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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: 19 September 2006, London
Project: Financial Statement Presentation
Subject: Application of working principles (Agenda Paper 9)

INTRODUCTION

1. The purpose of the September meetings on financial statement presentation is to continue our discussion of the application of the project's working principles.

This memorandum is organized as follows:

- Topic 1. Financing liabilities and treasury assets (pages 3–7)
- Topic 2. Strategic investment category (pages 7–13)
- Topic 3. Income taxes (pages 13–19)
- Topic 4. Discontinued operations (pages 20–26)
- Topic 5. Disaggregation working principle (pages 26–36)
- Topic 6. Comparability working principle (page 37)
- Topic 7. Extraordinary items (FASB only) [Topic omitted from Observer Notes]

Appendices:

- A. Summary of Input from JIG, ARG, and UAC members (pages A1-A3)
- B. [Appendix omitted from Observer Notes]
- C. Summary of July decisions and September staff recommendations (pages C1-C5).

SUMMARY OF RECOMMENDATIONS

2. In order to help Board members follow the memo, the following is a brief summary of the “presentation” recommendations in this memo (while there are

recommendations regarding definitions of terms, those are not reflected below).

A table reflecting this expanded working format is provided below.

- a. The treasury asset category should be included in the Financing section, not the Business section (the IASB tentatively agreed in July that it should be included in the Business section; the FASB did not reach a tentative conclusion)
- b. A strategic investment category should be included in the Business section.
- c. Income taxes should be presented as a separate section in the financial statements, thus all items will be shown on a pre-tax basis, and the need for intraperiod tax allocation would be eliminated.
- d. Discontinued operations should be presented as a separate section in the financial statements. Information about discontinued operations should be presented on a pre-tax basis and otherwise would continue to be presented in an aggregated manner on the face of the financial statements.
- e. Items should be presented by function on the statement of comprehensive income, and specific information should also be presented by nature on the face of that statement.
- f. The extraordinary item classification should be eliminated in U.S. GAAP.

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business <ul style="list-style-type: none"> ♦ Operating assets and liabilities <ul style="list-style-type: none"> ○ Short-term ○ Long-term ♦ Strategic investments 	Business <ul style="list-style-type: none"> ♦ Operating income ♦ Strategic investment income 	Business <ul style="list-style-type: none"> ♦ Operating cash flows ♦ Strategic investment cash flows
Discontinued operations	Discontinued operations	Discontinued operations
Income taxes	Income taxes	Income taxes
Financing <ul style="list-style-type: none"> ♦ Financing liabilities ♦ Treasury assets ♦ Equity 	Financing <ul style="list-style-type: none"> ♦ Financing expenses ♦ Treasury income 	Financing <ul style="list-style-type: none"> ♦ Financing cash flows ♦ Treasury cash flows ♦ Equity cash flows

TOPICS NOT YET ADDRESSED

3. The current plan is to discuss Topics (a)–(d) below at the October joint meeting and Topics (e)–(h) at the November/December meetings. Our goal is to complete all deliberations on Phase B by the end of the year.
 - a. **Operating asset and liability sub-categories and liquidity disclosures:**
The staff will be asking the Boards to reach a converged decision on whether operating working capital should be defined based on an entity's operating cycle (IASB preference) or a one-year notion (FASB preference). The staff will present several alternatives for presenting liquidity information in the notes. This topic will be discussed at the JIG meeting.

- b. **The measurement working principle:** The staff will be asking the Boards whether the statement of comprehensive income should present gains and losses that are the result of remeasurements separate from those that are not. This topic will be discussed at the JIG meeting.
- c. **Presentation of OCI, Recycling, and Totals:** The staff will be asking the Boards whether it would require some, if not all, of the items currently recognized in OCI to be recognized directly into income. This topic will be discussed at the JIG meeting.
- d. **Statement of Changes in Equity:** the staff will discuss this statement in light of cohesiveness being the governing principle.
- e. Whether the **operating category in the statement of comprehensive income and the statement of cash flows** should have sub-categories similar to those in the statement of financial position (related to Topic (a) above).
- f. The **direct and indirect method** on the statement of cash flows and related reconciliation.
- g. Application of the working format to **financial institutions**.
- h. Application of the working format to **not-for-profit entities** (FASB only).

TOPIC 1: FINANCING AND TREASURY

- 4. During the discussions at the July meetings regarding financing liabilities and treasury assets, the Boards were broadly in agreement with an approach that would present information through the eyes of management. That is, an approach that would classify items based on their function so that an entity could exclude from the treasury category or the financing section items that management views as operating assets and liabilities.

Issue 1a: Presentation of Treasury Assets

- 5. It is proposed in this issue that a functional approach to classification and display suggests that treasury assets and financing liabilities should be presented in a single section of the statement of financial position (and in corresponding sections in the other financial statements). This differs from the staff recommendation at the July meetings that treasury assets should be reported within the business section. The IASB agreed with that recommendation and some FASB members expressed a preference for it. The basis for the staff's recommendation and the Boards' tentative decision/leanings in July was as follows:
 - a. If the broad approach is adopted as the definition of financing, whereby financing is defined by nature to include all liabilities (and equity) but entities are allowed to exclude some liabilities and report them instead in the business section (thereby presenting the financing section through the

eyes of management), then it follows directly that assets should be excluded from the financing section. This is because assets cannot, in principle, be a source of financing if financing activities (liabilities) are defined by nature.

- b. In general, the relationship between an entity's treasury and business activities will differ across entities, with a dividing line in any given case that is subjective and difficult to draw.
6. The first basis for the Board's decision (paragraph 5.a) arguably places too much emphasis on defining financing activities by nature, given the broader context of the Boards' preference for reporting by function. If an entity manages its treasury activities as a single function, with liabilities raised and assets held with the purpose of providing the net financing of a given level of net operating assets, then presumably, in the context of a functional presentation, financing liabilities and treasury assets **should** be presented in the same section.
7. The second basis for including treasury assets in the business section (paragraph 5.b) can also be argued against in the light of the overall eyes-of-management approach that has been applied in developing the working format. Most Board members seem to agree that defining financing liabilities and treasury assets by function is inevitably subjective but nevertheless preferable to a standardized, relatively objective definition by nature. If the challenge of developing a workable boundary does not prevent an eyes-of-management approach for the financing section and the treasury category, then perhaps it should also not prevent the treasury category from being reported in the financing section as opposed to in the business section.
8. As suggested by the Boards in July, the staff spoke with users of financial statements to get a better understanding of how they analyze financing activities. Those users indicated that they include treasury assets as a part of their analysis of financing activities, rather than as a part of their analysis of business activities. This supports the staff's changed view that it would be more useful to present treasury assets in the same section as financing activities rather than in the business section alongside operating assets and liabilities. [Note: Topic 2 addresses a possible separate category in the business section for strategic assets.]
9. Reporting treasury assets in the financing section would also have the following benefits. (Note that the points below are provisional at this stage and will be reviewed in more detail at a later date. The staff has yet to consider in more depth issues raised by the reporting of financial instruments, such as the reporting

of derivatives, while the related issue of financial statement presentation for financial institutions also remains outstanding.)

- a. The dilemma posed by bank overdrafts, whereby any given account could be an asset one moment and a liability the next, would be taken care of to the extent that all of an entity's activities with its bank would be reported within financing.
- b. Similarly, the problem posed by derivatives would be less of a challenge. If a derivative is held as part of an entity's treasury activities then, regardless of whether it is an asset or a liability at the reporting date, it could be reported within the financing section. Equally, a derivative held (for example) to offset currency or commodity price risk in an entity's business activities would be reported within the business section. It would not, in principle, matter whether any given derivative qualified for or was designated as a hedging instrument, although in such cases the presentation ought to be more objective and straightforward because the function is in effect determined by the designation.

Staff Recommendation

10. The staff recommends that the treasury category be reported within the financing section, to show the financing-related activities of the entity in the same section, and that a gross presentation of the financing section be required.

Question 1a: Do the Boards agree that financing liabilities, treasury assets, and related activities should be presented gross in the same section in the statements of financial position, comprehensive income and cash flows?

Issue 1b: Approach to Defining Financing Liabilities and Treasury Assets

11. Although the Boards were in broad agreement at the July meeting that an eyes-of-management approach should be applied in presenting both treasury assets and financing liabilities, the Boards had somewhat different views on how treasury assets and financing liabilities should be defined. Specifically, the Boards agreed that the financing section should include all equity items but not all liabilities. This is because certain liabilities interact with an entity's business activities, making those liabilities (termed here *business liabilities*) candidates for inclusion in the business section. Likewise, the Boards agreed that the treasury category need not include all financial assets. The Boards also agreed that all cash and cash equivalents must be classified as treasury assets (in order to avoid requiring the subjective disaggregation of a single item (cash and cash equivalents) into both the business and financing sections).

12. The Boards differed, however, on whether financing liabilities and treasury assets should be defined broadly, with allowable exclusions, or defined more narrowly. FASB Board members suggested that the staff consult with users of financial statements in trying to develop a definition that would address their concerns. As noted previously, the staff did consult with users and is in the process of developing possible definitions for financing liabilities and treasury assets. This issue addresses the staff's recommended approach to developing those definitions. At the September meeting the staff will be asking for Board concurrence on that approach. The staff plans to bring the definitions to the Boards at the October joint meeting.

