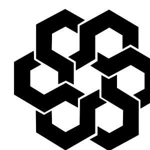

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**14 December 2006, London**
Project:	**Financial Statement Presentation (Phase B)**
Subject:	**Application of the Working Format to Financial Institutions (Agenda Paper 15C)**

INTRODUCTION

1. At the outset of this project, the Boards agreed that issues related to financial statement presentation should be addressed first for non-financial institutions (non-FIs) and second for financial institutions (FIs). While that is the approach that has been taken, the staff's underlying goal was to develop, if possible, principles for presentation that would apply to all entities. This memo addresses whether the financial statement presentation working format that the Boards have been developing for non-FIs is appropriate for FIs and, if not, what needs to be modified. Once the Boards have discussed how the working format developed to date should be applied by FIs, the staff plans to address further aspects of the working format in the context of both FIs and non-FIs. For example, there is more work to be done on remeasurements; those discussions will encompass FIs as well as non-FIs.

2. The recommendations in this memo are based on input from the recently-formed Financial Institutions Advisory Group (FIAG). Members of FIAG have expertise in either banking or insurance (or both) and the membership is reflective of the Boards' constituencies—preparers (4), users (4), auditors (1), and academics (1). A list of FIAG members is included as Appendix A.

3. FIAG input was achieved in a two-step process:

    a. In early October, FIAG members were circulated a questionnaire asking various questions about the suitability for FIs of the presentation format under consideration by the Boards. [sentence omitted from Observer Notes].

    b. In November, FIAG members participated, either by phone or in person, in a series of meetings to discuss their questionnaire responses in more detail and in light of Board decisions at the October joint meeting. Two of those meetings focused primarily on the insurance industry, while the other two meetings focused on the banking industry. IASB and FASB staff with banking and insurance expertise participated in the meetings along with a subset of the project team.

4. The overall conclusion that the staff reached after the meetings with FIAG members is that the working format under development will be appropriate for FIs once some slight modifications are made. However, the staff has yet to consider how this format and related guidance would be applied by a non-FI that has a significant FI business (and vice versa).

5. This memo addresses each aspect of the working format, summarizing the discussion with FIAG members and presenting the staff's recommendation on whether that aspect of the working format needs to be modified. The memo is organized in two parts.

    a. Part A addresses issues on which the Boards are asked to reach decisions and on which further discussion is not proposed. These are the issues on which the staff regards FIAG input as conclusive. Part A issues are: eyes-of-management approach; financing, investing, and operating categories; and some disaggregation issues.

    b. Part B addresses issues that will need to be addressed at a future meeting: short and long-term classification; remeasurements; function vs. nature; and other comprehensive income. The goal of the December meetings is to determine whether the Boards agree with the staff's overall tentative conclusion that the working format is sufficiently general so that further discussion of these issues can encompass both FIs and non-FIs. At the

December meetings, Board input will be sought on the additional work that needs to be done to address Part B issues.

PART A: ISSUES ON WHICH FURTHER DISCUSSION MAY NOT BE NEEDED

Issue 1: Eyes of Management Approach

6. An important general issue concerns the underlying eyes-of-management approach. Under this approach, two likely consequences are:
   a. FIs will categorize items differently from non-FIs. An FI's financial instruments, for example, are far more likely to appear in an operating category than in a financing category.
   b. FIs may categorize similar items differently from other FIs. For example, one bank may view any debt components of regulatory capital as a part of financing, while another may view it as operating.
7. FIAG members generally supported the eyes-of-management approach. This supports the staff's view that adopting an eyes-of-management approach is critical to developing presentation principles that can apply to FIs and non-FIs alike. Moreover, although some FIAG members expressed a degree of preference for a more objective approach, imposing greater consistency of classification across FIs, the balance of opinion (and not just from preparers!) was strongly in favour of imposing minimal constraints on an eyes-of-management approach. This was primarily because it was recognized that different FIs would have legitimate preferences for reporting information differently given variations in their business models. FIAG members were very supportive of the Boards' decision to require an entity to explain its basis for classifying assets and liabilities in the various categories, with any change in that classification viewed as a change in accounting policy that would result in retrospective application to prior periods.

Question for the Boards

1: Should an eyes-of-management approach be used by FIs to classify information in the financial statements?

