user can compare any companies in the same way.

▼Change Footnote disclosure

FY 2015		FY 2016	
18	Other comprehensive invome	19	Other comprehensive invome
19	Expense of SG&A		
		20	By nature classification of income and expenses
20	Employee benefits expense	21	Employee benefits expense
21(1)	Other income and expenses		
21(2)	Financial income and expenses	22	Financial income and expenses
22(1)	Deferred taxes	23(1)	Deferred taxes
22(2)	Income taxes	23(2)	Income taxes

※ Gray sections are detail disclosure of P&L

▼Merit of threshold

J-GAAP	Detailed requirement on items to be presented in P&L.（Requirements on presentation items and their classification, requirement to present an item larger or equal to 1/10 of net profit.）
IFRS **(IAS1.82)**	Requirement on minimum items to be presented in P&L, and no requirement on threshold of separate presentation. Entity shall present additional line items that are relevant.
Difference	Information which can be acquired in J-GAAP based P&L cannot be acquired in IFRS based P&L, and need to refer to the notes.

J-GAAP	Detailed requirement on items to be presented in BS.（Requirements on presentation items and requirement to present an item larger or equal to 1/100 of total assets.）
IFRS **(IAS1.54)**	Requirement on minimum items to be presented in BS, and no requirement on threshold of separate presentation. Entity shall present additional line items that are relevant.
Difference	Information which can be acquired in J-GAAP based BS cannot be acquired in IFRS based BS in many cases, and need to refer to the notes.（Because presentation items in IFRS based BS tend to be less granular than J-GAAP based BS, and have original line item names）

Discussion in past workshop in Hong Kong

“For the case about operating expense, in the footnote of other gain, there is a big impairment of investee company of (2,373) and gain on disposal of 3,813. We classify whether operating / non-operating and remove them individually from "other gain". This case, expense is disclosed by nature, and do not explain what is operating, so we have to classify ourselves.
However, this case is good to have disaggregation in the other part of financial report, under the Fixed Asset table, how depreciation is allocated into Cost of revenue and Cost of SG&A. CF and BS are both standardized quite well. Sometimes, there are items to be removed in our definition for cash and cash equivalent.

I have a complaint that company always try to have minimum disclosure. What kind of guideline should be needed for appropriate disaggregation?

It should be written on the Standard itself. Currently IAS 1 only indicate minimum, so when additional disclosure is required, we need to override IAS 1. That is difficult to do for Auditors.

One possibility could be industry specific disclosure (template). If there is one, it can be easily understood. If standard-setters could do some research on what is commonly disclosed in certain industry, than you will see that there are some comparable information in the same sector.

Usually ‘by function’ is good for comparison. But some business is good to compare ‘by nature’. In my company’s case, basically we use ‘by function’, this is the traditional way

"Other" seems to be the problem of materiality in the standard. It is better to have certain percentage such as 5% or 10%. Some rule is always needed under principles-based standard.

When disclosed by nature, there sometimes have a large "other operating expense".

The levels of materiality by companies and auditors are different from investors. The other day, in an engagement with a company, we said the number is material, and company and auditor said no because it is only few percent, though the number itself was big. This happens in major companies.

I understand that IAS 1 clearly requires material items to be disclosed separately. It is also needed for the companies to disclose so that they are comparable with other companies.

Discussion1,
“By Nature? By function? Makes difficult to grasp COG and SG&A?

Issue 1: Method of disaggregation used for the analysis of expenses

Questions – Issue 1

1. Which is the analysis of expenses methodology (function and/or nature) that investors in your jurisdiction prefer and why?

2. Do investors or analysts have any problems with the by-function or by-nature analysis being produced by companies? Do you have any suggestions about how this analysis could be improved?

Issue 2: Disaggregation of line items

Questions – Issue 2

1. Could you give us examples of when you have found that information in the primary financial statements is too highly aggregated. What problems has this caused for your analysis? In our review of financial statements we observed that cost of goods sold (COGS) and Selling, General and Administrative Expenses (SG&A) are line items in the statement of financial performance that tend to be highly aggregated.

Discussion1 in Tokyo…

Company has different nature of the business…in consolidated bases.

