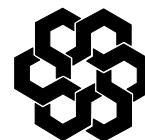




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INFORMATION FOR OBSERVERS

IASB/FASB Meeting: 24 October 2006, Norwalk

Project: Financial Statement Presentation

Subject: Financing Section and Investing Category
(Agenda Paper 6A/FASB Memorandum 44A)
(also issued as observer note for IASB meeting)

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1. The Boards are in agreement that
 - a. The financing section should comprise equity, treasury assets, and financing liabilities.
 - b. Both treasury assets and financing liabilities should be presented by function.
 - c. There should be consideration given to including another category (possibly for investments) in the business section.

Issue 1 of this memo addresses the definition of and what should be included in the financing section. Issue 2 addresses similar issues for a possible investing category. Issue 3 addresses presentation issues related to pension assets and liabilities. [Sentence omitted from Observer Notes].

Issue 1: Defining the Financing Section

Issue 1.1: Non-financial Assets and Liabilities

2. In September, the Boards indicated a willingness to consider defining financing liabilities and treasury assets (the financing section) by function. The Boards acknowledged that because functions vary from entity to entity there will be some subjectivity in applying a functional definition (that is, determining whether an item should or should not be included in the financing section). One possible downside of defining the financing section by function is that there could be flexibility as to items that can be excluded as well as included. Perhaps this is more flexibility than there needs to be. A suggestion for partially mitigating this concern is to restrict the financing section to include only *financial liabilities* and *financial assets*, as defined in existing standards. Thus, *financial* items could still be excluded from the financing section, but *non-financial* items could not be included. This presumes that there is no case for any non-financial asset or liability being considered as part of financing. In the staff's view, imposing this simple restriction will help to promote consistency, comparability, and understandability without compromising the purpose of the financing section. That is, there would be universal understanding that everything in the financing section was by definition *financial*, and this would not unduly constrain an entity from presenting its financial statements consistent with how it is managed.

Staff Recommendation

3. The staff recommends that non-financial assets and liabilities be precluded from the financing section.

Question 1.1. Should all non-financial assets and liabilities be excluded from the financing section?

Issue 1.2: Financial Assets and Liabilities

4. The next issue to consider is how the financing section should be defined—that is, which *financial* assets and liabilities should be included. The Boards are reminded that the need to define financing by function arises because of interactions between an entity's business activities and its liabilities. For similar reasons, certain financial

assets, such as accounts receivable, are candidates for inclusion in the business section.

5. This interaction with business creates a difficulty in defining financing. If an approach is taken that excludes items that interact with business activities, then an objective definition of financing requires that business activities are themselves defined. The same problem arises for an approach that tries to directly pin down the subset of liabilities that is independent of business activities. This is because in order to know when debt, borrowings, or capital really do serve only the purpose of providing financing, it is necessary to understand whether they might also interact with business activities, which in turn requires that business activities are defined.
6. The Boards have concluded already that the notion of business activity is inherently entity-specific, making a standardized definition unobtainable. For example, a given supplier may form part of the business activity of one entity but the financing activity of another. To illustrate, each of the following definitions of the *financing section* is subject to the difficulties raised in this paragraph.
 - a. The financing section in the financial statements applies only to those items that provide the entity with funds for general use and do not arise in connection with a specific business activity.
 - b. The financing section in the financial statements excludes transactions with customers, suppliers, and employees.
 - c. The financing section in the financial statements comprises liabilities which have the primary purpose of funding the business activities of the entity.
 - d. The financing section in the financial statements comprises liabilities which originated from an entity's capital-raising activities in capital markets.
7. The central point is that financing cannot, in principle, be defined tightly by function. The definition should therefore be kept simple, and should be supported by application guidance that clarifies how an entity should populate the financing section, and by disclosure requirements that make clear to users the method of presentation in use.

Staff Recommendation

8. The staff recommends the following definition for what should be included in the financing section.

The financing section may include only financial liabilities and financial assets (as defined in the literature). An entity should include in the financing section financial assets and liabilities that management views as part of the financing of the entity's business activities; those items are referred to as *financing assets and liabilities*.

Thus, the financing section in the statement of financial position would include all financing assets and liabilities. The statement of comprehensive income would include all income, expenses, gains and losses on financing assets and liabilities. The statement of cash flows would include all cash flows from income, expenses, origination, purchase, disposal or settlement of financing assets and liabilities.