Issue 2: Financing Section

8. The following describes the Boards tentative decision related to the financing section.

The Financing section in the statement of financial position would include equity as well as financial assets and financial liabilities that management views as part of the financing of the entity's business activities (referred to as *financing assets and liabilities*).

a. In determining whether a financial asset or liability should be included in the financing section, an entity should consider whether the item is interchangeable with other sources of financing and whether the item can be characterized as independent of specific business activities.

b. The following are examples of financial assets and financial liabilities that would generally be included in the financing section for a non-financial institution: cash and cash equivalents, bank loans, AFS financial instruments, bonds, and leases, plus financial instruments held to hedge any of these items. [Note different examples would be provided for financial institutions.]

c. Cash and cash equivalents would be included as a separate line item in the financing assets category.

9. An important benefit of an eyes-of-management approach is the flexibility that it allows in reporting the financing section differently for FIs than for non-FIs. For the most part, the financing section is considered to be of little relevance to FIs because there are few, if any, financial assets or liabilities that would fall in this section. Typically, the financing section might be expected to include the following:

    a. Equity (No FIAG member suggested any reason why it might be useful to report equity outside the financing section)

    b. For banks, certain subordinated debt, especially if it forms a part of regulatory capital

    c. For insurance companies, certain debt instruments, to the extent that those instruments share the characteristics of the debt components of the capital structure of non-FIs.

10. There was general support for reporting all cash and cash equivalents in the same category, but FIAG members said they would not support a requirement to classify them within financing. As drafted (refer to paragraph 8), the staff is of the view that the Boards' tentative decision was to *not* require cash and cash equivalents to be classified in financing. However, the staff is unclear whether this was the Boards intent at the October joint meeting (as in prior discussions the Boards indicated that cash and cash equivalents must always be in financing).

11. Similar to their comments on other financial assets, FIAG members stated that they would want to classify cash and cash equivalents within the operating category under an eyes-of-management approach. Because FIs manage their investment portfolios to a certain extent based on their liquidity needs, cash and cash equivalents are viewed as merely a subset of the investment portfolio. For example, an insurance company will estimate anticipated claim payments for a given time period (maybe a few days or a week) and sell longer term investments if it needs to have funds available for claim payments when due.

12. Given that under the working format (as interpreted by the staff) there is no requirement to include any assets or liabilities in the financing section and that that section clearly has value for non-FIs, FIAG members did not object to the financing section being part of the financial statement presentation format for all types of entities.

13. FIAG members shared the view of the Boards that there should not be a list of items typically included in or excluded from financing (against which reporting entities would have been required to explain departures).

Staff Recommendation

14. The analysis above suggests that the guidance related to the financing section would not need to be modified for FIs. Therefore, the staff recommends that the criteria and related guidance for classifying items in the financing section should apply equally to FIs. However, the staff would like the Boards to confirm the following two points:

    a. Cash and cash equivalents are not required to be reported within financing, as with other financial assets, an eyes-of-management approach should be applied in determining their classification.

    b. Cash and cash equivalents must all be classified in a single category (that is, they must either all be in operating or all in financing, they cannot be bifurcated).

Questions for the Boards

2a: Should the criteria for classifying items in the financing section apply to FIs?

2b: Should an eyes-of-management approach be applied to cash and cash equivalents, whereby its classification would be based on what is most appropriate for the reporting entity (the same as other financial assets)?

2c: Should cash and cash equivalents be required to be classified in a single category?

Issue 3: Investing Category

15. The following describes the Boards tentative decision related to the investing category in the business section.

    The ***Investing category*** (in the **Business section)** would include assets and liabilities that are not related to financing the entity's business activities that management views as not integral to its main business activities (referred to as *investing assets and liabilities*). All changes to *investing assets and liabilities* would be presented in the investing category in the statement of comprehensive income and the statement of cash flows.

    a. Examples of items classified in the investing category of a non-financial institution are: AFS financial instruments and financial instruments held to hedge items included in the investing category. [Note different examples would be provided for financial institutions.]

16. FIAG members expressed no strong support for the investing category, with views ranging from finding it useful to finding little value and yet nevertheless not being opposed to it. On balance, the conclusion was that while the investing category is not greatly important to FIs, it should nevertheless be retained as part of the working format that would apply to all entities.

17. The following are examples of where the investing category might be used:

    a. An FI may prefer to report assets backing free capital (and returns on those assets) separately from other interest-bearing assets and liabilities, which could be done by reporting the former in investing and the latter in operating

    b. As with non-FIs, investments in associates or in non-core assets such as real estate.