In our PL, each "Revenue" and "Cost of Revenue" are disclosed with three detailed items by Nature. There is "gross profit" at one line below, then SG & A. **Usually, "Cost of revenue" is variable cost, "SG & A" is fixed cost in case of our company.** Detailed tables of SG & A are disclosed in the footnote. We disclose two detailed tables as different types of SG & A; by nature based and per segments. We disclose two costs separately on PL (Cost of Revenue and SG & A), so we can separate details of them as well. This probably comes from the disclosure rules in Japan. Originally we disclosed in J-GAAP like this.

Company M's IR person

However**, "other expenses" is over 20% of the total,** what is included in this? Just small items?

Investor

The expense disclosure by nature is useful for calculating fixed and variable cost. When analysts make forecast, fixed / variable ratio is needed. **But when one company has many businesses with different nature as it is now,** I wonder if the expense disclosure by nature is really useful. Perhaps by function would be more useful to evaluate a company.

Analyst

Frankly speaking, the numbers in the financial statements of Company M, I do not think that it is useful. For example, their business's nature are trading, manufacturing, and mining, but how the nature of those business are included in the three items, such as 'cost of products sold', 'cost of service rendered', and 'cost of other revenue', there is no information about it. Same for the Revenue. We can certainly see breakdown of SG & A with this disclosure**, but it is difficult for analysts to make business forecasts using it.**

Investor

Discussion1 in Hong Kong…

Analyst usually focus on "operating or non-operating", so needs both.

In HK we have 1920 companies issuing annual report. Over 1600 companies are reporting SG&A or G&A on FS. Most of the companies are reporting by function because of market consensus, they are used for analyst report. From our experience, most analysts are using by function for evaluation of companies. At the same time, they need some separated items to calculate EBIT or EBITDA. However some companies' disaggregation are not very well. Whole HK and APEC companies, actually we cannot compare line items sometimes, because each definition are different, or having different breakdown items. Besides some company does not have consistent items.

The company discloses expense on PL by function. But for disaggregation on notes, all expenses above Profit before tax are disclosed by nature. some company disclose items are from total of cost of revenue, other expense, and financial cost, in detail table. So analysts have no idea how they should allocate for operating / non-operating section. In that case we have to ask IR section about it. **Analysts usually focus on distinguishing operating or non-operating,** because they are needed for calculation of EBIT, EBITDA. So, items clearly distinguish operating / non-operating are needed. Also consistent disaggregation. I hope that IFRS requires company to increase consistency.

Information provider

Analyst

About by function and by nature, we need both, **because items by nature makes us understand the company more.** Now we have better technology, so we look forward to that.

Why IASB is asking us 'by function, or by nature'. I think we, in the room would **probably say 'both'.** And for each company 'by nature' is different....quite difficult to understand for investors....

Investor

It was difficult in the past. **But with current technology, it is possible to disclose both.** But why preparers are reluctant to do that? Because they may think that disclosure would damage their competitive advantage, if users can compare clearly. They prefer to disclose by nature rather than by function. They give those information to management every day.

Discussion2,
Threshold? Minimum items as a MUST disclose?

Issue 3. Thresholds to prevent over aggregation

Questions – Issue 3
1. Do you think we should consider developing thresholds to prevent the over aggregation of line items? If so, could you suggest any specific thresholds? 2. Do you have in mind any particular line items to which thresholds could apply?

Issue 4. Minimum line items

Questions
1. What is your view about requiring more minimum line items in the statement(s) of financial performance (besides the ones already required by paragraph 82 of IAS 1)? For example, major expense lines in the by function/by nature analysis of expenses. 2. Do you think that the staff should identify additional minimum line items for the statement(s) of financial performance by considering line items that are commonly-reported across entities? Do you have any more suggestions about how we could identify additional minimum line items? 3. What is your view about developing high-level illustrative primary financial statements (ie templates) for a small number of industries (for example, banks, non-financial institutions, insurance companies and investment property companies)?

Discussion2 in Tokyo…

Thresholds and specific items should be considered, but "materiality" too.

We have seen in some cases, IFRS based FS tend to have **other income / expenses larger** than those of J-GAAP. Under IFRS assets and liabilities should not be netted unless requested or permitted. But there are cases in which items are netted because they are not material. **Items immaterial for management does not necessary mean that it is immaterial for investors.** Company should disclose detailed information enough so that investors can make same judgment on immateriality.
Even for the items required by IAS 1, different order of presentation by companies may mean different definition. There are cases where the equity method gains or losses are included or not included in operating income. **Defining items to disclose and introducing thresholds is one of the ways** to make the disclosure more detailed. It would take time to revise IAS 1, but introducing thresholds is probably faster.

