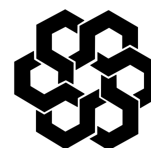

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International Accounting Standards Board

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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 June 2007, London**
Project:	**Financial Statement Presentation**
Subject:	**Basket Transactions and Foreign Currency Translation Adjustments (Agenda Paper 3A)**

INTRODUCTION AND BACKGROUND

1. At their respective July 2006 Board meetings, the Boards agreed that the cohesiveness principle should be the governing principle in the financial statement presentation project. Moreover, at their respective March 2007 meetings, the Boards agreed that the cohesiveness principle should be applied at the line item level, to the extent possible.

2. Under the cohesiveness principle, assets and liabilities are classified into a functional category (operating, investing, financing, and the like). The income and expense (including gains and losses) associated with those assets and liabilities are presented in the corresponding category in the statement of comprehensive income, and the cash flows associated with those assets and liabilities are presented in the corresponding category in the statement of cash flows.

3. However, it is not uncommon that a single transaction involves multiple assets (or a combination of assets and liabilities) that would be classified in more than one category under the proposed presentation format. This memorandum refers to

transactions of this nature as "basket transactions." Basket transactions include both the acquisition and the disposal of multiple assets (or a combination of assets and liabilities).

4. The first half of this memorandum (Issue 1) discusses how basket transactions should be presented in the financial statements. The second half of this memorandum (Issue 2) builds on the first half and discusses how foreign currency translation adjustments should be presented in the financial statements.

STRUCTURE OF MEMORANDUM

5. This memorandum is structured in the following manner:

Issue 1: Basket Transactions
- Issue 1(a): Classification in the Statement of Cash Flows
- Issue 1(b): Classification in the Statement of Comprehensive Income

Issue 2: Foreign Currency Translation Adjustments—Classification of in the Statement of Comprehensive Income

ISSUE 1: BASKET TRANSACTIONS

Issue 1(a): Classification in the Statement of Cash Flows

6. Under the cohesiveness principle, assets and liabilities are classified in a category and related cash flows would be presented in the corresponding category in the statement of cash flows. However, in a basket transaction, a single transaction involves multiple assets (or a combination of assets and liabilities) that would be classified in more than one category. The classification of cash flows related to those transactions may become problematic, for example when:

   (a) a combination of assets and liabilities classified in more than one category are acquired and the cash consideration is paid in a lump sum; and

   (b) multiple assets (or a combination of assets and liabilities) classified in more than one category are disposed of and the cash consideration is received in a lump sum.

7. This issue addresses how the cash outflow (or inflow) related to a basket transaction should be classified in the statement of cash flows. The staff considered the following Alternatives:

Alternative A: Require an entity to allocate cash flows related to ***all*** basket transactions to **existing** categories.

Alternative B: Require an entity to present cash flows related to ***all*** basket transactions in a **new** "Acquisitions and Disposals" **section**.

Alternative C: Require an entity to allocate cash flows related to ***certain*** basket transactions to **existing** categories and to present cash flows related to ***other*** basket transactions in a **new** "Acquisitions and Disposals" **section**.

Alternative A: Require Allocation to Existing Categories

8. Under Alternative A, cash flows related to all basket transactions would be allocated to existing categories. The staff identified the following Alternatives for allocating the cash flows related to basket transactions to existing categories:

   Alternative A-1: Allocate cash flows to various categories based on the relative carrying amounts of the assets and liabilities.

   Alternative A-2: Allocate the cash flow to one category based on the function (category) that is likely to be the predominant source of that cash flow.

   Alternative A-3: Do not prescribe how to allocate cash flows to categories; however, for material basket transactions, require an entity to disclose in the notes to financial statements how the cash flows were allocated.

9. To illustrate the differences between the Alternatives, consider the following example.

   > An entity initially acquires $100 of operating assets and $50 of financing liabilities for $50 cash. Subsequently, that entity disposes of $100 of operating assets and $50 of financing liabilities for $100 cash, resulting in a total gain of $50. Assume that the predominant source of the cash flows is operating activities for both the initial acquisition and the subsequent sale.

   a. Under Alternative A-1, cash flows presented for initial acquisition would be grossed up to $100 of cash outflows for operating activities and $50 of cash inflows from financing activities. Cash flows presented for the subsequent sale would be grossed up to $200 of cash inflows from operating activities and $100 of cash outflows for financing activities, resulting in a $100 operating income (gain) and $50 financing expense (loss).

b. Under Alternative A-2, cash flows presented for initial acquisition would be allocated as $50 of cash outflows for operating activities because the predominant source of the cash flows is operating activities in this particular case. Cash flows presented for the subsequent sale would be allocated as $50 of cash inflows from operating activities because the predominant source of the cash flows is operating activities, resulting in a $50 operating income (gain).

c. Under Alternative A-3, an entity would be able to choose how to allocate the cash flows, provided that, for material basket transactions, an entity discloses in the notes to financial statements how the cash flows were allocated.

10. The following table summarizes the differences between the Alternatives A-1 and A-2 (Alternative A-3 is not presented because an entity would be able to choose how to allocate the cash flows; an entity may choose Alternative A-1, A-2, or any other allocation method provided that, for material basket transactions, an entity discloses how the cash flows were allocated):

	Alternative A-1		**Alternative A-2**	
	Acquisition	Disposal	Acquisition	Disposal
Cash Flows				
Operating	(100)	200	(50)	100
Financing	50	(100)	-	-
Total	(50)	100	(50)	100
Comprehensive Income				
Operating	-	100	-	50
Financing	-	(50)	-	-
Total	-	50	-	50

Analysis of Alternatives

11. The advantage of Alternative A is that, because the cash flows are allocated to existing categories, cohesiveness will continue to be achieved.