18. There was some confusion about the purpose of the investing category, and it was suggested that clarification (additional guidance) would be helpful. Consider, for example the difference between the two following investments for an insurance company:

a. Taking a 5 percent equity stake in another company purely as a means of providing the basis for an alliance in an operating activity – that is, the stake is not held primarily for direct returns on the stake but indirectly to enable other, actively managed activity
b. Acquiring 100 percent of a brokerage entity (which is therefore consolidated) that contributes directly to expanding an entity's operating activities (that is, the brokerage entity is a new distribution channel for the insurance company)

19. Both items are investments made by an entity to increase future returns on the business, yet the investing category as currently defined (refer to paragraph 15) can be viewed as covering the first item and not the second. The first item is not integral to the main activities of the entity as it generates an income/gain (on the equity stake) that is independent of the entity's main operating activities. Thus that equity stake and its associated income and cash flows would be reported, consistent with the cohesive principle, in the investing categories of each of the financial statements. In contrast, the second investment generates net income (premium income, expenses, etc.) that is not independent of the entity's main operating activities, thus the cohesiveness principle would require the investment to be classified in the operating category.

20. FIs have pointed out, for example, that non-FIs would categorize new equipment for a new product as investing, and question why an FI shouldn't treat a new product line or new distribution channel as investing. The staff asserts that their question arises because the criterion for classifying an item in the investing category differs from the criteria in the existing cash flow statement standards. That is, some items that constituents are accustomed to classifying as investing, would be classified as operating. Thus, it is not surprising that additional clarification may be needed in the form of implementation guidance.

21. The staff notes that non-FIs have asked similar questions about the investment category and, thus, any additional guidance should apply to all entities. The staff also notes that there is subjectivity in the distinction made in the example in paragraph 19 (that is, different entities might reach different conclusions on how the items should be classified). It is precisely because of that subjectivity that an eyes-of-management approach is viewed as appropriate. The issue here is not

whether any given item can be objectively categorized in the investing category, but rather that there is a need for greater guidance on what the investing category is in principle intended to cover.

Staff Recommendation

22. The staff recommends that the criteria for classifying an item as investing apply to FIs as well as non-FIs. In addition, the staff recommends that additional implementation guidance be included in the financial statement presentation standard related to the investing category. The staff suggests that that guidance be developed during the drafting of the initial discussion document and circulated to the Boards at that time.

Questions for the Boards

3a: Should the criteria for classifying an item in the investing category apply to FIs?

3b: Do the Boards agree that additional implementation guidance is needed (for both FIs and non-FIs) on what should be included in the investing category?

Issue 4: Operating Category

23. At the October joint meeting, the Boards agreed that similar to the financing and investing categories, there should be criteria for determining whether an item should be classified in the operating category (rather than just stating that it is the residual). For discussion purposes, the staff developed the following criteria:

> The ***Operating category*** (in the **Business section)** would include assets and liabilities that are not related to financing the entity's business activities that management views as integral to its main business activities (referred to as *operating assets and liabilities*) plus any asset or liability not otherwise classified.

24. Given the views of FIAG members regarding the financing and investing categories, there is great significance placed on the operating category because, in contrast with non-FIs, a greater proportion of financial assets and financial liabilities would be classified as operating by an FI. For example, life insurance companies offer products that contain a deposit element or are deposits such as universal life insurance contracts and guaranteed investment contracts. In the case of a universal life insurance contract, the policyholder pays a premium which

is held on deposit by the insurance entity. These insurance contracts contain minimum crediting rates that are guaranteed by the insurance entity. For guaranteed investment contracts, a client deposits an amount with the insurance entity. The insurance entity guarantees a crediting rate on the deposit and agrees to make future returns of the deposit according to a predetermined schedule. For many insurance entities, both types of contracts are their core business and would be considered part of operating. However, if a non-FI entity entered into a similar arrangement, the arrangement would clearly be considered as part of financing. [sentence omitted from Observer Notes].

25. As most of the financial assets and liabilities of an FI will be included in the operating category, the staff asked FIAG members whether the operating category should be disaggregated into subcategories (instead of or in addition to the short- and long-term subcategories). FIAG members did not support **required** sub-classifications within operating. However, they indicated that they might want to include their own subcategories (possibly similar to reporting segments), which would vary based on the type of FI (that is, whether it is an investment bank, commercial bank, insurance company, and so forth). This would be consistent with an eyes-of-management approach. However, it was noted that if those subcategories would be similar to the entity's reporting segments, it might be duplicative to have subcategories on the face of the statement. The staff presumes that the current model would not preclude an entity from further disaggregating within a category. However, if an entity were to introduce subcategories within the operating category, the staff wonders whether the cohesiveness principle would require that those subcategories be reflected on each of the statements.

