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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: **21 July 2006, London**

Project: **Financial Statement Presentation**

Subject: **Application of working principles (Agenda Paper 17)**

INTRODUCTION

1. The purpose of the July meetings on financial statement presentation is to discuss application of some, but not all, of the project's working principles. The **goal** is for each Board to **reach agreement on the basic format for the financial statements** (the sections and categories for each financial statement) that will be included in the initial discussion document.

2. [Paragraph 2 omitted from Observer Notes]

WORKING PRINCIPLES

3. The first working principle states that *financial statements should present information in a manner that* ***portrays a cohesive financial picture of an entity***. That working principle implies that the financial statements should be presented in a way in which interrelationships between financial statements are easily understood—in other words, any relationship between items on different financial statements should be clear. Application of this working principle **should result in a set of financial statements that are as complementary as possible.** The staff has taken this to mean that:

a. **Changes in assets and liabilities** should be **explained in the statement of cash flows and** the statement of earnings and comprehensive income/statement of recognised income and expense (herein referred to as **the comprehensive income statement**).

b. The **sections and categories on each financial statement should be similar**, if not the same.

4. The staff employed a building block approach in developing its recommendations. We started with the **cohesive working principle as the "governing" working principle** and then looked to the financing working principle because it appeared it would be the driving force behind the primary categorization scheme. A very basic categorization scheme for each of the financial statements flowed from the combination of those two working principles. The result is that **each financial statement includes a business and a financing section**. (Note: use of the term *business* is consistent with working principle 5; as we are developing a working format, the terms used in this memo can be revisited at a later date.)

5. [Sentence omitted from Observer Notes]. This memorandum addresses not only how to <u>define</u> the term *financing*, it also addresses how to <u>apply</u> that definition (and other definitions in the business section) for presentation purposes in each of the financial statements. The following table illustrates the sections, categories, and subcategories that are recommended in this memorandum. The appendix to this memorandum includes a summary of the staff recommendations (defined terms and their application for presentation purposes) [remainder of paragraph omitted from Observer Notes].

SCOPE OF JULY MEETING (AND RELATED MATERIALS)

6. This memorandum is organized as follows:

Part One: The Financing Section

Issue 1: Defining financing (paragraphs 10-40)

Issue 2: Applying the financing definition for presentation purposes (paragraphs 41-49)

Issue 3: Transactions with owners (paragraphs 50 and 51)

Part Two: The Business Section

Issue 4: Treasury category (paragraphs 52-68)

Issue 5: Operating category (paragraphs 69-99)

Appendix: Summary of Staff Recommendations

Financial Statements Addressed

7. The focus of this memorandum is application of the working principles to the financial statements agreed to in Phase A of this project with the exception of the statement of changes in equity. That statement will not be addressed until the Boards have reached decisions on the other three financial statements—the comprehensive income statement, the statement of cash flows, and the statement of financial position (herein referred to as the balance sheet). Therefore, for purposes of the July meeting, *the financial statements* refer to those three financial statements. Future discussions on the statement of changes in equity will include changes to the presentation of controlling and noncontrolling interests (as discussed as part of the joint business combinations project).

8. There are at least two other projects that may affect the presentation of items within the comprehensive income statement—the Financial Instruments Project and the Liabilities and Equity project (FI and L&E projects). The focus of the FI project is to provide a means of reporting/presenting changes in fair value, while the L&E project's focus is specifically on reporting changes in fair value related to equity derivatives. The presentation issues in those projects will be considered as the staff develops further the complete set of financial statements based on the working principles.

Financial Institutions

9. While the Boards agreed that Phase B deliberations would initially focus on nonfinancial institutions and that the need for different provisions for financial institutions would be considered later, the staff believes it is necessary, at least at a high level, to consider how certain alternatives might impact financial institutions. Thus, this memorandum mentions how certain alternatives might impact financial institutions. However, as agreed, the **decisions made at the July meeting will be made with respect to nonfinancial institutions** and will be reconsidered when financial statements of financial institutions are discussed at a future Board meeting.

PART ONE: THE FINANCING SECTION

10. The separation of financing activities from all other activities of the entity is a common distinction in finance theory and in practice in the capital markets, but that distinction has not yet found a clear and consistent treatment in accounting standards. The need to distinguish between financing and other activities is embodied in working principle 5—*financial*

statements should present information in a manner that ***separates an entity's financing activities from its business and other activities*** *and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities.*

Conceptual Basis for Separating Financing Activities

11. There is, in principle, a distinction in the balance sheet between the assets employed by an entity in its operations and the funding provided for those assets. Correspondingly, the comprehensive income statement should be able to distinguish between the following:

    a. Flows that form part of the return on business assets (that is, the business profits that contribute to the generation of enterprise value)

    b. Flows that form part of the return to providers of finance (that is, distributions of enterprise value).

    Alternatively stated, if debt and equity can be viewed as alternative sources of finance, then financing costs can be viewed as closer in nature to profit than to other expenses.

Cohesive Financial Statements with a Financing Section

12. The combination of working principles 5 (financing) and 1 (cohesiveness) implies that financing income, expenses, and gains and losses in the comprehensive income statement should correspond to financing both:

    a. Assets and liabilities in the balance sheet; and

    b. Cash flows in the statement of cash flows.

    For example, in the simple case of a bank loan, the financing section in each financial statement should be as shown in the table below.

Comprehensive Income Statement	Balance Sheet	Statement of Cash Flows
Interest expense Gains or losses	Recognized liability for the loan	Cash flows for the receipt or repayment of capital Cash flows for the payment of interest expenses

13. Note that the above table differs from current practice, where interest expense can be reported as an operating item in both the comprehensive income statement and the statement of cash flows. For the statement of cash flows, FASB Statement No. 95, *Statement of Cash Flows*, requires interest to be classified as operating cash flows and IAS 7, *Cash Flow Statements*, allows interest to be classified as investing or financing in limited circumstances, and operating to be the default. At the time that Statement 95 was issued, most of the Board

and some constituents held the view that, in general, cash flows from operating activities should reflect the effects of transactions and other events that enter into the determination of net income. In other words, their sense of "cohesiveness" would require that *cash flows from operating activities* and *net income* be comparable.

14. However Board members who dissented from Statement 95 did not hold the view that interest and dividends were operating activities, and argued that

    a. Interest and dividends received are returns on investments in debt and equity securities that should be classified as investing activities

    b. Interest paid is a cost of obtaining financial resources that should be classified as a cash outflow for financing activities.

    The staff's current thinking is more in line with the dissenters to Statement 95 than with the Statement itself.

15. For an entity financed by equity and a bank loan, the discussion in the preceding paragraphs suggests the basic format illustrated below for the three financial statements. For illustrative purposes, this format ignores any categorizations outside of the financing section and presumes that the financing section is defined and items that don't meet the definition are reported together in a single, residual "business" section. Shading and ***bold italic*** font are used to highlight the relationships among the financial statements. Note that the cohesiveness working principle calls for separating financing cash flows related to financing liabilities (non-equity) and those related to transactions with owners (equity).