Possible Approaches

13. The *broad definition* approach defines financing liabilities and treasury assets broadly and allows entities to exclude items as a matter of accounting policy. Guidance would be provided on items that could be excluded. Financing liabilities and treasury assets as reported by management on the face of the financial statements could be reconciled to the broad definition in the notes. This approach was recommended by the staff and favored by the IASB in July.
14. The *narrow definition* approach attempts to define financing liabilities directly. The accounting standard would directly describe the amounts to be reported in the financing section, as opposed to giving a broad definition and describing allowable exclusions. This can be viewed as a more purposeful approach because it addresses what financing and treasury activities are, as opposed to what they are not. This narrow definition approach was preferred by the FASB over the broad definition approach, and the FASB members asked the staff to consider further how it could be implemented.
15. The broad definitions were stated in the July memo as follows:
- The *financing section* applies only to those liabilities for which accounting standards require the separate computation of interest income or expense. 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.

The *treasury activities* category includes treasury assets that are defined as *all financial assets*. For presentation purposes, an entity may choose to exclude from the treasury category financial assets that are classified as operating working capital assets.

16. In contrast to the above broad definitions by nature, an objective and tight functional (narrow) definition of financing liabilities and treasury assets is probably not possible to achieve. This is because the underlying basis of a functional presentation is entity-specific and viewed through the eyes of management. However, it may be possible to develop a narrow functional definition that is subjective. For example, treasury assets could be defined as “cash, cash equivalents and all other assets that are managed as part of an entity’s net financing of its business activities.” Note that the interpretation of *financing* and *business* in this definition is left open to the judgment of management (albeit within the constraint that categorization is a matter of accounting policy and there would be a reconciliation of the excluded items).

Staff Recommendation

17. In the staff’s view, promulgation of a narrow definition for classifying assets and liabilities in the financing section would be consistent with an overall eyes-of-management presentation approach. Any concerns about comparability of information associated with a subjective definition could be accommodated in the notes to the financial statements (for example, by way of a reconciliation to a standard (broader) definition). Therefore, the staff recommends that financing liabilities and treasury assets be defined narrowly, and thereby subjectively, for purposes of presenting information on the face of the financial statements.

<p>Question 1b: Do the Boards agree that financing liabilities and treasury assets should be defined narrowly for the purposes of presentation on the face of the financial statements?</p>
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TOPIC 2: THE STRATEGIC INVESTMENTS CATEGORY

18. During the July Board meetings, some members of each Board indicated that the definition of *treasury assets* was too broad because some assets included in that definition, equity method investments in particular, are clearly not viewed as assets that offset *financing liabilities*. Those Board members suggested that the staff consider a category for strategic investments that would be reported in the business section, separate from the treasury category.

19. Strategic investments is not currently defined in U.S. GAAP or IFRS; nor did the Boards discuss what items should be classified in a strategic investment category at the July meetings. However, existing guidance of the Boards requires the presentation of an investing category in the statement of cash flows.
20. This Topic discusses whether investments or strategic investments should be presented as a separate category within the business section and, if so, how that category should be defined.

Analysis of Existing Guidance

21. Both Boards require the investing category to be separately presented in the statement of cash flows. IAS 7, *Cash Flow Statements*, requires that the aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units be presented separately and classified as investing activities. The reason for separately presenting the investing category is cited in IAS 7 as follows:

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. [paragraph 16]

22. The staff is of the view that the current investing category in the statement of cash flows is too broad. That category includes cash flows related to acquisitions and disposals of the following asset groups:
 - a. productive assets;
 - b. investments in subsidiaries, affiliates/associates, and joint ventures; and
 - c. other investments.

The following paragraphs address whether those asset groups should be classified in a separate investment or strategic investment category.

Productive Assets

23. APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, defines *productive assets* as assets held for or used in the production of goods or services by the entity. It further notes that productive assets include equity method investments; however, for the purposes of this memorandum, equity method investments are discussed as part of “investments in subsidiaries, affiliates/associates, and joint ventures.”

24. The staff contends that productive assets (excluding equity method investments) should be classified in the operating category because they are held for or used in the production of goods or services, and thus a separate category for those assets is not warranted.

Investments in Subsidiaries, Affiliates/Associates, and Joint Ventures

25. The UK's FRS 1, *Cash Flow Statements* (revised 1996), requires an entity to discern cash flows from "acquisitions and disposals" and "capital expenditure and financial investments." Under FRS 1, acquisitions and disposals include investments in subsidiaries, affiliates/associates, and joint ventures; capital expenditures and financial investments include productive assets and other investments. Thus, investments in subsidiaries, affiliates/associates, and joint ventures are presented as a separate category in the statement of cash flows under UK GAAP. The staff contends that these investments generally should be presented in a separate category called *strategic investments* in the financial statements for the following reasons:

- a. Acquisitions and disposals of these investments effectively acquire or dispose of all or a portion of the assets and liabilities of the investee, which are classified in the various categories (treasury, operating, financing, and the like) in the investee's financial statements. Classifying gains and losses and cash flows related to these investments in a single category should make it easier to discern the effectiveness of the investor's (management's) decision to invest in the investee rather than acquire assets and liabilities individually and thereby assist users in assessing future cash flows of the entity.
- b. Investments in subsidiaries, affiliates/associates, and joint ventures are required to be either consolidated, accounted for by the equity method, or proportionately consolidated, even when those investments are publicly traded and the fair value of the investments can be estimated reliably.
- c. While an equity method investment represents the investor's portion of assets and liabilities of the investee (which in turn are classified in the various categories in the investee's financial statements), it is presented as a single line item in the investor's financial statements. Classifying an equity method investment in any category other than strategic investments may be misleading.
- d. While income from an equity method investment represents the investor's portion of income of the investee (which is classified in the various categories in the investee's financial statements), it is presented as a single line item in the investor's financial statements. Classifying income from an equity method investment in any category other than strategic investments may be misleading.

- e. Cash flows from an equity method investment represent dividends from the investee; they do not represent the investor's portion of the investee's cash flows.
 - f. IAS 31 allows an entity to account for joint ventures under the equity method or the proportionate consolidation method (US GAAP requires the equity method). If equity method investments are included in the strategic investments category, joint ventures accounted for by the proportionate consolidation method also should be included in the strategic investments category because the accounting policy choice should not affect the classification of assets and liabilities.
26. The next question is whether an investment in a subsidiary, affiliate/associate, or joint venture can be classified in another category. The staff asserts that an entity should be permitted to classify certain investments in other business categories because it is consistent with how the proposed financial statement presentation model has been developed so far (that is, "through the eyes of management"). For example, an entity may have an equity method investment that it would be more appropriate to classify as inventory (in the operating category).
27. If an entity chooses to classify an investment in a subsidiary, affiliate/associate or joint venture in another business category, that investment should be required to be presented as a separate line item in the statement of financial position so that users may reclassify that investment if they wish to do so. The policy for classifying investments in other categories should be described in the notes.

Other Investments

28. The remaining "other investments" asset group includes investments such as mid- or long-term equity investments that are **not** consolidated, accounted for by the equity method, nor proportionately consolidated; and speculative investments such as investments in artwork. The staff contends that certain "other investments" should be **permitted** to be classified in the strategic investment category. The staff is of the view that the main characteristic of a strategic investment is that an entity invests in a group of assets and liabilities by acquiring an interest in the investee (rather than acquiring individual assets and liabilities) and, therefore, the investment must be an equity investment. However, the ownership percentage or the method used to account for an investment should not dictate the classification of an investment.

Assets to be Included in the Strategic Investment Category

29. As discussed in the previous paragraphs, the staff is of the view that the strategic investment category should include investments in subsidiaries, affiliates/associates and joint ventures (permitting some to be excluded) and certain other investments. This part of the memo attempts to define strategic investments and determine the assets that are to be included in that category.

Definition of “Strategic” Investments in the Forthcoming SOP

30. The staff notes that the FASB has discussed the distinction between *pure* (or *passive*) investments and *strategic* investments in the context of clarifying the scope of the Audit and Accounting Guide, *Investment Companies*, in a forthcoming Statement of Position (SOP) to be issued by the AICPA.
31. In the forthcoming SOP, *pure* (or *passive*) investments and *strategic* investments are defined as follows:
- Pure* (or *passive*) investments: investments made for current income, capital appreciation, or both, with investment plans that include exit strategies.
- Strategic* investments: investments held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee.
32. The forthcoming SOP will require that all relevant facts and circumstances be considered in determining whether an investment is a *pure* (or *passive*) investment or a *strategic* investment. Significant levels of ownership interests in investees, particularly in circumstances in which an entity has controlling financial interests in investees, provide significant evidence that an entity is investing for strategic investment purposes. The existence of joint ventures or similar arrangements with the investee to jointly develop, produce, market or provide products or services also provide significant evidence that an entity is investing for strategic purposes.
33. The staff asserts that the definition of *strategic investments* provided in the forthcoming SOP should be adopted. The advantages of adopting this definition are:
- a. the definition is consistent with the staff’s view that strategic investments should be limited to equity investments
 - b. the definition does not rely on the percentage ownership of the investment or the accounting applied to the investment and thus would permit certain

investments in subsidiaries, affiliates/associates, and joint ventures to be excluded and certain “other investments” to be included

- c. the definition requires an entity to make a judgment after taking into account all relevant facts and circumstances, which is consistent with a “through the eyes of the management” approach
- d. the definition reflects the recent discussions of the FASB.