Staff Recommendation

26. The staff recommends that the criteria for classifying an item as operating apply to FIs as well as non-FIs.

Question for the Boards

4: Should the criteria for classifying items in the operating category apply to FIs?

Issue 5: Disaggregation Issues

27. The staff discussed with FIAG members the Board's decisions on two disaggregation issues:

    a. Information should be presented in the financial statements on a gross basis except when the additional information provided by a gross presentation (rather than a net presentation) provides no incremental value

    b. The standard should include general guidance and not a bright line rule for when line items should be further disaggregated on the face of the financial statements.

28. In general, FIAG members were supportive of those disaggregation decisions, and certainly did not think that they should be modified for FIs. There was some concern expressed with the principle for determining whether to present information on a gross or net basis being based on whether a gross presentation provides incremental value. Some FIAG members noted that it was ambiguous and expressed interest in a more rules-based provision; they questioned how one would measure incremental value. The staff suspects that non-FIs would have similar comments (which we will hear during the exposure process).

Staff Recommendation

29. The staff recommends that the Boards' tentative decisions on these two aspects of disaggregation (gross presentation and when line items should be further disaggregated) should apply to FIs. The staff is still developing the general guidance for disaggregation and will discuss that issue with the Boards in 2007.

Question for the Boards

5: Do the Boards agree that their tentative decisions regarding gross presentation and not providing specific disaggregation guidance should apply to FIs as well as non-FIs?

PART B: ISSUES THAT WILL NEED FURTHER DISCUSSION

Issue 6: Short- and Long-Term Subcategories

30. The Boards decided in October that assets and liabilities in each of the categories would be further classified into short- and long-term subcategories**.** An asset or liability (other than a deferred tax asset or liability) would be classified as short-

term if the shorter of (a) the contractual maturity or (b) the expected realization or settlement of the asset or liability is within one year. Otherwise, the asset or liability would be classified as long-term.

31. In discussing this decision, FIAG members (including the analysts) viewed a short-term/long-term distinction as simplistic and meaningless. Some of the reasons why having short-term and long-term subcategories for assets and liabilities isn't meaningful or useful for FIs include

    a. FIs have assets and liabilities with a continuum of maturities; classifying assets and liabilities based on a one-year notion provides little information. This is in contrast to non-FIs for which there is typically a relatively clear cut between short-term and long-term and one year is a reasonable dividing line.
    b. Many FI liabilities are contractually due on demand, or at a fixed date, but their expected maturity is much longer.
    c. The liquidity of an FIs assets do not always depend on their (expected) maturity. For example, if an FI has a short-term cash shortage it will sell liquid assets (which may have a long maturity), use receipts from new business, or borrow on the wholesale market.
    d. While solvency is important for FIs (as it's monitored by the regulators), FIs rarely become insolvent because of that regulatory oversight. (Of course that was not the case in the 1980's in the United States.)
    e. FIs do not currently present classified balance sheets.

32. FIAG members stated a preference for the disclosure of maturity schedules for assets and liabilities that is currently required to be provided in the notes to financial statements. If required to categorize assets and liabilities as short- and long-term (based on a one-year notion), most FIAG members thought that they would be able to do so, but could not see any value to users in this categorization. However, some insurers suggested that it might be difficult to estimate the timing of uncertain expected claims payments in order to classify them as short or long-term liabilities. [sentence omitted from Observer Notes].

33. The concerns expressed by FIAG members about the short and long-term subcategories raises the possibility of an alternative reporting format for FIs—that is, the Boards could decide to exempt FIs from the requirement to classify all assets and liabilities into short- and long-term subcategories. An alternative might

be to require the approach in IAS 1 that if a short-term/long-term distinction does not provide relevant information, the assets and liabilities should instead be presented in order of liquidity. In fact, paragraph 54 if IAS 1 states:

> For some entities, such as financial institutions, a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and is more relevant that a current/non-current presentation because the entity does not supply goods or services within a clearly identifiable operating cycle.