Comprehensive Income Statement	2005	2004	2003
Business income	165	150	130
Financing expenses	***30***	***30***	***30***
Comprehensive income	*135*	*120*	*100*

Statement of Cash Flows	2005	2004	2003
Business cash flows	150	140	130
Financing cash flows:			
Non-equity	***30***	***30***	***30***
Equity	***75***	***70***	***65***
Change in cash and cash equivalents	*45*	*40*	*35*

Balance Sheet	2005	2004	2003
Business assets, net	600	550	500
	600	*550*	*500*
Financing liabilities	***300***	***300***	***300***
Equity	***300***	***250***	***200***
	600	*550*	*500*

16. The above format results in the following:
    a. Information relating to the components of an entity's enterprise value is clearly presented.
    b. Information about business activities and financing activities (for financing liabilities and equity) can be easily found in each financial statement and items such as the numerator and denominator in the return on capital calculations are presented consistently.
    c. A clear starting point for users to understand how accrual accounting causes business income to differ from business cash flows.

Practical Difficulties in Defining Financing Activities

17. The simplicity of the illustration above is complicated in practice by the difficulty of answering the following questions:
    a. Do all liabilities provide financing, and if so should all liabilities and all flows thereon be classified as financing (in both the comprehensive income statement and the statement of cash flows)? [paragraphs 18-29]
    b. Should certain assets be classified as financing on the grounds that they represent part of a net financing position? [paragraphs 30-31]

Classify All Liabilities As Financing?

18. Conceptually, all liabilities are a source of financing. Consider, for example, the similarity between a loan from a bank and a pension obligation. (Note that this is a conceptual distinction, complicated in practice by current pension accounting standards.) In substance, a defined benefit pension plan involves the entity borrowing an amount of capital equal to the cumulative service cost, incurring interest costs thereon and then repaying the capital in the form of a pension. Employees could, in principle, accept immediate settlement of services rendered, instead of agreeing to defer settlement through a defined benefit pension scheme, and an entity could pay for the employee service by issuing either debt or equity, with the net effect being that the entity substitutes a bank loan for a pension obligation. There is a clear distinction between the expenses relating to business activities (that is, service cost) and the

method by which these expenses are financed (in this case, by borrowing from pension holders). Thus, because the pension obligation is in substance the source of financing, the associated interest costs should be reported as financing expenses. Similarly, it would be possible, for example, to separate the total cost of raw materials into two components: the value of the materials at the point of purchase and the financing cost that results from deferring payment.

19. Independent of the transaction or event that gives rise to any given liability, the entity's activities are in effect being financed by the existence of the liability. To the extent that holders of liabilities demand a return to compensate for the time value of money and risk associated with deferred settlement, the expense to the entity associated with this return, together with the underlying liability itself, should in principle be classified as financing.

20. This also holds true for gains and losses on (that is, remeasurements of) the liability, which represent a change in an entity's economic obligation to its providers of financing. For example, if an entity revises the estimated cash outflows for its pension obligation, this is in principle a financing expense because the employee has not provided any further service—the only change is in the estimated settlement amount of a financing arrangement entered into in a previous period. In substance, this is similar to a loan renegotiation. Gains and losses resulting from changes to the discount rate would be treated in the same way.

21. In practice, however, a categorization scheme that defines and reports <u>all</u> liabilities as a source of financing would be difficult to maintain for the following reasons:
    a. The measurement of the liability may be subjective, which may make the business-financing distinction difficult to draw (paragraphs 22-24).
    b. The business and finance components of net assets are not always easily distinguished or required to be calculated (bifurcated) (paragraph 25).
    c. The notion that all liabilities are interchangeable with equity is weak in certain cases (paragraphs 26-28).
    d. In some cases, financing activities constitute an entity's core activities (paragraph 29).

Subjectivity of Allocations

22. The first of the complicating factors is the extent to which the allocation of amounts between business and financing can be reliably determined. Consider again the example of pension obligations. One difficulty is that actuarial gains and losses resulting from changes to cash flow estimates can be viewed as a 'truing up' of an initial estimate (as a correction of a previously inaccurate estimate of future costs), and thereby as previously unrecognized

operating expenses. Thus, if the allocation of amounts between the initial expense (business) and the subsequent gain or loss (financing) cannot be reliably measured, the allocation may be inaccurate. Additionally, management has the opportunity, in part at least, to manipulate the split between business and financing.

23. This difficulty is greater still for certain other liabilities. In the case of pension obligations there is a clear distinction between:
    a. The point in time at which employee services are rendered and the financing liability incurred
    b. All subsequent changes to the liability.

    In contrast, a liability for environmental obligations might change because initial estimates are revised (in principle, a financing expense) or because further business activity generates a new liability (in principle, a business expense).

24. The key question for liabilities initially recognised as a result of a business expense is whether initial measurement is sufficiently reliable for all subsequent gains and losses (remeasurements) to be reported as financing. If not, and if cohesiveness across the financial statements is desired, then each of the following should be reported as *business* items: the liability, gains and losses on the liability, cash settlement of the liability, and interest costs. The inclusion of interest costs may seem surprising, but if the liability is not classified as financing, then neither should the returns to the creditor or returns to the providers of finance. (Note: an alternative would be to limit application of the *cohesive* working principle to alignment of the comprehensive income statement and the statement of cash flows and not align the balance sheet. This alternative is explored in Issue 5B.)

Distinction of components

25. The second complicating factor is that there is not always a separate calculation of the business and financing components of changes in net assets. Consider payments to suppliers. In principle there are two distinct components to these payments:
    a. The transaction value at the point of purchase (which is the cost of the resource consumed)
    b. The difference between (a) above and the actual settlement amount (which is a financing expense because it represents the return accruing to the supplier in exchange for deferred settlement).

    Yet, in practice, this distinction is rarely recognised. For the sake of consistency between the comprehensive income statement and the balance sheet, accounts payable should therefore also be classified as *business*. If they were not, measures of return on capital employed would be artificially low.

Interchangeability with Equity

26. The third factor is that certain liabilities are arguably not interchangeable with equity, and thus are different in nature from liabilities such as bank loans. An entity's capital structure could be changed by raising equity and paying down a bank loan, but the option to pay down certain other liabilities—such as obligations for asset retirement or pensions—may not exist. Conversely, there are constraints on an entity's ability to return capital to shareholders by means of increasing other liabilities, especially when an increase would require an entity to order more goods or services or risk damaging a supplier relationship by deferring payment.

27. Unlike a bank loan, most liabilities are simply the result of a specific *business* activity, rather than being a source of liquid funds that can be used for any purpose. This is evidenced by the fact that a typical treasury function manages only a subset of liabilities—those generated to provide financing to the entity—it does not manage the liabilities generated by the business activity of the entity (which, only as a consequence of remaining unsettled, have the effect of providing financing). Viewed in this way, the liabilities that are not interchangeable with equity are more like *negative assets*.

28. However, it can be argued that the liability is providing financing to the entity regardless of whether or not:
    a. A liability is in practice interchangeable with equity
    b. The origination or purpose of a liability is linked to a specific activity as opposed to being a source of funds for general use
    c. There are cash flows into the entity as opposed to an accrued liability.