Goodwill

34. In addition to the investments that meet the definition of *strategic investments* as defined in the forthcoming SOP, the staff contends that goodwill (as defined in accounting literature) should be classified in the strategic investment category for the following reasons:

- a. When an entity retains an equity investment as a result of a business combination, goodwill should be classified together with that investment. Goodwill is considered to be the amount of unidentifiable net assets (that is, the residual) and thus it would be inappropriate to classify this asset in any category other than the category the original equity investment would be classified in. Classification of goodwill together with the equity investment would enable users to assess the overall effectiveness of the decision of the management of the entity (the investor) to invest in the investee. Because equity investments held as a result of a business combination are generally strategic investments, goodwill related to those equity investments should also be classified in the strategic investment category for consistency.
- b. When an entity does not retain an equity investment as a result of a business combination, any goodwill generated from that transaction also represents the amounts of unidentifiable net assets (the residual). This goodwill should also be classified in the strategic investment category for consistency.

35. In the rare case that the equity investment an entity retains as a result of a business combination does not meet the definition of *strategic investments* and is classified in another business category, the staff contends that goodwill related to that equity investment should be classified together in that other business category.

Staff Recommendation

36. The staff is of the view that the investing category required in the current statement of cash flows is too broad to be useful and therefore that existing category should be eliminated. The staff recommends the following:

- a. A strategic investment category be presented within the business section in each of the financial statements

- b. A *strategic investment* be defined as an equity investment held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to a noninvestor entity that is not a related party (as defined in accounting literature) to the investee
- c. Goodwill (as defined in accounting literature) be classified in the strategic investment category unless the equity investment that an entity retains as a result of a business combination does not meet the definition of a strategic investment (which should be rare).
- d. Assets that do not meet the definition of a strategic investment that give rise to investing cash flows under current guidance should be classified in other categories (such as treasury assets or operating assets).

Question 2A: Do the Boards agree that

- i. the investing category currently required in the statement of cash flows is too broad? If so, do the Boards agree that a strategic investment category within the business section should be presented in each of the financial statements?
- ii. an entity should have some flexibility (through the eyes of management) in determining the assets to be classified in the strategic investment category? If so, do the Boards agree that a strategic investment should be defined as: an equity investment held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from an investee that is unavailable to a noninvestor entity that is not a related party to the investee?
- iii. goodwill should be included in the strategic investment category except when the equity investment that an entity retains as a result of a business combination is not a strategic investment?

TOPIC 3: INCOME TAXES

- 37. This portion of the memo addresses whether there should be a separate income taxes category or section in the financial statements and, if so, how income taxes should be presented in the statement of comprehensive income and the statement of cash flows. The presentation in the statement of financial position will be discussed at a future meeting in conjunction with other statement of financial position presentation issues.
- 38. The focus of the discussion in this memo is on the presentation of income taxes in the financial statements. The staff does not intend to address the accounting for income taxes, which includes the accounting for deferred income taxes (the so-called interperiod tax allocation) except for income taxes related to transactions with owners.

Existing Guidance

Statement of Comprehensive Income

39. FASB Statement No. 109, *Accounting for Income Taxes*, requires that significant components of income tax expenses attributable to continuing operations for each year be disclosed in the financial statements or notes thereto. Statement 109 further requires that the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items be disclosed for each year those items are presented.
40. IAS 12, *Income Taxes*, requires that tax expense (income) related to profit or loss from ordinary activities should be presented on the face of the income statement. IAS 12 also requires that the aggregate current and deferred tax expense related to items that are charged or credited to equity, which would include other comprehensive income (OCI) items, be disclosed.

Statement of Cash Flows

41. FASB Statement No. 95, *Statement of Cash Flows*, requires that cash flows related to income taxes be reported in the operating section. Paragraph 92 of Statement 95 explains that “the Board decided that allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved.” However, FASB Statement No. 123 (revised 2004), *Share-Based Payment*, provides an exception that requires the hypothetical income tax effects related to share based payments to be presented in the financing section.
42. IAS 7, *Cash Flow Statements*, states that cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless those cash flows can be specifically identified with financing and investing activities.

Intraperiod Tax Allocation

43. Under existing guidance, income tax expense for the period is allocated to
- a. income from continuing operations,
 - b. discontinued operations,
 - c. other comprehensive income (OCI) items, and
 - d. transactions with owners.

Statement 109 refers to this allocation as “intraproduct tax allocation” and the argument for justifying intraproduct tax allocation is that it provides useful information related to the after-tax results of each category within the statement of comprehensive income.

44. While the rules in Statement 109 are detailed enough that the allocated amounts can be calculated unambiguously, the rules themselves were determined arbitrarily and, in some cases, the allocated amounts are not useful to users of financial statements. For example, Statement 109 requires that the effects on changes in income tax rates be allocated to income from continuing operations regardless of the asset or liability it relates to. Accordingly, any income tax expense related to OCI items would not be adjusted for a change in income tax rates; in those instances, the amount reported for accumulated OCI may be misleading.
45. The rules in Statement 109 regarding intraproduct tax allocation are detailed and complex. At the April 2005 joint Board meeting, the IASB decided to amend IAS 12 and adopt the approach in Statement 109. Moreover, members of both Boards generally agreed that any income tax allocation will be arbitrary and asked the staff to explore eliminating intraproduct tax allocation, favoring a separate income tax category in the financial statements. However, Board members cautioned the staff that, if the Boards were to retain the *net income* subtotal, that subtotal would need to be presented net of tax and thus some allocation of income taxes would be unavoidable.

Issue 3: Presentation of Income Taxes

46. Some argue that intraproduct tax allocation is arbitrary and that the costs of providing this information exceed the benefits. Others argue that, while there may be some noise due to the arbitrariness of the allocation, the information is still useful and the benefits of providing this information exceed the costs. When discussing the presentation of income taxes in the financial statements, the Boards need to consider whether income tax is (a) integral to the transaction or event that gives rise to income taxes (the underlying transaction) or (b) a transaction separate from the underlying transaction. Those two views are addressed in the following paragraphs.

View A: Integral to the Underlying Transaction

47. Under the view that income taxes are integral to the related transaction, View A would present the taxes and transaction in the same category. One advantage of View A is that it better reflects the results of management's decisions. The decision of whether to enter into a transaction is usually made after considering the income tax consequences and, accordingly, accounting for income taxes together with the underlying transaction would enable users to better assess the effectiveness of management's decisions.
48. Another advantage of View A is that it can be argued that it is more consistent with deferred tax accounting, which identifies the temporary differences between the amount recognized in the statement of financial position and the tax bases, than View B.
49. One disadvantage of View A is that a portion of an entity's income tax expense (such as loss carryforwards) may not be directly related to a specific transaction recognized in the financial statements. In those circumstances, the portion unrelated to a specific transaction can be either
- a. presented separately and income taxes that are directly related to each transaction would be accounted for based on statutory tax rates (View A-1), or
 - b. allocated to income taxes that are directly related to each transaction (View A-2).
50. The problem with View A-1 is that it may be inconsistent with the objective of presenting the transaction and the related income taxes in the same category. For example, if an entity had a large amount of loss carryforwards in a certain period and entered into a specific transaction taking advantage of the "tax free" status, it might be misleading **not** to allocate the loss carryforwards to each transaction. The problem with View A-2 is that it would be difficult to develop an allocation method that is not arbitrary. After-tax amounts based on an arbitrary allocation of income taxes would not be useful.
51. A strict application of View A would lead to the conclusion that the proposed financial statement presentation model should present income taxes in each category, based on the classification of the underlying transactions. Under View A-1, a separate category might be presented for income taxes that cannot be directly related to a specific transaction recognized in the financial statements.

View B: Separate from the Underlying Transaction

52. Under the view that income taxes are separate from the related transaction, View B would present taxes and transactions separately. One advantage of View B is that it reflects the view that income taxes are a form of income appropriation. Income generated from business activities are appropriated to tax authorities as well as to providers of finance (shareholders and debtholders), and the remainder is retained within the entity. The amount appropriated to tax authorities is determined based on a formula promulgated by tax authorities, which may rely heavily on, but is nonetheless independent from, information presented in the financial statements.
53. The appropriation of income to tax authorities is a transaction with nonowners; that is, tax authorities are **not** owners in their capacity as owners. As such, under View B, income taxes should be presented as a component of comprehensive income and should not be recognized directly in equity. This is consistent with the FASB's recent decision in the Liabilities and Equity project that equity issuance costs should be expensed because they are not transactions with owners.
54. Another advantage of View B is that it allows users to assess the effectiveness of an entity's tax planning strategies. Because tax planning strategies would usually take into account all income taxes, including those related to transactions with owners, it would be appropriate to include all income taxes in comprehensive income.
55. One disadvantage of View B is that it can be argued that it is less consistent with deferred tax accounting than View A. If income taxes were indeed transactions with tax authorities, it would be relatively difficult to argue why the temporary differences between the amount recognized in the statement of financial position and the tax bases must be recognized. In other words, some may argue that only current income taxes (and no deferred income taxes) should be recognized.
56. A strict application of View B would lead to the conclusion that the proposed financial statement presentation model should present income taxes as a separate section (that is, along with the *business* and *financing* sections) because income taxes arise from not only those items reported in the business section but also from items reported in the financing (and possibly other) sections. Moreover, presenting all income taxes in a separate section (including those related to

transactions with owners) would eliminate the need for, and thus resolve the issues associated with, intraperiod tax allocation.