34. Based on the input from FIAG members, the staff is of the view that the requirement to present a classified statement of financial position should *not* apply to FIs. One possibility would be to require FIs to present their assets and liabilities in order of liquidity in each of the categories on the face of the statement of financial position. Another possibility would be to adopt an IAS 1 approach that would apply to all entities. The staff notes that that approach would be consistent with the eyes-of-management approach that was applied in developing the classification criteria.

35. At the December meeting the staff would appreciate hearing Board member views on whether FIs should be required to present a classified statement of financial position.

Issue 7: Remeasurements

36. There was considerable feedback and discussion among FIAG members on the subject of disaggregating information, either on the face of the comprehensive income statement or in the notes, to capture the different information content of various components of value changes, for example:
    a. For fair value items, separately display changes due to market factors, passage of time, revised model estimates, and revisions to the measurement method
    b. Separate fair value from historical cost or other values
    c. Separate business generated in the current year from runoff of previous years (life insurance) and revision of past estimates (non-life insurance).

37. There was general (though not universal) support for note disclosure showing remeasurements in a matrix format, although again there were suggestions that

more detailed supporting information (a breakdown of remeasurements by determining factors—interest rates, currency, market prices, management estimates) would be useful. On balance, the majority view was that it would be useful to separate remeasurements from non-remeasurements, and while it may be useful to further separate remeasurements into fair value and other changes, any further disaggregation (notably of fair value changes) would be difficult and unavoidably arbitrary to some degree. This view is consistent with the Boards' decision at the October joint meeting to consider further disaggregating remeasurements into fair value changes and other changes, thus, no further discussion is needed at this time. The staff plans to discuss presentation of information related to remeasurements and non-remeasurements at the January meeting and will take into account views expressed by FIAG members.

Issue 8: Function vs. Nature

38. There was some concern expressed in the FIAG responses to the October questionnaire that while displaying information in the comprehensive income statement by function may be appropriate for non-FIs, display by nature might be more appropriate for FIs. This appears to be the case at least for banks, as the majority of their expenses are either compensation or interest related, though probably not for insurance companies. For insurance companies it may be important to separate activities by function, for example distinguishing the costs of generating new business (acquisition costs) from costs of servicing existing business and from costs of handling claims. This concern, particularly for banks, could be mitigated by continuing the current practice in IAS 1, which allows a choice of displaying revenues and expenses by function or nature depending upon which is more appropriate to the circumstances of the reporting entity.

39. On closer examination and further discussion in the meetings with FIAG members, however, four important issues emerged.
    a. The meaning of function vs. nature is not clearly understood in an FI context, and further guidance and clarification is needed (for example, highlighting that nature refers to the type of financial instrument while function refers to its role within the entity, such as trading security, portfolio investment, or hedging instrument)

b. The interplay between segment reporting and reporting on the face may make functional information on the face redundant in some cases

c. The staff could not discern any case where functional reporting was misleading and inappropriate for FIs

d. There was a degree of support for the underlying consistency in having an overall eyes-of-management approach alongside a functional presentation, since both present the business in the way it is run by management.

40. The staff is of the view that the concerns expressed by FIAG members (points (a) and (b) above) are no different than what we heard from members of the Joint International Group (and others) regarding non-FIs. In other words, this seems to be a common concern. The staff is currently working on refinements to the Boards' disaggregation decisions and will take FIAG member views into account. The staff plans to discuss various disaggregation issues with the Boards in 2007. [sentence omitted from Observer Notes].

Issue 9: Other Comprehensive Income

41. The final issue discussed with FIAG members was the presentation of other comprehensive income (OCI) items. Views were mixed, not least because different OCI items affect different FIs. The two most salient examples were AFS securities, which are of particular significance for insurance companies, and cash flow hedges, notably for banks. Although there was some support for a single-statement of comprehensive income without recycling, the strong balance of opinion—whether or not a single statement was supported—was that any changes to the recognition and measurement of OCI items should be addressed in one or more projects aimed at those underlying standards and not in the financial statement presentation project. This is consistent with the views expressed by Board members at their October joint meeting with respect to how issues related to the recognition and measurement of OCI items should be addressed to achieve their expressed long-term goals.

42. The staff asserts that the concerns expressed by FIAG members are similar to concerns that we will hear from non-FI constituents on this topic and, thus, any further discussion of this issue will naturally address the concerns of all entities.

FINANCIAL INSTITUTIONS ADVISORY GROUP (FIAG)
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[Appendix B and C are omitted from Observer Notes]