Financing As the Core Activity

29. The last complicating factor is that some liabilities are not independent of an entity's business model and thus are jointly informative about the business itself as well as the way in which the business is financed. For example, a retail bank is similar to any other business in that it generates a return on assets (interest income) and incurs a cost of financing (interest expense) but it differs in that its primary focus is the net interest margin. Because the assets and liabilities are managed jointly, the inherent profitability of the entity cannot be understood independently of its sources of finance. A similar conclusion holds for the increasing number of companies that own financial subsidiaries. The problem is greater still for insurance companies, because it is their liabilities that are viewed as their core business. Even for a

"text book" business such as retail, the analyst who is seeking to understand the entity's value drivers will find it instructive to know that working capital requirements are low because of the nature of the business (that is, because inventory and accounts receivable turnovers are both high relative to turnover of accounts payable).

Classify Some Assets As Financing?

30. Conversely, cash and other liquid assets, which are also typically managed by the treasury function, can be used to repay equity or debt. They also can be swelled by an equity or debt issue and viewed simply as *negative debt*. Those assets could be viewed as part of an entity's financing activities. For example, suppose that an entity generates a surplus cash flow that is invested in cash or cash equivalents rather than being used to repay a loan. Although the loan remains outstanding, the entity's net financial position is hardly different in substance from the alternative where the loan had instead been repaid (some difference will arise in practice to the extent that interest rates on assets differ from those on liabilities).

31. It is not a simple matter however to draw a line around the assets that offset debt and those that do not, and any definition of financing assets could be viewed as either too broad or too narrow. There is a grey scale that runs from entities holding limited surplus cash to those holding significant portfolios of liquid assets, to those for whom financial activity forms a significant (though not dominant) part of the overall business, and to financial institutions, for whom there is little nonfinancial activity.

32. In general, the relationship between an entity's treasury and business activities will differ across entities, making impossible a consistently meaningful standard definition of financial assets for inclusion in a *net debt* definition of financing. Moreover, it is questionable whether any assets should be classified as financing. If financing is the commitment of economic resources to an entity to support the acquisition of operating assets, then assets of any type must not be classified as financing. This is because assets are a deployment of resources by an entity, leading to a generation of value, not a supply of resources by a financier, in return for which there is a distribution of value.

Issue 1: Defining *Financing*

33. To arrive at a definition of *financing*, the **Boards need to decide on the following three points**, which are discussed in more detail below:
    a. Whether to include any assets and, if so, which

b. Whether to exclude items for which financing components are not calculated separately

c. Whether to exclude any other liabilities and, if so, which?

34. Three alternatives related to **whether any assets should be included** in the financing definition are described below along with the staff's analysis of each:

    a. **Exclude all assets**. A robust case can be made for excluding all assets from the financing definition; doing so results in an objective definition of financing. Under this alternative, entities could present income from treasury assets in a separate category within the business section of the financial statements (discussed in Part Two of this memorandum).

    b. **Include assets that meet a standard definition** (for example, cash and cash equivalents). Even if the argument is accepted that a financing section should, in principle, include assets, it would be impossible to define a set of assets in a way that could meaningfully be applied equally to all entities.

    c. **Include assets as defined by an entity** (an *eyes of management* approach, with full discretion). The staff notes that this alternative does not actually define anything.

35. The choices on the second point (**whether to include financing components not calculated separately**) are fairly straightforward. The standard definition could either:

    a. Exclude from the financing definition items for which financing components are not calculated separately; or

    b. Require bifurcation of the financing component where it is not currently required under existing standards.

36. If financing expenses are not currently calculated and reported for certain items (for example, accounts payable) exclusion of the items in question from the definition of financing is a sensible, pragmatic solution. This alternative opens the possibility for inconsistent reporting across entities, to the extent that some may choose to bifurcate financial components while others might not. However, any notion of including bifurcation requirements in the standard is beyond the scope of this project.

37. The choices related to the third point, **what other liabilities**, if any, **should be excluded** from the definition of financing are to: ***not exclude any other liabilities*** (a broad definition) *or* ***exclude liabilities that originate from business activities*** (a narrow definition). Those two possible definitions follow:

    a. <u>Broad definition:</u> The financing section in the financial statements, *which applies only to those items for which accounting standards require the separate calculation of interest income or expense*, includes:

        (1) In the balance sheet, all liabilities

    (2) In the comprehensive income statement, all expenses, and gains and losses on liabilities

    (3) In the statement of cash flows, all cash flows associated with the origination and repayment of liabilities, with the exception of the settlement of amounts initially recognized as business expenses. (The exception arises in order to ensure that business income and business cash flows are equated over time.)

b. <u>Narrow definition:</u> The financing section in the financial statements, *which applies only to liabilities that originated from an entity's capital-raising activities in capital markets* (termed *debt*), include:

    (1) In the balance sheet, all debt

    (2) In the comprehensive income statement, all expenses, and gains and losses on debt

    (3) In the statement of cash flows, all cash flows associated with the origination and repayment of debt.

38. The staff asserts that **the broader definition of financing is conceptually purer** than the narrower definition because the latter excludes items that have a strong basis in theory for inclusion in a financing section. Moreover, the broader definition is **unambiguously defined**, whereas the narrower definition is not. For example, it could be argued that 'capital-raising activities in capital markets' includes wholesale funding in retail banking, which also passes the test of being the business of the entity. Conversely, one might argue that the obligation recognized under a finance lease does not arise from capital raising in capital markets, but nevertheless should be reported in the same way as a bank loan. Ultimately, it is probably not possible to narrowly define, for all entities, activities that are unambiguously only financing activities. After all, if the aim is to exclude activities that interact with business activities, then it becomes necessary to define *business activities,* which may be possible on an entity-specific basis, but not in a standardized way for all entities.

39. One way to bridge the two definitions would be to permit some flexibility in application of the definition for categorization or presentation purposes (as discussed in Issue 2). This is important to note because the staff recommendations in this memorandum allow for a term to be defined broadly, yet provide the opportunity for items that meet the definition to be excluded from that "defined term" section or category. Thus, before the Boards address application of the definition, they need to decide on the definition.

Staff Recommendation (Issue 1)

40. For the reasons noted above, **the staff recommends** that the financing definition:

    a. **Not include** any **assets**

    b. **Include all liabilities except** those for which a financing component is not required (by accounting literature) to be calculated separately.

Question 1:	***Do the Boards agree that* financing *should be defined to include all liabilities except those for which a financing component is not required to be calculated separately and to exclude all assets?***

Issue 2: Applying the Financing Definition for Presentation Purposes

41. Once the Boards have agreed on a *financing* definition, they can discuss how to apply that definition for presentation purposes. The alternatives are as follows:

    a. **Alternative A—Strict application** of the financing definition. Each entity would be required to put items that meet the financing definition into the financing section, regardless of the type of business or how the business is managed.

    b. **Alternative B—Flexible application** of the financing definition. The standard would permit but not require all entities to include items that meet the financing definition in the financing section. Entities would have discretion over what items to exclude from the financing section and report elsewhere.

    c. **Alternative C—Flexible application** of the financing definition **with some guidelines**. The standard would permit but not require all entities to include items that meet the definition in the financing section. The standard would provide guidelines for determining what items can be excluded from the financing section and reported elsewhere.