Staff Analysis and Recommendation

57. Existing guidance seems to mix the two views discussed above. In the statement of comprehensive income, income taxes related to continuing operations seem to be consistent with View B, while income taxes related to other items seem to be consistent with View A. Income taxes related to transactions with owners are recognized directly in equity. Income taxes generally are required to be presented in the operating section of the statement of cash flows, which is consistent with View B. However, as noted in paragraph 41, Statement 123(R) provides an exception that requires the hypothetical income tax effects related to share based payments to be presented in the financing section, which is in line with View A.
58. The staff contends that the Boards should consistently apply either View A or View B in developing the financial statement presentation model. Of the two views, the staff recommends View B because in the staff's opinion, conceptually, income taxes are a form of income appropriation to tax authorities.
59. While some may argue that income taxes must be allocated to each transaction because that is an assumption underlying deferred tax accounting, the staff does not take this view. If an entity can estimate the amount and timing of income tax payments to tax authorities, that should be reflected in the financial statements. Accordingly, the staff is of the opinion that View B is not inconsistent with deferred tax accounting.
60. If the Boards conceptually disagree with View B and prefer View A, the staff notes that there are practical issues associated with View A. Under View A, income taxes that cannot be directly related to a specific transaction would need to be either presented separately or allocated—neither of which, in the staff's view, would be useful to users of financial statements. That is because separate presentation would not represent the actual after-tax result of each transaction and an allocation, which is unavoidably arbitrary, would not be useful. Accordingly, View B can be viewed as a practical solution as it avoids the need for intraperiod tax allocation.
61. As noted in paragraph 45, the Boards previously noted that if the subtotal *net income* were to be retained, income taxes would need to be allocated between

items that are included in *net income* and those that are not. Whether to retain the subtotal *net income* will not be discussed at the September meeting. Nonetheless, the staff is of the view that, if the Boards decide to retain the subtotal *net income*, View B would lead to the conclusion that *all* income taxes should be recognized in *net income* and thus no taxes would be recognized in OCI, as income taxes related to OCI items would be considered to be a transaction separate from the original transaction that gives rise to OCI.

62. In line with View B, the staff recommends that income taxes be presented as a separate section (along with the *business* and *financing* sections) in the financial statements. This effectively eliminates intraperiod tax allocation, which means that:
- a. There would be no need for a pre-tax subtotal, such as “income from continuing operations”, in the statement of comprehensive income.
 - b. The results of discontinued operations would no longer be presented net of applicable income taxes (those results would be presented on a pre-tax basis). (The presentation of discontinued operations is discussed in Topic 4.)
 - c. OCI items will no longer be presented on an after-tax basis. Accordingly, changes in tax rates would no longer raise the issue of “truing up” OCI for prior periods or the accumulated OCI on the statement of financial position (the so-called “backwards tracing” issue).
63. The staff also recommends that income taxes related to transactions with owners **not** be recognized directly in equity but be included in comprehensive income. Those amounts should be presented in the income tax section of the statement of comprehensive income. The staff acknowledges that this recommendation to change the **accounting** for income taxes related to transactions with owners may be beyond the scope of the financial statement presentation project. If the Boards believe that this is the case, or if the Boards disagree with the staff recommendation and support continuing to recognize taxes related to transactions with owners directly in equity, the staff will, at a future meeting, bring to the Boards possible improvements to intraperiod tax allocation, given the criticisms against the current allocation method. The staff notes that its recommendation would resolve the issue of “backwards tracing” to equity transactions.

Question 3: Do the Boards agree that

- a. income taxes should be presented as a separate section (along with the business and financing sections) in the financial statements, thereby

eliminating the need for intraperiod tax allocation and the presentation of discontinued operations and OCI items on a net-of-tax basis?

b. income taxes related to transactions with owners should not be recognized directly in equity? If so, do the Boards agree that income taxes related to transactions with owners should be recognized in the income taxes section in the statement of comprehensive income?

TOPIC 4: DISCONTINUED OPERATIONS

64. This Topic addresses the following issues:

- a. **Issue 4A**—whether developing a common (converged) definition of *discontinued operations* should be in the scope of the project.
- b. **Issue 4B**—how discontinued operations should be presented in the financial statements
- c. **Issue 4C**—what information about discontinued operations should be presented in the financial statements.

Issue 4A: Definition of a Discontinued Operation

65. The existing guidance for reporting discontinued operations can be found in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* (2004), and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

- a. IFRS 5 (paragraph 32) establishes that: “a discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale” [emphasis added];
- b. Statement 144 (paragraph 42) does not define the term *discontinued operation* but makes a reference similar to IFRS 5, by stating that: “the results of operations of a component of an entity that either has been *disposed of* or is classified as *held for sale* shall be reported in discontinued operations” [emphasis added].

66. The size of a *component* classified as a discontinued operation is different in the two standards and could be considered smaller in Statement 144. Paragraph 41 of Statement 144 states that a component may be an operating segment (as defined in FAS 131), a reporting unit (as defined in Statement 142), a subsidiary, or an asset group (the lowest level for which identifiable cash flows are largely independent from cash flows of other groups). IFRS 5 (paragraph 31), states that for a *component* to be classified as a discontinued operation it must at least represent a separate major line of business or geographical area of operations or a subsidiary acquired exclusively with a view to resale.

67. When the IASB deliberated IFRS 5 (from 2002 through 2004), it was intended that the new IFRS would converge with Statement 144. However, after considering comments from constituents, the IASB decided not to fully converge with Statement 144, noting that the size of the component classified as a discontinued operation in accordance with Statement 144 would be too small. Nevertheless, the IASB considered it as a possibility, stating that “[the Board] intends to work with the FASB to arrive to a converged definition within a relatively short time” (IFRS 5, paragraph BC71).
68. While converging the definition of discontinued operations is arguably outside the scope of a project on financial statement presentation, the staff notes that while this project may result in a seemingly converged and improved presentation of discontinued operations, there will be a false sense of comparability until the definitions are converged. Thus, the time may have come to “arrive at a converged definition.”

Question 4A: Do the Boards want to include converging the definition of discontinued operations in the scope of the financial statement presentation project? If yes, should that be addressed in the current Phase B or in new, later phase of the project?

Issue 4B: Presentation of Discontinued Operations

69. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that information in the financial statements should be grouped by items with essentially similar characteristics (such as continuity or recurrence, stability, risk, and reliability) and items with essentially different characteristics should be separated. Discontinued operations are different in nature from the ongoing activities of an entity in terms of their continuity and recurrence. While cash flows from continuing operations are expected to arise on an extended basis, cash flows from discontinued operations are considered limited and non-recurring. Discontinued operations represent cash flows that have been (or will be) eliminated from the operations of an entity as a result of a disposal transaction.
70. The staff contends that segregating discontinued operation information from continuing operation information provides decision-useful information as it gives

users a clearer picture of the components that are not (will not) be part of an entity in the foreseeable future and that are not having (will not have) any significant continuing involvement in an entity's operations. This segregation of information removes distortions in "continuing" figures and increases their predictive value, thereby improving the ability of users to assess the amounts, timing, and uncertainty of an entity's future cash flows. Thus the staff is of the opinion that discontinued operations should continue to be distinguished from the ongoing or continuing activity of the entity on the face of financial statements.

71. The staff identified the following alternatives for presenting the assets and liabilities related to a discontinued operation and the changes in those assets and liabilities in the financial statements:
- a. **Alternative A**—in a **separate section** in each financial statement, along with the *business* and *financing* sections
 - b. **Alternative B**—in a **separate category within the *business* section** (in addition to the "operating" category).
 - c. **Alternative C**—**within the appropriate categories and subcategories** (for example, include operating assets and liabilities of discontinued operations in the "short-term operating" or the "long-term operating" subcategory; treasury assets of a discontinued operation in the treasury category, and so forth).