Information provider

For comparison, users usually adjust operating profit, **extraordinary income/loss** are excluded. Users need to identify those data.

- Acquired In-Process R&D
- Disposal of Assets
- Asset Write-Down
- Impairment of Goodwill
- Impairment of Intangible Assets
- Sale of Business
- Unrealized Investments
- Merger Expense
- Restructuring Expense
- Insurance Settlements
- Legal Expense
- Other One Time Items

Important to disclose thresholds and specific subjects, but materiality is also important. When a company starts a new business with acquisition, we want to know **what is really happening**. The new business could be small, the detail and why the company thinks it is important.

Investor

Each jurisdiction has local regulation and company would inherit it, so that the presentation could be different between each jurisdiction. **Even if IFRS introduce a threshold, each regulator would still have other thresholds**, and company has to comply with two different requirements?

Accounting Setter

We should not forget about the **Fair Disclosure Rule** with the problem of insider information, as we look at the financial statements day by day. Mandatory disclosure of items should be set by regulator or other authority. Because we cannot ask companies to tell items that are not disclosed under the FD Rule, **only information that is forced to disclose will eventually become available.**

Investor

Discussion2 in Hong Kong…

Thresholds and materiality are very much different on industrial bases.

In case of HK, we do not see company reporting other operating expense that exceeds 10 % of total revenue. But it made me a little surprised, if we compare it with SG&A or net profit that attribute to common shareholder, things are different. I think introduction of threshold is good, because currently no rule in HK and it happens that other operating expense becomes 100% of net profit.

Analysts are focusing operating or not-operating. So we provide 2 sets of data, general company reporting revenue, gross profit, operating income, profit before tax. And we provide “adjusted operating income". Many analyst report, they use EBIT, or EBITDA, so we provides it for calculating them.

How we adjust special company case is, **Bank, Finance, Utilities, Real estate, Investment trust, we see industrial specific FS.** Financial companies generally do not display current asset / liability on Balance sheet. I think that financial companies reported total revenue and other income. They are 'bank' items and lost consistency. Other income is included but it is not like other companies.

Information provider

When company profit was very low, the other operating expense would be 100% of net profit. So for investors, **regulator could say that the other operating expense should be smaller than 10% of total expense**. In that case, as long as size of net profit, we could have certain granularity for expense. I also agree with developing certain template for special industries. **IASB should set up to clear guideline for what they need to disclose**, it also valuable to know what investor need to asses companies.

Investor

About 10% issue. I have a concern that company will think down only by figures. But investors often look more at qualitative side. **Even if the number is 1 %, for investor’s perspective, maybe it is extremely material depending on what this 1% is related to**. So I think maybe it is useful to have 10% as a starting point of discussion. I'm not really sure that management have the data when he has discussion with shareholders. They really need to decide what is material, and to share it with shareholders, we give him this level of disclosure is sufficient for you, when you look at particular company, or particular market sector, at least relevant. I think that management has a different view, as much more quantitative view for materiality than investors.

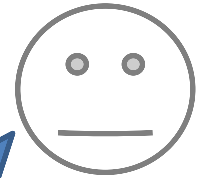
Thresholds and materiality are very different on industrial bases. I think it would be useful for each industry to have a different peer benchmark. The thresholds should also be different for each industry. Another point is that when we look at materiality, figures itself is of course important, but what we should put **as the denominator is also important.** For example if we use 'total expenses‘ as the denominator, then when the profit goes down, which is when investors would want a closer look at the financials, the “total expenses” figure is usually larger, so if with a set percentage, it will automatically push up the threshold in this case.

Investor

Materiality of Disclosure

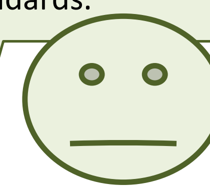
What is the material for management is sometimes different from the idea of investors

Investors said "they are disclosing large numbers as others", but for company, it is only an aggregation of small number items. The problem is related to **whether these pieces of information are material and what it means to be 'material'.** Is it just the matter of percentage? Whether it is necessary for investment decision-making or not? On the other hand, if you do business in various areas, expense should include various things. This is where there are conflicts in companies.



Accounting Setter

There is not much difference in the concept of materiality between management and auditor. The difference only appears in **professional skepticism.** Due to it, auditors may have a different view from the management. Managements tend to be optimistic, because they are running their business. On the other hand, auditor is also required to exercise professional skepticism when examining whether management assumption is appropriate or not. Difference of views regarding whether particular information is material. Nevertheless, the concept of materiality does not differ in accounting standards and auditing standards.