Analysis of Alternatives

42. Strict application of the financing definition (**Alternative A**) would enable a consistent and conceptually grounded presentation. The downside would be that the practical difficulties discussed previously would not be addressed.

43. A flexible approach to applying the financing definition that provided <u>no</u> guidance on what items could be excluded from the financing section (**Alternative B**) would retain the underlying consistent and conceptual grounding of Alternative A, but would make allowance for the unavoidable difficulties that would arise in practice. Alternative B would achieve the following:

    a. Make clear the conceptual basis for the financing section, thereby increasing consistency across entities

    b. Prevent items that are, by definition, not financing from being reported in the financing section

c. Provide a benchmark treatment against which departures by entities could be reconciled and understood.

44. Under Alternative B, different business models could give rise to different classifications. In particular, some entities may view financing activities as part of their business, while others may not. Moreover, because the distinction is based upon the way management views its business, two entities in the same business would be able to classify similar items differently.

45. **Alternative C** has similar attributes as Alternative B but it would provide for some control over the items that could be excluded from the financing section.

46. For those who might prefer strict application of the financing definition, **Alternatives B and C could be supplemented,** either by a presentation on the face of the financial statements that made clear when an activity that met the definition of financing was reported in the business section, or else with a requirement to report the following information in the notes to the financial statements:

    a. Expenses and cash flows based upon the given definition of financing

    b. A reconciliation between the amounts disclosed pursuant to (a) above and the amounts actually reported on the face of the financial statements.

    This **supplemental note would provide investors with information about financing activities that is calculated consistently by all entities**. This would facilitate an understanding of the entity's financing liabilities as well as the distinction management makes between business and financing activities.

47. In addition, **Alternatives B or C could be supplemented** with a requirement that entities that choose to classify items in the business section instead of the financing section be **prohibited from moving those items in and out of the business section**. In other words, once an item is included in the business section it would be required to stay in that section; it could not be later moved to the financing section (at least not without cause).

Staff Recommendation (Issue 2)

48. The staff prefers that the **standard provide some flexibility** in application of the financing definition so that the presentation of information in the financial statements is reflective of an entity's business practice. However, the staff asserts that there **should be some guidelines** for entities to follow in determining which items that meet the financing definition can be excluded from the financing section. The guidelines will allow for more consistent

application of the definition from entity to entity. The difficulties with a standard definition of financing outlined earlier should be used as the basis for the guidelines.

49. The **staff recommends** the following:

   a. The financing section should **include only those items that meet the financing definition** (refer to Issue 1).

   b. An entity may **choose to exclude financing items from the financing section if one or more of the following conditions are met**:

      (1) Initial recognition of the liability contains sufficient measurement uncertainty that the subsequent reporting of remeasurements as financing gains or losses would be misleading.

      (2) The source of financing in question is not viewed by the entity as interchangeable with other sources of financing.

      (3) The activity in question is viewed by the entity as part of its overall business, and not as only a financing activity.

   c. Items that meet the financing definition that are excluded from the financing section would be included in the business section.

   d. Liabilities classified as financing should be reported in the ***financing liabilities*** category in the finance section of the balance sheet.

   e. Cash flow effects of financing liabilities should be reported in the ***cash flows from financing activities*** category in the finance section of the statement of cash flows

   f. The effects of financing liabilities on comprehensive income should be reported in the ***financing expenses*** category in the finance section of the comprehensive income statement.

   g. The notes to the financial statements should include the expenses and cash flows based upon the definition of financing and a reconciliation between these amounts and those actually reported on the face of the financial statements.

   h. Entities would not be permitted to move items in and out of the financing section, except by means of a change in accounting policy.

The recommendations in the remainder of this memorandum regarding the business section are based on the above recommendations related to the financing section.

Question 2: Do the Boards agree that there should be some flexibility in applying the financing definition for presentation purposes? If so, do the Boards agree with the application guidance recommended above?

Issue 3: Transactions with Owners

50. The definition of comprehensive income excludes transactions with owners. Accordingly, the comprehensive income statement does not include transactions with owners. In contrast,

the financing category in the existing statement of cash flows includes both transactions with owners and nonowners (typically debt holders).

Staff Recommendation

51. In applying the cohesive working principle, the staff recommends separating transactions with owners and nonowners in the statement of cash flows within the financing section because it would enhance the understandability of the financial statements, in particular the relationship between items in the comprehensive income statement and the statement of cash flows.

Question 3:	***Do the Boards agree that the statement of cash flows should separate* cash flows from financing transactions with owners *from* cash flows from financing with nonowners*?***

PART TWO: THE BUSINESS SECTION

52. Part One of this memorandum recommended that there be a financing section in each of the financial statements and that items not presented in the financing section be presented in the business section. Part Two of this memorandum addresses the business section and the following categories and subcategories that should be included in the business section on each of the financial statements:

    a. **Treasury**: *financial assets* are included in this category. Entities can choose to exclude assets from this category for presentation purposes if those assets are classified as *operating working capital assets* (Issue 4).

    b. **Operating**: assets and liabilities that are not classified as *financing liabilities* or *treasury assets* are to be included in this category (Issue 5).

       Operating assets and liabilities are further classified into two subcategories (Issue 5A):

       (1) ***Operating working capital*** (assets and liabilities)

       (2) ***Other operating assets and liabilities***.

    Because these terms are defined in the context of assets or liabilities, the classification of an individual element into one of the categories on the balance sheet generally drives the placement of the related changes in that element on the comprehensive income statement and statement of cash flows. Issues 5B-D of the memorandum address the presentation of those categories and subcategories in each of the financial statements.

Issue 4: Treasury Category

53. As noted in Part One, assets that are typically managed by the treasury function can be viewed as negative debt. However, the staff recommends that those assets <u>not</u> be included in the financing definition. This memorandum refers to assets that are typically managed by the treasury function as *treasury assets*. Issue 4 discusses the definition and presentation of *treasury assets* in the financial statements.

Defining *Treasury Assets*

54. The staff considered the three alternatives that are explained in the following paragraphs for defining *treasury assets* and determining what should be included in the *treasury* category. Since *treasury assets* are considered to be the "flip side" of *financing liabilities,* application of the definition of *treasury assets* in determining what gets included in the *treasury* category should be as flexible as application of the *financing* definition in determining what gets included in the *financing* section (Issue 2). Accordingly, all three alternatives allow entities to exclude certain assets that meet the treasury assets definition from the treasury category.

55. Under **Alternative 1**, *treasury assets* are defined as those items currently classified as *cash and cash equivalents. Cash* includes cash on hand and demand deposits. *Cash equivalents* include <u>short-term</u>, *highly liquid investments that are readily convertible to known amounts of cash and* <u>that are so near their maturity</u> *that they present insignificant risk of changes in value because of changes in interest rates* (<u>*generally, only investments with original maturities of three months or less*</u>). (Note: Underscored words are those excluded from the definition in Alternative 2.) For presentation purposes, entities would be:

    a. Allowed to exclude from the *treasury* category any investments they believe should be classified as *operating working capital assets* (refer to Issue 5)

    b. Required to disclose the items that constitute *treasury assets* in the notes.