Analysis of Alternatives

72. While allocating assets and liabilities of a discontinued operation and the changes therein into categories/subcategories (Alternatives B and C) may have confirmatory value, it has little predictive value given that a discontinued operation is or will no longer be part of an entity's ongoing operations. Only Alternative A is consistent with the view that a discontinued operation is separate from the rest of the business (because it is not an ongoing operation).
73. If a discontinued operation is presented with the same prominence as ongoing operations (that is, included in the *business* section (Alternative B)), one could interpret that presentation to mean that a discontinued operation contributes to the performance of an entity in the same manner as the assets or liabilities from ongoing operations. Moreover, this may result in the aggregation and classification (within the business section) of items with dissimilar characteristics in terms of continuity and recurrence. This classification scheme would result in total amounts for the business section being less decision useful than if the

discontinued operation had been separately presented. Thus, Alternative B could be considered to be providing misleading information.

74. However, some may be of the view that a discontinued operation does continue to provide value to the business/entity prior to its disposition and thus it is appropriate to include the discontinued operation in the business section. One disadvantage of Alternative B (include a discontinued operation category in the business section) is that a discontinued operation may have financing liabilities (or treasury assets) and thus it would be inappropriate to present the discontinued operation only in the business section.
75. Alternative C, which would allocate a discontinued operation to the categories in both the *business* and *financing* sections, would resolve that issue. Those who support Alternative C are of the view that a discontinued operation is an integral part of an entity prior to its disposition. A 1999 G4 + 1 Paper proposed that discontinued operations be disaggregated in a separate column for each applicable line item within the “Operating Income” category. The UK ASB favored a similar approach—presenting the results of discontinued operations in the various sections of the comprehensive income statement (operating income, financing and treasury, other gains and losses) in its Financial Reporting Exposure Draft No. 22 (FRED 22), *Revision of FRS 3 Reporting Financial Performance*.
76. The staff’s opinion is that discontinued operations should be presented in the financial statements in a separate section and should not be classified as a category/subcategory within a section. In the staff’s view, a discontinued operation will not affect an entity’s future performance and a presentation that suggests otherwise would be of limited usefulness as it will have little predictive value. Presenting a discontinued operation in a separate section will allow a user that may view a discontinued operation as part of an entity’s business to add the discontinued operation section to the business section for purpose of their analysis.

Staff Recommendation

77. For the reasons noted above, the staff recommends that discontinued operations be presented in a separate section in each financial statement (Alternative A); this presentation reflects the staff view that a discontinued operation is no longer part of an entity's ongoing operations.

Question 4B: Do the Boards agree that discontinued operations should continue to be presented separately in the financial statements and that information related to a discontinued operation should be displayed as a separate section in the financial statements?

Issue 4C: Presenting Information about a Discontinued Operation

78. In Issue 4B, the staff recommended that discontinued operations should be a separate section in each of the financial statements. This issue addresses how much information about discontinued operations should be presented on the face of each of the financial statements and in the notes. As described in the following paragraphs, IFRS 5 and Statement 144 have similar approaches for the presentation and disclosure of discontinued operations within the financial statements.
79. In the statement of financial position, assets and liabilities that meet the definition of a discontinued operation are presented separately, and not offset, as a single line item separated from the rest of an entity's assets/liabilities and classified as long-term assets/liabilities *held for sale*. The term *held for sale* refers to those long-term assets, or groups of long-term assets and liabilities (called *disposal groups*) available for immediate sale whose carrying amount will be recovered principally through sale rather than continuing use (IFRS 5, paragraphs 6-9; Statement 144, paragraphs 30-32). Both IFRS 5 and Statement 144 require at least note disclosure of the major classes of assets and liabilities classified as held for sale (display on the face is also acceptable).
80. In the income statement, the results of discontinued operations, including any gain or loss recognized on the measurement to fair value less costs to sell, less applicable taxes, are presented as a separate component of income (separate from continuing operations) according to both IFRS 5 and Statement 144. IFRS 5 requires disclosure of a single amount on the face of the statement of comprehensive income for the total impact of discontinued operations with a breakdown of that total into revenue, expenses, and pre-tax profit or loss;

remeasurement gain or loss; and related tax effects presented either on the face of the statement or in the notes. Statement 144 does not specify that a single amount be presented on the face of the statement; however, it does specify that a gain or loss recognized on the disposal should be disclosed either on the face of the income statement or in the notes.

81. In the statement of cash flows, cash flows related to a discontinued operation are not presented in a separate section. IFRS 5 requires that those cash flows be segregated by category (operating, investing, and financing) either on the face of the statement or in the notes. Statement 144 does not specify how the cash flows of a discontinued operation should be presented; however, if an entity chooses to present those cash flows by category, it must do so consistently across all periods.

Staff Recommendation

82. The staff recommends that long-lived assets, and assets and liabilities within disposal groups classified as held for sale be presented in the discontinued operation section of the **statement of financial position**, with the assets presented separately from the liabilities and not offset. In addition, the staff recommends that the Boards retain the current requirement that the major classes of discontinued assets/liabilities be disclosed in the notes to the financial statements. This recommendation retains the current presentation requirements of IFRS 5 and Statement 144, but changes the location of that presentation to the discontinued operations section of the statement of financial position.
83. The staff recommends that, consistent with IFRS 5, an entity should disclose a single amount in the discontinued operation section of the **statement of comprehensive income** comprising the total of:
- a. the profit or loss of the discontinued operation and
 - b. the gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal groups constituting the discontinued operation.

An entity should disclose the components of the profit or loss (revenue and expenses) and the components of the gain or loss (from remeasurement or disposal) either on the face of the statement or in the notes. (As recommended in Issue 3, those amounts should be on a pre-tax basis.) This recommendation retains the current presentation requirements of IFRS 5 and Statement 144 and

clarifies what information is required to be presented on the face of the statement of comprehensive income and what information may be presented in the notes.

84. The staff recommends that cash flows from a discontinued operation be presented as a single line in the discontinued operation section of the **cash flow statement**. This recommendation would change the presentation required by IFRS 5, as separation of those cash flows into their respective categories (operating and financing, for example) would no longer be required. The staff is of the opinion that cash flows by category for a discontinued operation is of limited usefulness, as a discontinued operation is not considered part of an entity's ongoing operations. However, the staff recommends that if an entity wants to present discontinued operation cash flows by category in the notes, that it be required to do so for each period presented.

Question 4C: Do the Boards agree that

- i. the assets of a discontinued operation and the liabilities of a discontinued operation be presented separately and not be offset?
- ii. the income statement effects be presented as one amount on the face of the income statement and further disaggregated either on the face of the statement or in the notes?
- iii. the cash flows from a discontinued operations be presented as a single amount in the statement of cash flows?

TOPIC 5: DISAGGREGATION

85. One of the project working principles that the Boards agreed to in March and April states that financial statements should present information in a manner that disaggregates items into groups that respond similarly to changes in the same economic condition, and presents subtotals and totals where appropriate. This topic addresses the following issues related to that disaggregation working principle:
- a. Revisions to the working principle
 - b. Presenting information by nature or function
 - c. Presenting information on a gross or a net basis
 - d. Disaggregating other line items.
86. At the March/April 2006 Board meetings, the Boards agreed that in applying the disaggregation working principle they would consider a number of

disaggregation schemes. As noted above, this memo focuses on two of those schemes: presenting information by nature or function and presenting information on either a gross or a net basis. The staff sought input from members of the Joint International Group (JIG), the IASB's Analysts Research Group (ARG), and the FASB's User Advisory Council (UAC) on a variety of disaggregation issues. Their responses are summarized in Appendix A.

87. Another potential disaggregation scheme is one that presents information about fixed and variable costs. The staff asked members of various user groups whether disaggregating fixed and variable costs would be helpful. Users from the JIG, the ARG, and the UAC suggested that that information would be useful in the management commentary (management discussion and analysis), but not in the financial statements. In addition, they noted that any such breakdown would be arbitrary and difficult to substantiate. (Refer to questions 7 and 8 in Appendix A). Based on that input, the staff chose not to pursue that disaggregation scheme any further. If the Boards would like the staff to pursue this scheme, please let us know.

Issue 5A: Should the Disaggregation Working Principle be Revised?

88. Based on discussions at the May brainstorming meetings with Board advisors, it was apparent to the staff that the intent of the disaggregation working principle was not clear. In the staff's view, this working principle was intended to convey that items should be reported at the "highest" level that is useful for predictive purposes, bearing in mind that reporting information that is too highly aggregated is not useful. Those participating in the brainstorming meetings agreed that the working principle should be clarified to state that information should be presented in the financial statements in a way that investors and analysts can use it to predict future cash flows without needing to perform additional calculations. That notion is consistent with the project's overall objective of providing information that will help users assess the amounts, timing, and uncertainty of an entity's future cash flows.

Staff Recommendation

89. The staff recommends that the working principle be revised as follows:

Financial statements should present information in a manner that **disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows.**

That revised working principle does not include the phrase “and present subtotals and totals where appropriate” because it is already included in the project objective.

Question 5A: Do the Boards agree that the disaggregation working principle should be revised to read: “Financial statements should present information in a manner that disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows?”

Issue 5B: Should Information in the Statement of Comprehensive Income be Presented by Function or Nature?

