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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 January 2007, London**

Project: **Financial Statement Presentation (Phase B)**

Subject: **Hybrid Entity Considerations (Agenda paper 13C)**

INTRODUCTION

1. The purpose of this memorandum is to solicit Board member views on how and when to address issues associated with applying the financial statement presentation working format to entities with both substantial financial operations (for example, banking or insurance) and substantial non-financial operations (for example, manufacturing or retail) (herein referred to as a *hybrid entity*). Thus far, the staff and the Boards have discussed *financial institutions* and *non-financial institutions* without defining those terms. Board members have noted that not all entities can be classified clearly in one of the two categories (financial or non-financial); those entities—*hybrid entities*—are the focus of this memorandum. The staff is seeking Board member input on (a) how much consideration should be given to any implications of applying the working format to a hybrid entity and (b) when that consideration should be given.

BACKGROUND

2. Prior to the December 2006 meetings, the Boards considered the application of the project's working principles and developed the basic financial statement presentation working format only in the context of non-financial institutions. The Boards' plan was to consider potential modifications to this working format for financial institutions once the issues related to non-financial institutions have been addressed. At their respective December 2006 meetings, the Boards considered how the working format being developed might be applied by financial institutions, and what modifications, if any, would be necessary to address the presentation needs of the users of financial institution financial statements.

3. In general, the Boards tentatively agreed that the overall working format—the categorization scheme and criteria for classifying items in the financing, operating, and investing categories—should apply to financial institutions as well as non-financial institutions. The Boards did, however, note that the working format may need to be modified to be responsive to the reporting needs of financial institutions (for example, the presentation of short- and long-term subcategories for assets and liabilities). The Boards agreed to consider financial institutions together with non-financial institutions in discussing the remaining issues, including presenting information about remeasurements and disaggregating information by function and then nature. The Boards directed the staff to develop principles-based guidance that could be applied by both financial and non-financial institutions rather than develop one or more exceptions for financial institutions.

4. During the discussion related to financial institutions, Board members questioned the potential implications of applying the working format to the financial statements of a hybrid entity. The following paragraphs discuss some of the issues related to hybrid entities that may deserve further consideration.

ISSUES TO CONSIDER

5. Even though the goal is for the principles in the standard to apply equally to all entities, the staff fully expects that financial and non-financial institutions will apply

the principles-based guidance differently and thus their financial statements will look different—and rightfully so. The following issues serve as examples of areas where financial institutions may apply the standard differently than non-financial institutions, with a focus on the related implications for hybrid entities:

a. **Presentation of cash—**The Boards previously decided that cash and cash equivalents must be classified in a single category, but agreed that the financial statement presentation standard should not specify what that category would be. However, a hybrid entity may have justifiable reasons for classifying a portion of cash in one category (the cash used for the "manufacturing" operation) and another portion of cash in a different category (the cash used in the "financial" operation). Therefore, the standard may need to include an exception that would allow hybrid entities to classify cash in more than a single category on the statement of financial position.

b. **Classification criteria and related guidance—**The Boards developed the classification criteria (and related application guidance) considering entities that can be clearly classified as either non-financial or financial. While these definitions were found to be workable for entities that are either all non-financial or all financial, the application of the criteria to a hybrid entity has not been considered.

   A hybrid entity may struggle with determining the level at which the criteria should be applied. That is, a hybrid entity may question whether all assets and liabilities should be classified in the same way at the consolidated level, the segment level, or at another level. It is possible, and probably logical, for an entity with both substantial non-financial and financial operations to want to classify similar items differently within the consolidated entity's financial statements. For example, while a bank loan payable may be justifiably classified as a financing liability for the "non-financial segment," a bank loan payable may be justifiably classified as an operating liability for the "financial segment." Therefore, the financial statement presentation standard may need to clarify that for hybrid entities, similar items are not necessarily expected to be classified similarly at the consolidated level.

   The staff notes that the Boards may need to consider this issue as part of a broader discussion on whether entities should take a "bottoms up" or "top down" approach in preparing their financial statements. In the "bottoms up" approach, the divisions or operating units of an entity would apply the classification and other presentation principles, and the consolidated statements would essentially be an addition of those divisions or operating units. Under this scenario similar items would likely be classified differently by different divisions or operating segments. In the "top down" approach, the consolidated entity would make the classification decisions and each division or operating unit would adhere to that classification. Under this approach similar items would be classified similarly throughout the consolidated entity.

c. **Liquidity information and related disclosures**—The Boards tentatively agreed that financial institutions should **not** be required to present short- and long-term subcategories for each category on the statement of financial position and asked the staff to develop a principle for presenting liquidity information that would apply to both financial institutions and non-financial institutions. The question that arises is if the financial statement presentation standard develops a principle for which financial institutions are likely to present liquidity information in one way and non-financial institutions are likely to present liquidity information in a different manner, how then would a hybrid entity present that information.

ADDRESSING THE HYBRID ENTITY ISSUES

6. The staff suggests that the Board consider the following possible alternatives for addressing the issues associated with applying the working format to the financial statements of hybrid entities:

   a. **Alternative A**—Explore further the issues associated with applying the working format to hybrid entities and attempt to reach Board decisions on these issues. Board decisions would be exposed in the initial discussion document.

   b. **Alternative B**—Defer Board decisions on hybrid entity issues—the initial discussion document would include a neutral discussion of the issues identified and would present specific questions on which commentators would provide feedback.

Timing

7. If the Boards choose Alternative A, issuance of the initial discussion document will likely be deferred at least two months. Alternatively, if the Boards choose Alternative B, the project will be able to progress as currently scheduled. Under Alternative B, the Boards will seek input through the initial discussion document and will more fully explore the issues associated with hybrid entities as part of redeliberations. The Exposure Draft would include the Boards' tentative decisions on these issues and those decisions would be subject to public comment upon issuance of the Exposure Draft.

Staff Recommendation

8. The staff is of the view that addressing issues related to application of the working format by hybrid entities **prior** to issuance of the initial discussion document is **not** necessary. The initial discussion document will describe the Boards' preliminary

views and will include higher level principles than the detailed requirements that are included in an Exposure Draft—the staff asserts that presentation issues related to hybrid entities involve more than high-level principles. In addition, as previously discussed, the Boards' views on some of the issues in the project may not be included in the initial discussion document either because they are dependent on the answers to the first level of issues, or they are of the type that the Boards are seeking more input prior to deliberating. In the staff's opinion, hybrid entity issues are of the type that are dependent on answers to first level issues **and** that would benefit from input received during the comment period. In other words, the Boards should wait until the working format has been discussed with constituents in the context of both non-financial institutions and financial institutions before making any decisions related to hybrid entities.

9. In the staff's view, a neutral, general discussion of the issue in the initial discussion document, along with specific questions, will solicit useful input that will be beneficial in discussing hybrid-entity presentation issues in the redeliberations. Therefore, the staff recommends that:
    a. The Boards not address how the working format should be applied by hybrid entities prior to issuing the initial discussion document
    b. The initial discussion document include a neutral discussion on the issues associated with applying the working format to the financial statements of hybrid entities along with related questions.

Question for the Boards

Should the staff consider the issues associated with hybrid entities and seek Board decisions on these issues prior to issuance of the preliminary views document? If not, should the preliminary views document include a neutral discussion of these issues and solicit input from constituents on the initial discussion document?