56. Under **Alternative 2**, *treasury assets* are defined as *cash, and highly liquid investments that are readily convertible to known amounts of cash and that present insignificant risk of changes in value because of changes in interest rates*. For presentation purposes, entities would be:

    a. Allowed to exclude from the *treasury* category any investments they believe should be classified as *operating working capital assets* (refer to Issue 5)

    b. Required to present *cash and cash equivalents* as a separate line item (or as a subtotal if "cash" and "cash equivalents" are presented separately) in the *treasury* category

c. Required to disclose the items that meet the definition of *treasury assets* but are excluded from the *treasury* category (and are included in the *operating working capital* subcategory) and the reasons for exclusion in the notes.

57. Under **Alternative 3,** *treasury assets* are defined as all *financial assets.* For presentation purposes, entities would be

   a. Allowed to exclude from the *treasury* category any assets that they believe should be classified as *operating working capital assets* (refer to Issue 5)

   b. Required to present *cash and cash equivalents* as a separate line item (or as a subtotal if "cash" and "cash equivalents" are presented separately) in the *treasury* category

   c. Required to disclose the items that meet the definition of *treasury assets* but are excluded from the *treasury* category (and are included in the *operating working capital* subcategory) and the reasons for exclusion in the notes.

Analysis of Alternatives

58. **Alternative 1 is based on the current definition of *cash and cash equivalents***. The staff notes that both Boards have essentially the same definition of *cash and cash equivalents*; however, there is a difference in the treatment of bank overdrafts. The term *bank overdrafts* refers to the services provided by financial institutions to allow customers to have a negative bank balance for interest or other types of fees. The IASB allows bank overdrafts to be included as a component of *cash and cash equivalents*, although it is not clear whether it should be considered as *cash* or a *cash equivalent*. This issue is not addressed in Statement 95, which implies that bank overdrafts are not cash or cash equivalents.

59. The staff contends that **bank overdrafts should be excluded from the definition of *cash and cash equivalents* and classified as *financing liabilities*** for presentation purposes because bank overdrafts meet the definition of a *liability* in that they represent probable future sacrifices of economic benefits arising from present obligations.

60. Because of the small change, if any, in practice, **Alternative 1 would be the easiest to implement**. The staff notes that Alternative 1 would enable users to understand the "net debt" of the entity by assessing *financing liabilities* and *treasury assets* collectively. That is, *treasury assets* would include only items that can immediately offset *financing liabilities*.

61. However, the staff notes that the cut-off point of three months in the definition of *cash equivalents* is arbitrary. This was one of the reasons the UK ASB decided not to use *cash and cash equivalents* as its basis for presenting the statement of cash flows; the UK ASB decided to use only *cash*. The staff contends that there are assets that currently do not meet

the definition of cash equivalents but function very similarly to cash equivalents and thus function as negative debt.

62. **Alternative 2 relaxes the current definition of *cash equivalents*** by eliminating the term "short-term" and not referring to three months. It focuses on the "known amount of cash" to be received with "insignificant risk of changes in value because of changes in interest rates," and **does not impose restrictions based on the time horizon of the investment.** If Alternative 2 were adopted it would allow held-to-maturity investments to be included as *treasury assets.*

63. The scope of *treasury assets* in Alternatives 2 and 3 are broader than *cash and cash equivalents*. Because the statement of cash flows will report the entity's flows of *cash and cash equivalents,* those alternatives would require that cash and cash equivalents be presented as a separate line item (or as a subtotal if "cash" and "cash equivalents" are presented separately) within the *treasury* category so that users of financial statements will be able to clearly understand the relationship between the balance sheet and the statement of cash flows. (As discussed previously, cash and cash equivalents should not include bank overdrafts.)

64. The staff notes that requiring the presentation of cash and cash equivalents as a separate line item (or a subtotal) is currently required by Statement 95. IAS 7 requires a reconciliation of the amounts in the statement of cash flows with the equivalent items reported in the balance sheet. **The presentation of cash and cash equivalents in Alternatives 2 and 3 would converge to the approach in Statement 95**.

65. **Alternative 3 is the broadest definition of *treasury assets*** as it includes all *financial assets.* The staff notes that the current definition of *financial assets* differ between the Boards.

    a. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* defines *financial assets* as follows:

        Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity.

    b. IAS 32, *Financial Instruments: Disclosure and Presentation,* defines *financial assets* as follows:
        (a) cash
        (b) an equity instrument of another entity
        (c) a contractual right:
            (i) to receive cash or another financial asset from another entity; or
            (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:
    (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
    (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [Emphasis omitted.]

66. The staff acknowledges that a converged definition is desirable. However, the staff contends that changes in the definition of *financial assets* is beyond the scope of this project and, accordingly, does not propose any changes to the definitions in this project.

67. The reason for expanding the definition of *treasury assets* to include all *financial assets* in Alternative 3 is to enable users to contrast *treasury income* and *financing expenses* so that they can understand the efficiency of the treasury function of the entity. It is acknowledged in Alternative 3 that not all *financial assets* classified as *treasury assets* can be immediately offset with *financing liabilities*.

Staff Analysis and Recommendation (Issue 4)

68. Because *treasury* activities contribute to the ability of the entity to increase its wealth, the staff contends that those activities should be included as a category in the business section rather than in a section other than business or financing. Thus, **the staff recommends the following**:

    a. *Treasury assets* be defined as ***all financial assets***
    b. For presentation purposes, **entities may choose to exclude** from the *treasury* category *financial assets* that are classified as *operating working capital assets* (refer to Issue 5)
    c. The policy for determining the items included in the *treasury* category be disclosed as an accounting policy.
    d. ***Treasury assets*** be presented as a category within the business section in the balance sheet
    e. Cash flow effects of treasury assets be reported in the ***cash flows from treasury activities*** category in the business section of the statement of cash flows
    f. The effects of treasury assets on comprehensive income be reported in the ***treasury income*** category in the business section of the comprehensive income statement
    g. **Bank overdrafts be excluded from *cash and cash equivalents*** and be treated as *financing liabilities*

h. **Cash and cash equivalents be presented as a separate line item** (or as a subtotal if "cash" and "cash equivalents" are presented separately) in the *treasury assets* category.

Question 4:	***Do the Boards agree that:***
	***a) Treasury assets should be broader than cash and cash equivalents and defined as* all financial assets?**
	b) There should be some flexibility in applying the treasury assets definition for presentation purposes as recommended above?
	c) The policy for determining what items get classified as treasury assets be disclosed?
	d) A treasury category should be presented in the business section in the financial statements as described above?
	e) Bank overdrafts should be excluded from cash and cash equivalents and be treated as financing liabilities?
	f) Cash and cash equivalents should be presented as a separate line item (or as a subtotal if "cash" and "cash equivalents" are presented separately) in the treasury assets category?