Background

90. The current focus on whether information should be presented in the statement of comprehensive income based on function or nature has roots in user surveys done by the FASB staff between December 2001 and February 2002 as well as more recent discussions with JIG members—many of which indicate a keen interest in presenting information by function as that best describes the way businesses operate. In addition, it is based on the IASB agreement in May 2002 that analysis by function “was more likely to provide useful information in understanding and predicting performance, and...was more likely to reflect an entity’s internal reporting.”
91. Members of the JIG, ARG, and UAC that are users of financial statements have asked specifically that certain expenses be disaggregated by nature; for example—labor, materials, utilities, rent, depreciation of PP&E, and amortization of intangibles. They also have asked for greater disaggregation of information currently presented on the face of the statement of comprehensive income so that they can evaluate information more effectively. Users have stated that more disaggregation will provide information that can be used to adjust subtotals and totals and aid in comparing information across entities and across periods of the same entity.
92. At the September Board meetings, the discussion of disaggregating information based on nature or function will be in the context of the statement of comprehensive income. Based on the results of those discussions, the staff will assess whether disaggregating information by nature or function should be considered for the statements of financial position and cash flows.

Current Guidance and Practice

93. Currently, paragraph 88 of IAS 1, *Presentation of Financial Statements*, requires that “an entity...present an analysis of expenses based on either the nature of expense or their function within the entity, whichever provides information that is reliable and more relevant.” It goes on to state that “entities classifying expenses by function [should] disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense.” There is no similar guidance in U.S. GAAP.

How Information is Used to Make Predictions

94. For users of financial statements to forecast future earnings, it is helpful to have information grouped in such a way that they can apply their assumptions about a future economic event (that will impact earnings) to only those items in the financial statements that will be impacted by that event. For example, cost information relating to raw material, labor, transportation, and distribution generally is grouped into a single line item (cost of sales). That grouping has value in determining if the revenue generated from the sale of the items covers the cost; however, disaggregating the components of cost of sales may be useful to an investor or creditor because those components are affected in different ways. For example, labor costs may be affected by the number of employees and the cost of living, but transportation costs may be affected by the price of gas or oil or even a railroad strike. If the financial statements disaggregate the components of costs of sales, an investor will be able to make more accurate assumptions about how the number of employees or the price of gas may affect certain expenses.
95. Slightly more than half of the entities that were surveyed for the 2005 Trends and Techniques publication present expenses by function (for example, cost of sales or research and development) rather than by nature (for example, labor and materials costs). The CFA Institute’s Centre for Financial Market Integrity’s October 2005 draft paper, *A Comprehensive Business Reporting Model*, recommends that individual line items be reported based on the nature of the items rather than the function for which they are used. Reporting information based on its nature would aggregate like expenses such as depreciation, material costs, transportation costs, employee benefits, and advertising costs; it would not

allocate those expenses to the various functions of the entity (such as cost of sales).
An example of each disaggregation scheme can be found below.

Presentation by Function

Revenue	X
Cost of sales	(X)
<i>Gross profit</i>	<u>X</u>
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Profit	<u>X</u>

Presentation by Nature

Revenue	X
Other income	X
Changes in inventories of finished goods and work in progress	X
Raw materials and consumables used	X
Employee benefits costs	X
Depreciation and amortization expense	X
Other expenses	X
<i>Total expenses</i>	<u>(X)</u>
Profit	<u>X</u>

Presentation by Nature

96. Users who support reporting individual line items by nature state that it is important to understand the factors that can increase or decrease the value of an entity or impact its future profitability. They suggest that when information is reported based on the function for which a resource is consumed, unlike items are aggregated which results in information loss. That loss is said to reduce both the predictive power of the information in the financial statements and the value of any related analysis. (Refer to questions 1 and 3 in Appendix A.)

97. [Paragraph 97 omitted from Observer Notes].

Presentation by Function

98. Users who support reporting information based on function suggest that it provides useful information about the allocation of resources to the various activities (functions) of an entity, thus allowing users to understand and predict the relationship between revenues and other expenses.

99. Some members of the JIG, ARG, and UAC indicated that information presented on the comprehensive income statement using a functional approach may be at too high a level, or may aggregate dislike items which, in turn, makes it difficult to predict the effect of changes on those items. They suggested that classification by function is highly subjective and may not always lend itself to making

comparisons. A number of members of the ARG, JIG, and UAC indicated that reporting information by function better describes how the business is run, provides more relevant information, and provides information about gross margin—an important metric that cannot be developed if the information is presented by nature. (Refer to questions 1 and 3 in Appendix A.)

Presentation by Both Function and Nature

100. IAS 1 states that the choice between the *function of expense method* and the *nature of expense method* depends on historical and industry factors as well as the nature of an entity. Both methods provide an indication of costs that may vary, directly or indirectly, with the level of sales or production of an entity.

101. Although information presented by function is generally more descriptive of an entity's overall operations, information presented by nature is useful in predicting future cash flows. The staff contends that it may be unnecessary to choose between the *function of expense method* and *nature of expense method* and that a combination of the two methods may be the best. The question then arises as to whether function or nature should be the primary sort. Function seems to be a more logical first sort because it includes items that can be broken down (disaggregated) into more meaningful units. Nature seems to be a more logical secondary sort because it reports items at a more granular level. While a function-then-nature presentation is contrary to the CFA model, it is more consistent with the functional categories in the working format the Boards tentatively agreed to in July (business, treasury, operating, and financing). In addition, a function-then-nature presentation will allow users to rearrange information if they prefer to analyze the information differently.

102. There are a variety of ways in which this dual disaggregation scheme could be presented in the comprehensive income statement. One approach (Approach 1) would be to require that, at a minimum, the following components of cost of sales be reported by nature within the functional presentation:

- a. personnel costs
- b. research and development costs
- c. depreciation expense
- d. amortization expense
- e. cost of raw material and finished goods inventories
- f. employee benefit expense (including pensions).

In addition, an entity would be encouraged to break out any other costs or expenses that are important in understanding their business (for example, special or nonrecurring items such as restructuring charges and legal fees or selling, general, and administrative (SG&A) expenses such as advertising, rent, and shipping). (Approach 1 is illustrated on page 33.)

103. The advantages of Approach 1 are that it is simple and consistent with

- a. the requirement in IAS 1 to disclose additional information when expenses are classified by function,
- b. the requirement in IAS 1 to provide additional information about the nature of expenses that can be useful in predicting future cash flows, and
- c. the recommendations of certain JIG, ARG, and UAC members. (Refer to questions 1 and 3 in Appendix A.)

104. The principle disadvantage of Approach 1 is that it is ruled-based in that it is a list of items that need to be presented separately—there is no underlying principle, except perhaps in the catch-all requirement to break out any component that is important in understanding the underlying business.

105. Approach 2 is more principles-based in that it would require cost of goods sold to be disaggregated in a manner that would reconcile beginning and ending inventory. In essence, it would require cost of goods sold to be broken down into broad sub-classifications that are widely used in cost accounting. (Approach 2 is illustrated on page 33.)

106. The advantages of Approach 2 are as follows:

- a. the number of line items are realistic (a pure “by nature” presentation could possibly have many more line items)
- b. the classification is widely used in cost accounting and therefore implementation should be relatively easy
- c. the classifications are general enough that there should be no competitive harm (that is, sensitive information would not be required to be shown on the financial statements)
- d. it will display cash expenses similarly in both the statement of comprehensive income and the statement of cash flows
- e. it is consistent with what we have heard from JIG members and other users as to what items they would like to see broken down by nature.

107. The principle disadvantage of Approach 2 is that it may only be useful for certain industries (for example, manufacturing) and not others (service industries). (Refer to questions 2 in Appendix A.)

Approach 1

Sales		X
Cost of sales		
Personnel costs	X	
R&D	X	
Depreciation	X	
Amortization	X	
Employee benefits	X	
Pensions	X	
Other	X	
Cost of Sales		(X)
Gross profit		(X)
Other income		X
Distribution costs		(X)
Administrative exp		(X)
Other expenses		(X)
Profit		X

Approach 2

Sales			X
Cost of sales			
Beginning Finished Goods		X	
Cost of Goods Purchased		X	
Cost of Goods Manufactured			
Beginning WIP	X		
Direct Materials	X		
Direct Labor	X		
Direct Expenses	X		
Overhead	X		
Less: Ending WIP	(X)		
Total Cost of Goods Manufactured		X	
Less: Ending Finished Goods		(X)	
Cost of Sales			(X)
Gross profit			X
Other income			X
Distribution costs			(X)
Administrative exp			(X)
Other expenses			(X)
Profit			X

Staff Recommendation

108. Based on the advantages discussed in paragraph 106, the staff recommends that line items be presented in the statement of comprehensive income by function and that cost of good sold be further disaggregated in a manner that would reconcile beginning and ending inventory (Approach 2).

109. The staff also recommends that entities be encouraged to separately present any costs or expenses by nature that are important in understanding the business. In Issue 5D, the staff recommends that the Boards consider including guidance in the financial presentation standard for when items should be presented as a separate line item and not aggregated. As noted in paragraph 120, a bright-line rule of this type would most likely result in separate display of information important to understanding an entity's business.

Question 5B: Do the Boards agree that information should be presented on the statement of comprehensive income by function with supplemental

information provided by nature about cost of goods sold and other items important to understanding an entity's business (as described above)?

