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Corporate profits: The new norm

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Abstract

Companies can freely define their profits. This will soon come to an end.

Zusammenfassung

Unternehmen können ihre Gewinne frei definieren. Das wird bald ein Ende haben.

Corporate profits: The new norm

Profit is a matter of opinion. This realisation should have long been accepted by those who are active on the financial markets. And yet the price/earnings ratio (P/E ratio) is still one of the most important indicators on the stock market. However, companies not only like to present their shareholders and potential investors with the basis for the P/E ratio, the net profit, but also embellish it. This can be recognised by "adjusted" or "adjusted" earnings statements.

Clean-up on the agenda

This is blossoming. For example, the German company Northern Data adjusted its earnings (EBITDA) for the items trading losses/gains from cryptocurrencies, expenses for stock option plans, litigation/legal costs, system implementations, severance payments for executives, impairment of receivables in connection with the bankruptcy of a third party and depreciation of non-commissioned assets. [1]

Many people know that such adjusted earnings - which, as with Northern Data, are often also found in earnings before interest, taxes, depreciation and amortisation (EBITDA), EBITA or EBIT - have been cobbled together by the company management itself.

What many people don't realise: Even unadjusted "real" EBIT or EBITDA is not subject to a clear definition. The *International Financial Reporting Standards* (IFRS), which are applied by companies in many parts of the world, do not provide a scheme here. EBIT or EBITDA are not part of the standardisation within the IFRS accounting regulations. However, they play an important role in the context of the stock market.

Companies are also fairly free to define an "operating result" or "operating profit". This makes it difficult to compare several annual or quarterly financial statements of the same company as well as comparisons from group to group.

New standard changes the rules

At least until now. Because now there is a new standard that will change that. The new standard is IFRS 18, which all companies that prepare their accounts in accordance with IFRS will have to use from January 2027, with comparable figures from the previous year.

[1] https://lp.northerndata.de/hubfs/Investor%20Relations/Financial%20Reports/ND_AR2022_EN.pdf, page 38

The International Accounting Standards Board (IASB), which is responsible for IFRS, received criticism from investors regarding the presentation of companies' income statements back in 2014. Even back then, many investors were concerned that companies were utilising too many options in their figures.

In 2016, the IASB's rule-makers launched the *"Presentation and Disclosure in Financial Statements"* project, and the standard was finalised this April. This was preceded by an extensive reality check. According to the IASB, companies generally define "their own subtotals" and "group items in their own way".[2]

For example, operating profit is one of the most frequently cited subtotals in annual financial statements. In a sample of 100 companies conducted by the IASB, 61 companies reported a figure labelled operating profit in the income statement. The IASB found "nine different definitions". [3]

Biggest reform in 20 years

A remedy is therefore needed. The new Standard 18 is even being hailed by the IASB as the biggest reform since the introduction of IFRS over 20 years ago. [4]

The accounting regulators are now restricting the room for manoeuvre of company boards. Companies may continue to publish self-created key figures (so-called non-IFRS figures). However, such *alternative performance measures* (APMs) or *management-defined performance measures* (MPMs) must in future be explained, disclosed and derived in detail in specially designated appendices. The detailed explanations required are likely to cause many a management board to flounder.

Clearly defined scheme

The key point, however, is that for the first time there will be a clearly outlined and content-defined scheme for the income statement. According to the IASB, investors will therefore spend less time in future obtaining the information they need for their analyses.

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[2] https://www.ifrs.org/content/dam/ifrs/publications/amendments/english/2024/effect-analysis-ifrs18-april2024.pdf, page 2
[3] op. cit., page 30
[4] https://www.ifrs.org/news-and-events/news/2024/04/new-ifrs-accounting-standard-will-aid-investor-analysis-of-companies-financial-performance/

The new standard stipulates that in future, companies must categorise income and expense items in their income statement as "operating", "investing" and "financing".[5] In addition, the disclosure of interim results is mandatory: an operating result (operating profit) and a result before financing and income taxes must be disclosed (see table). [6]

Table: Future mandatory income statement in accordance with IFRS

Operating
Revenue
Cost of sales
Gross profit
Other operating income
Selling expense
Research and development expenses
General and administrative expenses
Goodwill impairment loss
Other operating expenses
= Operating profit
Investing
Share of profit or loss and joint ventures
Other investment income
= Profit before financing and income tax
Financing
Interest expense on borrowings and lease liabilities
Interest expense on pension liabilities and provisions
Profit before tax
Income tax expense
Profit

Source: IFRS Foundation, Flossbach von Storch Research Institute

This is a new standardisation. Another change is, for example, that in future companies must allocate the net interest expenses of pension liabilities to the financing category. Investments that are not fully consolidated but recognised in accordance with the share in the subsidiary (*at equity*) must be reported in the investment category in future. In addition, there are specific requirements as to which expense and income items companies may summarise and which must be broken down.

[5] The operating category is the standard category that includes all of a company's income and expenses, regardless of whether they are in any way volatile or unusual. Operating profit is not a measure of "persistent" or "recurring" operating performance. It is intended to provide a complete picture of the results of a company's operations for the period in question.
[6] There will be separate regulations for banks, insurance companies and other financial service providers with regard to the allocation of income and expenses to the various categories.

The new subtotals in the income statement do not correspond to the non-IFRS key figures EBIT, Ebita and EBITDA. This means that these will not be shown directly in the income statement in future either. [7]

Significant relief

According to the IASB, all of this should provide a better picture of a company's financial performance.

There is no doubt that this will be the case. The IFRS finally provide a standardised scheme that ensures period comparability and puts company comparisons on a uniform basis. This will put a stop to a lot of trickery within the income statement. As far as non-IFRS data is concerned, it should be easier for external readers of financial statements to understand the calculation method.

In any case, anyone who is confronted with the proliferation of adjusted figures should be aware of this: Companies are taking on a task that is not their own, namely that of financial analysts. They should and must look behind the P&L and cash flow statements in order to get as close as possible to the true performance of the company. IFRS 18 will make this task easier. However, profit will still remain a matter of opinion.

[7] IFRS 18 also affects other regulations, such as IAS 33 (Earnings per Share) and IAS 34 (Interim Financial Statements). In addition, IFRS 18 now defines the determination of cash flow more narrowly. In future, only operating profit or loss will be considered as the mandatory starting point for the indirect determination of cash flow from operating activities. For interest and dividends, options for categorisation within the cash flow statement no longer apply. Tricky: The individual categories within the income statement and cash flow may have the same name, but in some cases have different content according to the regulations.

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