Issue 5: Operating Category

69. Up to this point, this memorandum has discussed the classification of *treasury assets* and *financing liabilities*. Assets and liabilities that are not classified as either *treasury assets* or *financing liabilities* are collectively referred to as *operating assets and liabilities* (or collectively, the *operating* category). This issue considers whether *operating assets and liabilities* should be further classified (Issue 5A) and, if so, the presentation of those amounts in the balance sheet (Issue 5B), the comprehensive income statement (Issue 5C), and the statement of cash flows (Issue 5D).

70. Both US GAAP and IFRS currently distinguish between *current* and *noncurrent* assets and liabilities by referring to the *operating cycle* concept.

a. ARB No. 43, Chapter 3A, "Working Capital—Current Assets and Current Liabilities," defines the *operating cycle* as "the average time intervening between the acquisition of materials or services entering [the] process and the final cash realization" (paragraph 5). When there are several operating cycles occurring within a year, a one-year time period is used as a basis for segregating current assets; however, when the operating cycle is more than twelve months, the longer period is used. Where a particular business has no clearly defined operating cycle, the one-year rule governs.

b. IAS 1, *Presentation of Financial Statements,* defines the *operating cycle* as "the time between the acquisition of assets for processing and their realization in cash or cash equivalents" (paragraph 59). When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

71. The existing distinction between *current* and *noncurrent* assets and liabilities attempts to achieve the following objectives simultaneously:

a. To discern *assets and liabilities related to the operating cycle* from *other assets and liabilities*

b. To provide information related to *liquidity* (that is, the amount of assets that can be converted to cash and the amount of liabilities that are required to be settled within a year).

However, because the operating cycle for some entities is longer than one year, some assets are classified as *current* even though they cannot be converted to cash within a year. For example, a distillery company may classify its work-in-process goods as inventory for more than 20 years. Conversely, some assets are classified as *current* because they are expected to be converted to cash within a year even though their original maturity was longer than one year (such as the short-term portion of long-term loans). Other long-term assets are considered *current* because IAS 1 requires an asset and a liability held primarily for the purpose of being traded to be accounted for as *current,* regardless of whether they relate to the operating cycle. This is consistent with the notion that assets and liabilities used for the purpose of trading are expected to be converted to or settled with cash within one year.

72. Thus, the existing distinction between *current* and *noncurrent* often fails to meet either objective stated in the paragraph above. However, many users of financial statements like the fact that "current" assets and liabilities are segregated from "noncurrent" assets and liabilities. Therefore, the staff contends that the balance sheet should continue to distinguish more current/liquid assets and liabilities from those that are less current/liquid.

Issue 5A: Distinguishing Operating Working Capital from Other Operating Assets and Liabilities

73. Financing theory and practice in capital markets use the notion of *working capital.* Chapter 3A of ARB 43 defines *working capital* as "the excess of current assets over current liabilities" (paragraph 3). However, some argue that it is useful to exclude current portions of financial items from working capital because they do not help generate sales. For example, Stephen Penman's book, *Financial Statement Analysis and Security Valuation*, uses the term *operating working capital*, which is defined as "current assets less current liabilities less current financial assets plus current financial liabilities." He also uses the term *long-term net operating assets*, which excludes financial items and is usually made up of property, plant, and equipment; intangibles; and investments in subsidiaries. The staff recommended a categorization scheme based on similar notions:

a. The notion of *operating working capital* is adopted.

b. *Long-term net operating assets* are similar to *other operating assets and liabilities.*

c. *Financial items* are similar to *treasury assets* and *financial liabilities.*

Staff Recommendation and Analysis

74. The **staff recommends** that the terms *operating working capital* and *other operating assets and liabilities* be used (as defined below) and that **information related to *operating working capital* be presented separately from information about *other operating assets and liabilities*** as subcategories within the *operating* category in the balance sheet.

    a. ***Operating working capital***: the excess of *operating working capital assets* over *operating working capital liabilities.*

    b. ***Operating working capital assets***: assets reasonably expected to be realized or consumed in the *operating cycle* of the entity.

    c. ***Operating working capital liabilities****:* liabilities that are incurred and reasonably expected to be settled in the *operating cycle* of the entity.

    d. ***Other operating assets****:* assets that are not classified as *treasury assets* or *operating working capital assets*.

    e. ***Other operating liabilities****:* liabilities that are not classified as *financing liabilities* or *operating working capital liabilities*.

    f. The ***operating cycle****:* the average time between the acquisition of materials or services entering the process and their final conversion to cash.

75. The above definition of *operating cycle* would allow an entity to determine the length of its operating cycle. Therefore, the assets and liabilities that are classified as *operating working capital* and *operating working capital liabilities* would vary across entities. The staff notes that this *management approach* was pursued by the FASB prior to this being a joint project.

76. Distinguishing *operating working capital* from *other operating assets and liabilities* should be useful to users of financial statements because the implications of changes in these two "asset/liability" groups on the assessment of future cash flows are likely to be different. For example, *operating working capital* would generally be expected to have a higher turnover ratio compared with *other operating assets and liabilities* because *operating working capital (assets and liabilities)* are held for the sake of turning them over quickly. Conversely, changes in *other operating assets and liabilities* may imply changes in production capacity, which typically affect future cash flows in the long run.

77. Because an operating cycle may be longer than one year, it is possible that an *operating working capital asset* might be a long-term asset (that is, converted into cash in more than a

year) or that an *operating working capital liability* might be a long-term liability (that is, a liability settled in more than a year).

78. In the staff's proposed model, the *other operating assets and liabilities* subcategory is considered the default or residual. Thus, assets that are not classified as *treasury assets* or *operating working capital assets* will be classified as *other operating assets*. Similarly, liabilities that are not classified as *financing liabilities* or *operating working capital liabilities* will be classified as *other operating liabilities*.

79. The staff notes that in the earlier stages of this project:

    a. The IASB considered a model that would treat the *operating income* category as the default. The *operating income* (default) category included sales and cost of sales.

    b. The FASB considered a model that would treat the *nonbusiness/nonfinancing* category as the default. The *business* category (not the default) included sales and cost of sales.

    The staff's recommendation that *other operating assets and liabilities* should be the default is consistent with the prior FASB model. The staff contends that the information most important in assessing future cash flows is information about the entity's core or business operations and, therefore, that category should be defined directly rather than being determined as a residual.

80. The staff considered presenting *operating working capital* and *other operating assets and liabilities* as distinct categories, rather than subcategories within the *operating category*. While that distinction is sensible and can be operationalized for the balance sheet, the staff noted that having those two distinct categories on the comprehensive income statement (see Issue 5C) and statement of cash flows (see Issue 5D) would not be as useful, and concluded that *operating working capital* and *other operating assets and liabilities* should be subcategories within the *operating* category.

Question 5A: Do the Boards agree that there should be an operating category on the balance sheet and that operating assets and liabilities should be further classified into "operating working capital" and "other operating" based on the "operating cycle" notion?