9. The staff notes the following:

- a. The term *financing assets* is used in preference to the term *treasury assets*. This is because the treasury function of an entity could manage financial assets that would not, under the definition above, be reported in the financing section. An example would be a forward contract hedging foreign currency exposure on revenues.
- b. Presentation in the financing section would be gross. That is, amounts relating to financing liabilities would be presented in the *financing liabilities* category and amounts relating to financing assets would be presented in the *financing assets* category.

10. The staff also recommends that application guidance be provided that identifies a set of financial assets and liabilities that would typically be included in the financing section and a set that would typically be excluded based on how an entity finances its business activities. In determining whether a financial asset or liability should be included in the financing section, an entity would be guided to consider whether the item is interchangeable with other sources of financing and whether the item can be characterized as independent of specific business activities. Hence, for a typical manufacturing business, there might be a clean and simple distinction between the capital raised in financial markets to fund the business (equity, loans, bonds, and so forth) and the activities engaged in as a part of the business (which could include payables and receivables arising from trading activity, or AFS financial instruments held because of the way in which the entity conducts its business). The financial assets and financial liabilities typically included or excluded could therefore be as follows:

- a. **Include:** equity, cash and cash equivalents, bank loans, bank overdrafts, bonds and other traded debt, and leases, plus financial instruments held to hedge any of these items including net investment hedges of foreign operations.

- b. **Exclude:** payables, receivables, AFS financial instruments, vendor financing, guarantees payable in cash, pension assets and obligations, plus financial instruments held to hedge any of these items.

11. The staff notes the following:

- a. Financial instruments held as hedges would not need to qualify for hedge accounting. The classification would be based upon whether management views the financial instruments as part of the financing of the entity's business activities. So, for example, this would lead to interest rate swaps typically being included in the financing section and foreign exchange derivative hedging revenue or costs of goods sold typically being excluded. Net investment hedges of foreign operations are included in financing as a pragmatic solution because, as there is a net position being hedged, there is no clear distinction that relates the hedging instrument to the related assets and liabilities.
- b. Financial assets and liabilities excluded from the financing section would be reported in either the Operating or Investing category (refer to paragraphs 15–20).

12. To further enhance comparability and understandability, the staff recommends that an entity be required to explain, as a matter of accounting policy, any departures from the 'base case' application guidance (that is, the items on the 'include' list above that are **not** shown in the financing section and the items on the 'exclude' list that **are** shown in the financing section). For example, while most entities might be expected to **exclude** AFS financial instruments from financing, some might hold financial assets designated as AFS that are managed as part of the entity's financing activity and are independent of business activities.

13. Given that financial liabilities and financial assets could be reported in financing, operating, or investing (refer to Issue 2), and that presentation will vary across entities, comparability and understandability would be enhanced by requiring footnote disclosure. Thus the staff recommends that the notes to financial statements include a break-down of total financial liabilities and financial assets (and associated amounts in the income statement and cash flow statement) by the section/category in which each component is presented (refer to the Illustrations in FASB memorandum 44D/IASB agenda paper 6D).

14. Most of the analysts that the staff spoke with about the financing section suggested that for primarily comparability reasons there should be a strict definition for what could be included in that section and no flexibility. The staff is of the opinion that its

recommended include/exclude list is in line with user views of the types of items that they would expect to be in/out of the financing section. The recommended disclosures should mitigate most of the users concerns with being able to compare entities that classify similar financial assets and liabilities in different categories because of how their business is financed.

Question 1.2a Should the financing section be defined as follows?

The financing section in the statement of financial position should include only financial liabilities and financial assets that management views as part of the financing of the entity's business activities (referred to as *financing assets and liabilities*). Financing assets and financing liabilities and the changes therein would be presented in separate categories in each of the financial statements.

Question 1.2b If so, should the following application guidance be included in the standard?

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

- Items typically included in the financing section are: equity, cash and cash equivalents, bank loans, bank overdrafts, bonds and other traded debt, and leases, plus financial instruments held to hedge any of these items, including net investment hedges of foreign operations.
- Items typically excluded from the financing section are: payables, receivables, AFS financial instruments, vendor financing, guarantees payable in cash, pension assets and obligations (see below), plus financial instruments held to hedge any of these items

Question 1.2c Should an entity be required to explain, as a matter of accounting policy, why items on the 'include' list are not included in the financing section and why items on the 'exclude' list are not excluded from the financing section?

Question 1.2d Should an entity be required to disclose in the notes to the financial statements a break-down of total financial liabilities and financial assets (and flows thereon) by the section/category in which each component is presented?