Issue 5C: Presentation on a Gross or Net Basis

110. U.S. GAAP cites specific items/accounts that should be reported either on a gross basis or on a net basis (that is, offset). However there is no **general** guidance as to whether items in the financial statements should be presented on a net or a gross basis. IAS 1, on the other hand, requires that assets and liabilities, and income and expenses **not** be offset unless required or permitted by a standard or an interpretation. Paragraphs 34 and 35 of IAS 1 permit netting of
- a. any income with related expenses arising from the same transaction (for example, net interest) and
 - b. gains and losses arising from a group of similar transactions (gain on sale of inventory and net gains/losses on sales of securities).
111. As a result of the differences between IFRS and U.S. GAAP, current reporting practices vary. The staff is of the opinion that the financial statement presentation standard should provide guidance on this issue not only because it is currently on area of divergence but because doing so will further achieve the project objective.
112. Based on discussions with the staff, ARG, JIG, and UAC members clearly favor presenting items on a gross basis. They suggest that gross presentation is preferable because it gives more information, in particular when reporting information about allowances. However, users advocate a net presentation if items are ancillary to the business, the items turn over quickly, or standards currently permit net presentation (for example, Statement. 95, IAS. 1, 12, and 19, *Employee Benefits*). (Refer to questions 9 in Appendix A.)

Staff Analysis

113. Presenting information on a gross basis generally provides more useful information because gross amounts can be used to calculate net amounts but not the other way around. FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, states that “there are many instances in which an enterprise’s interest is represented more faithfully by a gross presentation of assets and liabilities” (paragraph E33). IAS 1 states that “while gross amounts can be used to calculate net amounts, the reverse is not true” (paragraph 33).

114. Currently, IAS 1 states that offsetting (netting) detracts from the ability of users both to understand and to assess the entity's future cash flows (IAS 1 does not consider measuring assets net of valuation allowances "offsetting"). However, there are times when presenting information on a gross basis may be unnecessary or misleading. Statement 95 and IAS 7 require/permit netting in certain instances. For example, the acceptance and repayments of demand deposits of a bank; and rents collected on behalf of, and paid over to, the owners of properties.
115. The staff is of the opinion that in most cases assets, liabilities, revenues, and expenses should be reported on a gross basis. However, there are circumstances in which a net presentation may be more appropriate. For example, when a gross presentation
- a. detracts from the ability of users to understand the transactions or events that have occurred and assess the entity's future cash flows or
 - b. does not provide any incremental value—that is, there is no benefit in a user knowing the two amounts; the net amount provides all of the information that is necessary. In fact a gross presentation in those instances could reduce the usefulness of the reported information.

Staff Recommendation

116. The staff recommends that assets and liabilities and income (revenues and gains) and expenses (expenses and losses) be shown on a gross basis except when:
- a. net presentation is required or permitted by a standard other than the financial statement presentation standard or
 - b. there is no incremental value in the additional information provided in a gross presentation; for example, a gain on the sale of a piece of equipment that is ancillary to the business would be shown net rather than presenting the fair value (price paid) and its cost.

Question 5C: Do the Boards agree that information should be required to be presented in the financial statements on a gross basis except when required or permitted by another standard or when the additional information in a gross presentation provides no incremental value?

Issue 5D: What Other Information Should be Disaggregated in the Financial Statements?

117. Oftentimes, the financial statements include line items that are an aggregation of various items. In order to make the information found in the financial statements useful in predicting cash flows, it is important that there be sufficient but not overly

excessive disaggregation. There is a delicate balance between having too much or too little information. As a result, it is important in aggregating items that an entity considers whether the items together are similar enough or if predictive value would be increased if those items were separately reported.

118. Currently paragraph 83 of IAS 1 provides the following guidance for disaggregation of line items in the statement of comprehensive income: “Additional line items, headings, and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity’s performance.” Paragraph 84 of IAS 1 goes on to explain that because the effect of an entity’s various activities, transactions, and other events differ in frequency, potential for gain or loss, and predictability, disclosing the components of financial performance assists in an understanding of the financial performance achieved and in making projections of future results.
119. Some users have indicated in conversations with the staff that the requirements in IAS 1 do not always result in as much disaggregation of items as they would find useful. They note that because the guidance in IAS 1 is subjective (principles-based), oftentimes too many items with different characteristics are aggregated together. They suggested that more objective guidance be provided that would limit aggregation of items to a certain percentage or dollar amount (for example 10 percent of revenue or total assets). In light of those comments, the Boards may wish to consider including an objective, numerical basis for determining whether or not a line item should be presented separately (for example, percentage of revenues, net income, or total assets). While a principles-based approach to standard setting avoids the use of bright lines, the staff is of the view that because this is a presentation issue and not one of recognition or measurement, a bright-line rule should be considered. Current SEC literature has bright-line rules in a number of places. For example the Staff Accounting Bulletin on materiality references use of a numerical threshold, such as 5 percent, and SEC Rule 5-02, which addresses the balance sheet, requires separate disclosure of any items in excess of 5 percent of total assets or total liabilities.

Staff Recommendation

120. At a minimum, the staff recommends that the language in paragraphs 83 and 84 of IAS 1 be included in the financial statement presentation standard and apply to each of the financial statements. Because the subjective guidance in IAS 1 to

present additional line items when that presentation is relevant to understanding an entity's performance does not always produce the desired results, the staff also recommends that the financial presentation standard include a bright-line rule for when items should be presented as a separate line item and not aggregated. If the Boards agree with this recommendation, the staff will discuss how that provision might be worded at a future meeting. The staff observes that a bright-line rule of this nature would most likely result in costs and expenses that are important in understanding an entity's business being displayed on a separate line, thus capturing the type of information that is the subject of the second staff recommendation in Issue 5B (paragraph 108).

Question 5D: Do the Boards agree with providing guidance similar to that in IAS 1 for disaggregating items in the financial statements and supplementing that guidance with a "bright line" rule?

TOPIC 6: COMPARABILITY WORKING PRINCIPLES

121. The working principles the Boards agreed to in March and April include two principles related to comparability: financial statements should present information in a manner that allows for comparability (a) over time and (b) across entities. In discussions earlier this year related to prioritization of the working principles, the staff noted that the comparability working principles were embodied in the qualitative characteristics of financial reporting. The staff noted that it did not seem appropriate to include some qualitative characteristics in the working principles and not others. Thus, the staff concluded that to the extent something is addressed in the objectives of financial reporting or the objective of the project, it should not be repeated in the working principles.
122. The staff views the working principles as flowing from the project objective, which flows from the objectives and qualitative characteristics of financial reporting. That is, the working principles can be viewed as a way to apply the overall objectives and qualitative characteristics of financial reporting to financial statement presentation. Therefore, the working principles should be more granular than the objectives and qualitative characteristics.

Staff Recommendation

123. The staff recommends eliminating the two working principles related to comparability as they are encompassed by the qualitative characteristics of financial reporting.

<p>Question 6: Do Board members agree that the working principles need not include the notion of comparability as that notion is encompassed in the qualitative characteristics of financial reporting?</p>
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TOPIC 7: EXTRAORDINARY ITEMS (to be addressed by FASB ONLY)

124. [Paragraphs 124 – 128 omitted from Observer Notes].

Summary of Input from JIG, ARG, and UAC Members

General Note

The staff sent a request for information on financial statement presentation to members of the Joint International Advisory Group (JIG), the Analysts Resource Group (ARG), and the User Advisory Council (UAC) in late May/early June 2006. These three groups are the staff's principle source of input on the financial statement presentation project. They provide the staff with valuable input on the user's perspective relating to proposed changes to how financial statements are presented. The request for input focused primarily on the nine questions summarized below.

1. Should presentation by function be the general requirement or should we permit either function or nature?

Of the 12 JIG members that responded in writing and the 6 JIG/UAC members that participated in the conference calls, there was a fairly even split between those who would require presentation by function, those that would require presentation by nature, and those who would permit the use of either. Of the 12 UAC members and the 5 ARG members who submitted input in writing, a slight majority preferred presentation by function.

Those who would require a functional presentation believe that it best describes how the business is run and that gross margin is an important metric that cannot be developed if the information is provided by nature. One supporter of providing information by nature pointed out the following problems with using nature, namely: (a) reporting information by nature does not easily assist with the assessment of the comparative cost performance of one entity within a sector with another entity and (b) not providing standardized listings of what the line items need to be, so that it is possible that each entity will use different lines for all but the most obvious captions. Some suggested that presentation by nature offers greater insight into the way management allocates costs, so long as the functional categories are clearly defined.

Those who support nature believe that if the information is presented using a functional approach at too high a level, dislike items will be aggregated which, in turn, will make it difficult to predict the effect of changes on those items. They suggest that presentation by function is highly subjective and that it does not lend itself to comparability.

Those who would give an option of using either presentation by nature or function do so for a number of reasons. One respondent believes that functional is too company specific, while another believes that allocations required to provide functional categories is either too arbitrary or difficult.

2. What type of industries might prefer the presentation by nature? Which might prefer the presentation by function?

A number of JIG members suggested that industries that are more likely to prefer **function** are retail, service industries, and simple manufacturers. UAC and ARG members did not indicate which industries, if any, would prefer function.