Issue 5B: Presentation in the Balance Sheet

81. In the prior issue the staff recommended that there be two subcategories within the *operating* category in the business section of the balance sheet. Thus, based on the recommendations thus far, the balance sheet would look something like this:

Debtor (Business Assets/Liabilities)	Creditor (Financing Liabilities /Equity)
Operating assets and liabilities • Operating working capital • Other operating assets and liabilities Treasury assets	Financing liabilities Equity

While that categorization scheme flows from the financing and cohesiveness working principles, it does not take into account the **liquidity working principle**—*the financial statements should present information in a manner that helps a user* ***assess the liquidity of an entity's assets and liabilities*** *(nearness to cash or time to conversion to cash).*

Providing Information about Liquidity

82. The "liquid" or "nonliquid" nature of an asset or a liability is usually defined in terms of "how near," "how quickly," or "how soon" until an asset is realized or otherwise converted into cash or until a liability has to be paid. The current format of the balance sheet uses "the elements" (assets, liabilities, and equity) as the primary categories. While US GAAP does not require it, many present a classified balance sheet (that is, assets and liabilities segregated into *current* and *noncurrent*). The classification of assets and liabilities into current and noncurrent is generally considered to present information about the liquidity of the assets and liabilities of the entity. Entities that apply IAS 1 are required to present a classified balance sheet *except when a presentation based on liquidity provides information that is reliable and is more relevant*. Under IAS 1, that presentation would be in either increasing or decreasing order of liquidity (referred to as the *ordering by liquidity* approach).

83. In addition to the *current/noncurrent* approach and the *ordering by liquidity* approach currently being used today, another way to present liquidity information on the face of the balance sheet would be to classify assets and liabilities based solely on a "one-year-to-liquidity" rule. In other words, an asset expected to be converted to cash within 12 months or a liability expected to be settled with cash within 12 months would be classified as short-term; all others would be classified as long-term. This approach is referred to as the *short-term/long-term* approach. Thus, there are three possible ways to present information about liquidity in the financial statements:
    a. Current/noncurrent
    b. Ordering by liquidity
    c. Short-term/long-term.

Analysis of Approaches

84. The main advantage of the ***current/noncurrent approach*** is that it breaks out assets and liabilities based on whether or not they are going to be converted/settled in the current operating cycle. This allows a user to assess an entity's financial flexibility and solvency. However, because this approach is based on an operating cycle, it results in assets that are *not* expected to be converted into cash within a year being classified as current assets, or assets with a long-term nature that *are* expected to be converted into cash within a year being classified as noncurrent assets.

85. The ***ordering by liquidity approach*** would be useful for entities that do not supply goods or services within a clearly identifiable operating cycle (which is needed for application of the current/noncurrent approach). The main disadvantage of the ordering by liquidity approach is that it does not provide information related to *when* an item is expected to be converted to or settled by cash—only whether that conversion or settlement will happen sooner than the item above/below it. For example, long-term debt would be considered less liquid than short-term debt regardless of its time to maturity at the reporting date.

86. The ***short-term/long-term approach*** addresses the disadvantages of the other two approaches: it is not dependent on the length of an entity's operating cycle and it provides information about *when* an item is expected to be converted or settlement is expected to occur. In addition, under this approach "like" items in the same category (such as *operating* assets and liabilities) are presented in one group, which will allow users to calculate financial ratios that are more meaningful. The staff acknowledges that the use of a one-year cut-off in the *short-term/long-term approach* is arbitrary. However, one year is consistent with the "going concern" requirements in IAS 1 and U.S. GAAS (generally accepted auditing standards) and has been adopted in most major jurisdictions in classifying assets and liabilities as *current* or *noncurrent*.

87. Of the three approaches, **the staff prefers the short-term/long-term approach for displaying liquidity information in the financial statements**. This approach will enable a user to assess the ability of an entity to settle its liabilities due within a year with the assets that are to be converted into cash within a year.

Alignment of Primary Categorization Scheme

88. Before the Boards decide how to present liquidity information in the financial statements, they need to decide whether the balance sheet categories should be the same as those on the

other financial statements. In other words, **should aligning the format/categories across all three financial statements take precedence over providing information about liquidity** in the balance sheet? The staff asserts that it should, noting that changing the primary categorization scheme on the balance sheet does not rule out providing information about liquidity on the face of the balance sheet. The **advantages** of having a primary **business/financing categorization scheme** on the balance sheet are that it:

a. **Displays the assets and liabilities used for operations on the debtor side** and **how those assets and liabilities, as a whole, were funded on the creditor side.**

b. **Clearly distinguishes business assets and liabilities from financing liabilities and equity,** which enables users of financial statements to calculate financial ratios that may be more meaningful for analytical purposes. For example, the debt-to-equity ratio can be calculated by dividing total *financing liabilities* by total *equity*, which is likely to be more useful than dividing total *liabilities* by total *equity*.

89. The **disadvantages** of this categorization scheme are that it would be **a major change to current practice** and **would not provide information related to total assets of the entity and the total claims on those assets**. However, these difficulties could be overcome by disclosing information related to total assets, liabilities, and equity in the notes to financial statements.

Staff Recommendation

90. The staff recommends the following:

a. **The balance sheet should be formatted using the same business/financing sections and categories used in the comprehensive income statement and statement of cash flows**. The staff contends that it would be more useful to view like assets and liabilities (such as *operating working capital* assets and liabilities) together as one group than to present all like elements (assets and liabilities) together.

b. **Information about the total amounts for each element (assets, liabilities, and equity) should be provided in the notes to the financial statements** as that will continue to be useful information.

c. **Information that will help users assess the short-term liquidity of an entity should be provided in the notes to the financial statements based on the long-term/short-term approach** (as illustrated below). The staff recommends that this information be presented in the notes rather than on the face of the balance sheet to enhance the cohesiveness of the financial statements. That is, a presentation format based on the business and financing sections should be given higher priority than a format based on liquidity.

Supplemental information in the **notes**:

Assets	Liabilities
Assets	**Liabilities**
Short-term assets	***Short-term liabilities***:
Treasury assets	Operating liabilities
Operating assets	Operating working capital liabilities
Operating working capital assets	Other operating liabilities
Other operating assets	Financing liabilities
Subtotal	Subtotal
Long-term assets	***Long-term liabilities***
Treasury assets	Operating liabilities
Operating assets	Operating working capital liabilities
Operating working capital assets	Other operating liabilities
Other operating assets	Financing liabilities
Subtotal	Subtotal
Total	Total
	Equity
	Total

91. The **downside** of this recommendation is that **totals and subtotals for assets and liabilities as well as liquidity information would be provided in the notes** rather than on the face of the balance sheet. Thus, users will need to read the notes for information about the short-term liquidity of an entity. The **upside** is that the **financial statements will be aligned and the presentation** on the face of the balance sheet **will be fairly simple** and thus **more understandable**.

92. If the Boards agree that the categories on the balance sheet should align with the other statements but decide that liquidity information should be presented on the face of the balance sheet rather than in the notes, the staff recommends the short-term/long-term approach; however any of the three approaches discussed in paragraphs 83-87 can be applied to the face of the balance sheet.