Issue 2: Defining the Investing Category in the Business Section

15. In September, the Boards expressed a willingness to consider including a category other than operating in the business section. The Boards asked the staff to consider

what financial or other assets might be included in that category, which might possibly be labeled *investments* (referred to in this memo as the *investing* category). This issue was addressed with members of the joint international group (JIG) in September.

16. A similar overall approach to the suggestions recommended above for defining the financing section could also be used defining the investing category. That is, only financial assets and liabilities would be allowed (but not required) to be reported in the investing category based on an eyes of management approach. Under this approach, an entity would first determine whether its financial assets and liabilities should be included in the financing section (by reference to the guidance for determining the financial items that should be classified as financing). (Note that the inclusion of liabilities might seem inconsistent with the notion of investing, but as described below, financial instruments held to hedge investing assets might themselves be liabilities.) This approach would have the following benefits:
 - a. While financial assets and liabilities viewed by an entity as not related to investing could be excluded from the investing category, other (non-financial) items could not be included. As a result, there would be a mechanism for preventing the category from being used to take items ‘below-the-line’—that is, for excluding them from operating income. An entity could not, for example, present income and expenses relating to an underperforming business unit as investing in order to inflate operating income.
 - b. Permitting inclusion of only financial assets and liabilities in the investing category supports the purpose of categorising information relevant to predictive value because the items included would typically be independent of one another and additive for valuation purposes (and often carried at fair value with a valuation multiple of one).
 - c. The category could include items viewed by management as non-operating items or activities, notably equity method investments and AFS securities.
17. The staff notes, however, that an approach that limits the investing category to financial assets and liabilities would exclude non-financial assets such as real estate, or excess capital ‘parked’ in other non-financial assets, from being included in the investing category. The staff’s view is that the benefits from greater objectivity in items allowed to be reported outside the operating category outweigh the possible adverse effects of the constraint that, in certain cases, an entity would be prohibited from including in the investing category items that it managed as an investment. This

view is driven by the aim of imposing some control over an entity's flexibility in reporting operating income.

Staff Recommendation

18. The staff recommends that the investing category be defined as follows.

The investing category should include only financial assets and liabilities (as defined in the literature) not classified in the financing section that management views as incidental to the entity's main business activities (referred to as *investing assets and liabilities*). Items typically included in the investing category are

- a. AFS financial instruments
- b. Equity method investments,
- c. Financial instruments held to hedge (a) or (b) above.

19. Thus, the investing category in the statement of financial position would include all investing assets and liabilities. The investing category in the statement of comprehensive income would include all income, expenses, gains, and losses on investing assets and liabilities, and in the statement of cash flows would include all cash flows from income, expenses, origination, purchase, origination, or disposal of investing assets and liabilities.

20. As with the financing section, the staff recommends that an entity be required, as a matter of accounting policy, to explain any items listed above that are not included in the investing category.

Question 2.1 Should the investing category be defined as follows?

The investing category should include only financial assets and liabilities (as defined in the literature) not classified in the financing section that management views as incidental to the entity's main business activities. Items typically included in the investing category are

- a. AFS financial instruments
- b. Equity method investments
- c. Financial instruments held to hedge (a) or (b) above.

An entity would be required, as a matter of accounting policy, to explain any items listed above that are not included in the investing category.

Issue 3: Presentation of Pension Assets and Liabilities

21. The staff is in the process of considering how pension assets and liabilities and related changes should be presented in the financial statements. Once the Boards have

reached a tentative decision on Issues 1 and 2 in this memo, the staff will continue its analysis of the issues, which include the following:

- a. Not all pension obligations meet the definition of financial liabilities as pension obligations are only financial liabilities to the extent that they have vested. Similarly, not all pension assets meet the definition of financial assets as pension assets could include, for example, real estate investments. However, the staff is of the view that users' interests are best served by classifying an entity's total pension obligation or total pension assets in the same category because the components of pension assets or obligations have similar informational properties regardless of whether they are financial assets or financial liabilities.
 - b. Pension assets could be viewed as part of an entity's investing activities, whereas pension obligations could not. Users have expressed the view that pensions should be included in the financing section, possibly on a net basis. This raises the question of whether pension assets and pension liabilities must be classified similarly.
 - c. If an entity's pension assets and liabilities are required to be classified in the same category, there needs to be some consideration of how much information related to pensions should be displayed on the face of the financial statements.
22. The staff does not plan to address this issue at the October meetings, but welcomes Board member views.