A number of UAC and ARG members seem to think that using a nature presentation in the financial statements would be better for financial institutions, service industries, manufacturing, industrial companies, and healthcare. JIG members thought the industries that would be best shown using a nature classification were retail and manufacturing, because gross margin is important, and financial services and small and medium entities (also known as SMEs), because cost center accounting is not necessary. There was one JIG member that suggested service industries would be better reporting by nature because he believed that cost of goods sold is not as meaningful to service industries.

3. If items are reported by function, should any information be reported by nature? If reported by nature, should any information be reported by function?

If statements are required to use a functional classification, then JIG/UAC/ARG members suggested that the following items also be provided by nature: costs of goods sold (either by line item or as a percentage of cost of goods sold), depreciation, amortization, employee benefit costs, materials, labor, research and development, interest income and expense, changes in inventories of finished goods and work in progress, and any other items that are important to understand the business. One JIG member, Pat McConnell, suggested that a functional presentation with additional disclosure by nature has the advantage of clearly illustrating the relationship between line items. A few suggested that the additional information about the natural classification be provided in the notes to the financial statements.

If statements are required to use a natural classification, JIG members recommended that cost of goods sold, gross margin, and R&D be provided.

4. Should segment reporting be done on a similar basis as the income statement?

Close to all of those who responded to this question stated that segment reporting **should** be consistent with the income statement or, if it were not, there should be either a detailed reconciliation with the income statement or additional disclosure.

5. Are there costs/expenses that can't be reported by function?

The only items that JIG members suggested could not be reported by function were taxes, impairment, and some general expenses related to cost of goods sold and financing costs.

6. How should we limit the grouping of significant items into an "other" category?

About one third of the JIG, ARG, and UAC members suggested using a percent of X or some dollar amount to limit the number of significant items residing in the "other" category. Most suggested that if the other categories were clearly defined and there was sufficient disaggregation, the number of significant items categorized as "other" would be minimal.

7. For which costs is it important to differentiate between fixed and variable?

JIG members did not suggest any costs that should be broken down between fixed and variable. Some suggested that a breakdown between fixed and variable costs might be useful information in the MD&A, but not in the financial statements, while others suggested that requiring such a breakdown might be too difficult or arbitrary to do in an accounting standard and individual companies should decide if that information should be provided. This was not an issue that many UAC or ARG members commented on.

8. How should fixed vs. variable costs/expenses be presented in the financial statements?

Most suggested fixed vs. variable costs/expenses be presented either in the footnotes or not at all. Many were unsure as to why it is important to differentiate such costs. Some indicated that it is a distinction that is important for management's purposes and perhaps equity analysts but not for external financial reporting purposes. Others noted that what constitutes a fixed cost depends on the industry.

9. When is presentation on a gross basis better than presentation on a net basis?

JIG, UAC, and ARG members clearly favored presenting items on a gross basis. They suggested that gross is preferable because it gives more information, in particular when reporting allowances.

Those individuals, however, would advocate net presentation if items were ancillary to the business, the items turned over quickly, or standards permitted net presentation (for example Statement 95, IAS 1, 12, 19, and IFRS 7).

[Appendix B omitted from Observer Notes]

Appendix C

Summary of Staff Recommendations and Prior Board Tentative Decisions

The following table summarizes the staff's recommendations for how items would be presented in the financial statements. Following the table is a summary of the current staff recommendations and of the Boards' tentative decisions to date.

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business <ul style="list-style-type: none"> ♦ Operating assets and liabilities <ul style="list-style-type: none"> ○ Short-term ○ Long-term ♦ Strategic investments 	Business <ul style="list-style-type: none"> ♦ Operating income ♦ Strategic investment income 	Business <ul style="list-style-type: none"> ♦ Operating cash flows ♦ Strategic investment cash flows
Discontinued operations	Discontinued operations	Discontinued operations
Income taxes	Income taxes	Income taxes
Financing <ul style="list-style-type: none"> ♦ Financing liabilities ♦ Treasury assets ♦ Equity 	Financing <ul style="list-style-type: none"> ♦ Financing expenses ♦ Treasury income 	Financing <ul style="list-style-type: none"> ♦ Financing cash flows ♦ Treasury cash flows ♦ Equity cash flows

SEPTEMBER STAFF RECOMMENDATIONS

Treasury Assets and the Financing Section

1. The treasury category should be reported within the financing section and a gross presentation of the financing section should be required.
2. Financing liabilities and treasury assets should be defined narrowly, and thereby subjectively, for purposes of presenting information on the face of the financial statements.

Strategic Investment Category

3. A strategic investment category should be presented within the business section in each of the financial statements.
4. A *strategic investment* should be defined as “an equity investment held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to a noninvestor entity that is not a related party (as defined in accounting literature) to the investee.”

5. Goodwill (as defined in accounting literature) should be classified in the strategic investment category unless the equity investment that an entity retains as a result of a business combination does not meet the definition of a strategic investment (which should be rare).

Income Taxes

6. Income taxes should be presented as a separate section in the financial statements.

This effectively eliminates intraperiod tax allocation, which means that:

- a. There would be no need for a pre-tax subtotal, such as “income from continuing operations,” in the statement of comprehensive income.
 - b. The results of discontinued operations would no longer be presented net of applicable income taxes (those results would be presented on a pre-tax basis).
 - c. OCI items will no longer be presented on an after-tax basis.
7. Income taxes related to transactions with owners should not be recognized directly in equity but be included in comprehensive income. Those amounts should be presented in the income tax section of the statement of comprehensive income.

Discontinued Operations

8. Discontinued operations should be presented as a separate section in the financial statements.
9. Long-lived assets, and assets and liabilities within disposal groups classified as held for sale, should be presented in the discontinued operation section of the statement of financial position, with the assets presented separately from the liabilities and not offset. The current requirement that the major classes of discontinued assets/liabilities be disclosed in the notes to the financial statements should be retained.
10. A single amount should be disclosed in the discontinued operation section of the statement of comprehensive income comprising the total of (a) the profit or loss of the discontinued operation and (b) the gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal groups constituting the discontinued operation. An entity should disclose the components of the profit or

loss (revenue and expenses) and the components of the gain or loss (from remeasurement or disposal) either on the face of the statement or in the notes.

11. Cash flows from a discontinued operation should be presented as a single line item in the discontinued operation section of the cash flow statement.

Disaggregation Working Principle

12. The disaggregation working principle should be revised as follows:

Financial statements should present information in a manner that disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows.

13. Line items should be presented in the statement of comprehensive income by function and cost of good sold should be further disaggregated in a manner that would reconcile beginning and ending inventory.
14. Entities should be encouraged to separately present any costs or expenses by nature that are important in understanding the business.
15. Assets and liabilities and income (revenues and gains) and expenses (expenses and losses) should be shown on a gross basis except when:
- a. net presentation is required or permitted by a standard other than the financial statement presentation standard or
 - b. there is no incremental value in the additional information provided in a gross presentation.
16. The guidance in IAS 1 that additional line items should be presented when such presentation is relevant to an understanding of an entity's financial performance should be included in the financial statement presentation standard and apply to each of the financial statements. The Board should consider whether the financial statement presentation standard should include a bright-line rule for when items should be presented as a separate line item and not aggregated.

Comparability Working Principle

17. The two working principles related to comparability should be eliminated.

Extraordinary Items

18. [Paragraphs 18-19 omitted from Observer Notes]

SUMMARY OF JULY TENTATIVE DECISIONS

Cohesiveness Working Principle

20. Cohesiveness should be the overall governing principle.

Business and Financing Sections

21. Financial statement information should be presented in two broad sections: business and financing.

Financing Liabilities and Treasury Assets

22. The FASB and the IASB decided that the financing section would include all equity items and would not include any assets. The IASB decided that the definition of financing should include liabilities for which an accounting standard requires the separate calculation of interest. For presentation purposes, an entity would be permitted to exclude liabilities from the financing section and include them in the business section if specified criteria are met.

- The FASB did not conclude on a definition of financing.

23. The IASB decided that the definition of *treasury assets* should include all financial assets (as defined in accounting standards). For presentation purposes, an entity would be permitted to exclude financial assets (other than cash and cash equivalents) from the treasury category and include them in the operating category.

- The FASB did not conclude on a definition of *treasury assets*.

24. Cash and cash equivalents should be included as a separate line item in the treasury category. The definition of cash and cash equivalents should be revisited.

Operating Assets and Liabilities and Liquidity

25. An asset not classified as a treasury asset or a liability not classified as a financing liability would be classified as an operating asset or liability.

26. Operating assets and liabilities (the operating category) should be classified into two sub-categories.

- The FASB decided that a one year cash conversion cycle should be the basis for classifying assets and liabilities as either "short-term" or "long-term" assets and liabilities.
- The IASB decided that an entity's operating cycle (the average time between the acquisition of materials or services entering the process and their final conversion to cash) should be the basis for classifying assets and liabilities as either operating working capital assets and liabilities or other operating assets and liabilities.

27. The notes to financial statements would include supplementary information about liquidity, if deemed necessary.