Question 5B: Do the Boards agree that:

i) The balance sheet should be formatted based on the business and financing sections?

ii) Information about liquidity should be presented using the short-term/ long-term approach?

iii) Information about liquidity should be presented in the notes to the financial statements along with totals for assets, liabilities, and equity?

Issue 5C: Presentation in the Comprehensive Income Statement

93. The staff recommends that the effects of all *operating assets and liabilities* be presented in an *operating income* category in the business section of the comprehensive income statement. As noted previously, the staff considered whether the effects on *operating working capital* and *other operating assets and liabilities* should be presented separately in the comprehensive income statement. However, as described below, the staff concluded that doing so would not be useful to users of financial statements.

94. Depreciation relates to *other operating assets.* A strict application of the cohesiveness working principle would require that depreciation be presented in the "income from other operating assets and liabilities" category. However, if that depreciation related to a machine used by the company to manufacture goods, some of the depreciation costs would be capitalized as inventory, which is a typical *operating working capital asset*, at the end of the period. Including only the effects of changes in *operating working capital* as a measure of costs for manufacturing goods would not be useful.

95. Moreover, a strict application of the cohesiveness working principle would require that impairment losses be classified in the "income from other operating assets and liabilities" category. However, many view impairment losses as adjustments of prior period depreciation costs.

96. Because of the interaction between changes in *operating working capital* and changes in *other operating assets and liabilities*, the staff recommends that those changes <u>not</u> be presented as separate categories in the comprehensive income statement. If the Boards prefer to further classify components of *operating income*, the staff recommends that that classification be made by "relaxing" the cohesiveness working principle. (If this is the case, the staff will bring that issue to the Boards in September.)

Question 5C: Do the Boards agree that an* operating income *category should be included on the comprehensive income statement and that the effects of operating assets and liabilities on comprehensive income need not be further classified based on the "operating cycle" notion?

Issue 5D: Presentation in the Statement of Cash Flows

97. The staff recommends that the cash flow effects related to *operating assets* and *operating liabilities* be presented as *cash flows from operating activities*. Similar to the analysis for the comprehensive income statement, the staff considered whether cash flow effects related to *operating working capital* and *other operating assets and liabilities* should be presented

separately in the statement of cash flows. However as discussed below, the staff concluded that doing so would not be useful to users of financial statements.

98. One of the objectives of presenting the statement of cash flows is to help users understand the difference between accrual accounting and cash basis accounting. To achieve that objective, the comprehensive income statement and the statement of cash flows should have similar, if not the same, categories. Hence, if the comprehensive income statement would not present the effects of *operating working capital* and *other operating assets and liabilities* separately, the statement of cash flows also should not present those effects separately.

99. If the Boards prefer to further classify components of *cash flows from operating activities*, the staff recommends that that classification be made by "relaxing" the cohesiveness working principle. The staff suggests that if in Issue 5C the Boards agreed to further classify the components of *operating income*, the Boards consider doing something similar on the statement of cash flows. (If the Boards are interested in relaxing the cohesiveness working principle, the staff will bring that issue to the Boards in September.)

Question 5D: ***Do the Boards agree that a* cash flows from operating activities *category should be included on the statement of cash flows and that the cash flow effects of operating assets and liabilities need not be further classified based on the "operating cycle" notion?***

100. Presuming that the Boards reach agreement on a working format for the financial statements at the July meetings (that is, the sections, categories, and subcategories for the financial statements), the plan is for the Boards to discuss the issues listed below in September. Topics for the September Board meeting include:

a. Measurement working principle
b. Disaggregation working principle
c. Comparability working principles
d. Subtotals, totals, and recycling
e. Discontinued operations
f. Extraordinary items (FASB only)
g. Income taxes
h. Equity method investments
i. Direct or indirect method on the statement of cash flows
j. Statement of changes in equity.

101. [Paragraphs 101- 105 omitted from Observer Notes].

Subtotal, Totals, and Presentation of Net Income

106. While the illustrations in this memorandum include subtotals and totals, those are not part of the staff recommendation. **This memorandum is not meant to address the subtotals and totals** for each financial statement**, nor does it address** whether to require, permit, or eliminate **the net income subtotal (including the recycling issue) because those decisions are dependent on the basic format/categorization scheme**. If the Boards reach agreement on a working format at the July meeting, the follow-up issues of whether subtotals and totals should be required for all items in a specific category, items of more than one category, or certain (but not all) items within a specific category **will be addressed at the September Board meetings (and at the September 15 JIG meeting**) as well as the recycling issue.

APPENDIX: SUMMARY OF STAFF RECOMMENDATIONS

The following table summarizes the staff's recommendations for how items would be presented in the financial statements. Following the table are defined terms and related application and implementation guidance.

Balance Sheet	Statement of Comprehensive Income	Statement of Cash Flows
Business: ◆ Operating assets and liabilities o Operating working capital o Other operating assets and liabilities ◆ Treasury assets	**Business income:** ◆ Operating income ◆ Treasury income	**Business cash flows:** ◆ Operating cash flows ◆ Treasury cash flows
Financing: ◆ Financing liabilities ◆ Equity	**Financing expenses**	**Financing cash flows:** ◆ Non-equity ◆ Equity

Financing Section

Financing liabilities: all liabilities except those for which a financing component is not required (by the accounting literature) should be calculated separately.

An entity may choose to exclude items from financing if one or more of the following conditions are met:

(a) Initial recognition of the liability contains sufficient measurement uncertainty that the subsequent reporting of remeasurements as financing gains or losses would be misleading.
(b) The source of financing in question is not viewed by the entity as interchangeable with other sources of financing.
(c) The activity in question is viewed by the entity as a part of its overall business, and not as only a financing activity.

Entities would not be permitted to move items in and out of the financing section, except by means of a change in accounting policy.

Notes to the financial statements: should include:

- The expenses and cash flows based upon the *financing* definition
- A reconciliation between the above amounts and those actually reported on the face of the financial statements.

Business Section

Treasury Category

Treasury assets: all financial assets (as defined in accounting literature)

An entity may choose to exclude from the *treasury* category *financial assets* that are classified as *operating working capital assets*.

Bank overdrafts should be excluded from *cash and cash equivalents* and be treated as *financing liabilities.*

Cash and cash equivalents should be presented as a separate line item (or as a subtotal if "cash" and "cash equivalents" are presented separately) in the *treasury* category.

Operating Category

Operating working capital: the excess of *operating working capital assets* over *operating working capital liabilities*

***Operating working capital assets**:* assets reasonably expected to be realized or consumed in the *operating cycle* of the entity

***Operating working capital liabilities**:* liabilities that are incurred and reasonably expected to be settled in the *operating cycle* of the entity

Other operating assets: assets that are not classified as *treasury assets* or *operating working capital assets*

***Other operating liabilities**:* liabilities that are not classified as *financing liabilities* or *operating working capital liabilities*

Operating cycle: the average time between the acquisition of materials or services entering the process and their final conversion to cash

Notes to the financial statements should include:

- Information about the total amounts of assets, liabilities, and equity
- Information that will help users assess the short-term liquidity of an entity should be provided in the notes to the financial statements based on the long-term/short-term approach.