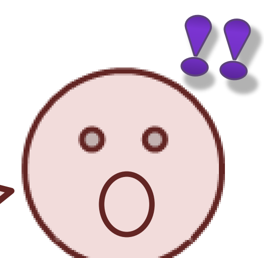


Auditor

What is the material for management is sometimes different from the idea of investors. So what we need is to have **more dialogue** enough between companies, investors, and other stakeholders, to find **how much different aspects of materiality** we have. The IASB probably adds items that seem to be responsible for explanation to shareholders and other stakeholders by management on standards, as well as 'how to decide materiality'.
FS lack the viewpoint of proper explanation of the meaning of each items. Even though big "other" contain many small items, managers should be able to explain at least what happened. If this number is 20% of the total SG & A, obviously big.

Investor

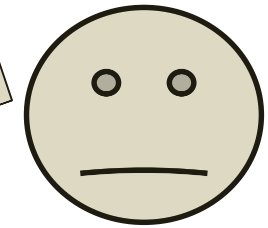
I would like to comment on the "Other" item. When I talked to a company, the company did not disclose Water nor Sewage because separately they are less than 5 % of total, even though the sum of Water and Sewage is large enough (They have factories). Company can make excuse of "not to disclose" as much as they can. Even if the ratio is small, if the company is able to obtain information about it, we want to know.



Investor

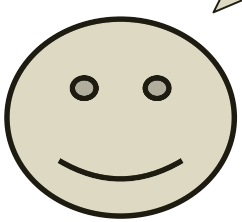
How Operating profit should be provided?

We are an e-commerce company. We provide **Non-GAAP Operating income as relevant and useful performance information.** We also disclose same non-GAAP operating income as segment profit and loss. We provide the reconciliation of this Non-GAAP operating income and GAAP operating income. We are adding three items back to GAAP operating income. This figure is more consistent when **making comparisons within the group, other companies in the same industry, and for historical comparisons, as well as for making estimate of future performance.** We need to compare with US companies. For that purpose, the items we should expect are 'Stock based compensation' and 'amortization of intangible assets related to acquisitions of some companies'.
I think that it is complicated, but if IFRS based Operating income is sufficient as a performance indicator, we do not need to disclose Non -GAAP measure on the financial statements.



Company Accounting Department

Having only one definition for operating profit in the standard and comparing globally is difficult. **One of our main businesses is LNG oil field in Qatar. This company cannot be held completely.** We have only 3 percent. According to IFRS, **it is only increasing the value of investment in OCI**, in the lower part of PL. **But this is our main business.** I think that your image of operating income should include the benefit of Oilfield, but actually it is not included. However, it has the most influence on our business. As a result, the 'operating profit' is different from what actual business of the company is.
I would like to show another example. The iron mining business is also our main business. We have an iron mining field in Australia, which we hold 100%. We are mining and shipping the products to China. The profit is recorded as a trading profit in our consolidated financial statements so it is included in operating profit. They are seen on PL in a completely different way, but both are our main business. Therefore, we need to consider how to represent our business expressing as operating income.



Company Accounting Department

Conclusion and Message…

Discussion1

- Why ‘By nature’ or ‘By function’ disclosure becomes an issue is because EBIT or EBITDA ,used most in analysis, cannot be calculated with only one of them.
- However, with current presentation, correspondence between notes and items on the face is not clear, therefore users cannot allocate operating and non-operating, or creates large ‘Other’.
- ‘By nature’ disclosure is useful in understanding business, but entity’s businesses are added up in consolidated FS. Also, understanding a business and assessing it differ in how detailed the information should be.
- Either disclosing enough details by function on PL or disclosing details in Notes, having the totals of by function items in Notes match by nature details on PL, should be the best way at present.

Discussion2

- It is meaningful to introduce threshold as minimum requirement. However, in doing so, denominator should be made clear, different from IASB’s current proposal. That is to hold down the amount of ‘Other’ as less than 10% (or certain %) of a subtotal.
- Given above, subtotals required to be disclosed need to be made clear, and items should be proposed with respect to industries.
- Other than above, items recognized as ‘One time expense’ should be added to IAS 1 so that they are presented separately and not included in other even when the amount is immaterial.

We would like the IASB to discuss also about Materiality in the discussions of operating / non-operating.