12. Because an entity will assign a value to all the assets and liabilities involved in a basket transaction related to the acquisition of assets and liabilities (including goodwill in a business combination), it is mechanically possible to allocate the related cash flows to each category. However, as in the above example, when an entity acquires assets and assumes liabilities simultaneously, the cash flows would need to be “grossed up,” and some may hold the view that the resulting information would not be representationally faithful.

13. The staff notes that Alternative A-1 is consistent with the FASB's decision to gross up cash flows when it amended FASB Statement No. 95, *Statement of Cash Flows,* as part of FASB Statement No. 123 (revised 2004), *Share-Based Payment*. That is, the "cash retained as a result of the tax deductibility of increases in the value of equity instruments issues under share-based payment arrangements that are not included in the cost of goods or services that is recognizable for financial reporting purposes" is classified as cash inflows from financing activities (paragraph 68(a)) and the "cash that would have been paid for income taxes if increases in the value of equity instruments issues under share-based payments arrangements that are included in the cost of goods or services recognizable for financial reporting purposes also had not been deductible in determining taxable income" would be classified as cash outflows for operating activities (paragraph 68(b)). The same amount would be reported for these two cash flows.

14. The staff notes that the amendments to Statement 95 can be viewed as a "construct" to achieve cohesiveness. Statement 123(R) states:

> [The FASB] concluded that Statement 95 should be amended to report the tax reduction from excess tax benefits in the financing section of the statement of cash flows. The Board concluded that this item differs from other components of taxes paid that might be allocated among categories in the statement of cash flows because this item involves both compensation cost included in the income statement and an adjustment of paid-in capital as a result of an issuance of shares – a financing transaction. [Paragraph B227]

15. A disadvantage of Alternative A-1 is the need to gross up cash flows in a basket transaction related to the disposal of assets and liabilities. In a basket transaction related to the disposal of assets and liabilities, the cash flows would need to be grossed up based on the profit margin of the net assets. In the example in paragraph 9.a, cash flows related to the disposal of assets and liabilities were grossed up to $200 of operating cash inflows and $100 financing cash outflows in order to present a $50 gain. If the gain was $100, the cash flows would need to be grossed up to $300 of operating cash inflows and $200 financing cash outflows in the statement of cash flows and the resulting operating income (gain) would be $200 and the financing expense (loss) would be $100 in the statement of comprehensive income.

16. Alternative A-2 is somewhat consistent with current guidance in Statement 95, which states:

> Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. [Paragraph 24]

17. The advantage of Alternative A-2 is that it would not gross up cash flows and that the cash flows would be classified in the category that the entity determines as being the predominant source. The disadvantage would be that income and expense (including gains and losses) related to the transaction would be presented in only one category and that may result in the presentation of information that is not representationally faithful.

18. The advantage of Alternative A-3 would be that it would allow an entity to present the cash flows in a way it views as representationally faithful. This is consistent with the management approach notion that has been adopted in several occasions in this project. The disadvantage would be that comparability may not be achieved for similar transactions and that the choice of allocation methods may provide an opportunity for an entity to manage its subtotals in the statement of cash flows, the statement of comprehensive income, or both.

19. Between Alternatives A-1, A-2, and A-3, the staff supports Alternative A-3. The staff is of the view that it would be difficult to develop a "one-size-fits-all" allocation method that would result in presenting information that is representationally faithful under all circumstances. Accordingly, the staff is of the view that the Boards should not prescribe how the cash flows should be allocated; rather, they should permit an entity to choose how to allocate cash flows and, for material basket transactions, require disclosure in the notes to financial statements of how the cash flows were allocated.

Alternative B: Require Allocation to the "Acquisitions and Disposals" Section

20. Alternative B is based on the view that any allocation of cash flows to existing categories would be arbitrary and thus not representationally faithful. Therefore, Alternative B would require that cash flows be prohibited from being allocated to

various existing categories; rather, it would require that the unallocated, single cash flow amount be classified in a new "Acquisitions and Disposals" section.

21. The staff is of the view that the unallocated, single cash flow amount should be classified in a new separate Acquisition and Disposals section, rather than the operating category or a new separate category within the business section, because the cash flow amount relates to a number of categories and thus it would be inappropriate to classify that amount to only one of those categories or sections. It is also consistent with the Boards' previous decision to present discontinued operations as a separate section rather than as a separate category within the business section.

22. If the Boards are not in favor of allocating cash flows to existing categories (Alternative A), any approach that does not allocate cash flows to the same categories as the assets and liabilities in the basket transaction would create an exception to the cohesiveness principle. The staff is of the view that exceptions to the cohesiveness principle should be clearly indicated as such in the financial statements. By introducing a new section, Alternative B would present the exception in a prominent manner.

Alternative C: Require Allocation to Existing Categories for Certain Basket Transactions and Allocation to the "Acquisitions and Disposals" Section for Other Basket Transactions

23. Alternative C is a hybrid of Alternatives A and B. It would require certain basket transactions to follow Alternative A (as discussed in paragraph 19, the staff recommendation would be Alternative A-3) and other basket transactions to follow Alternative B.

24. The staff is of the view that basket transactions that cannot be further broken down (hereinafter referred to as "integrated basket transactions") should follow Alternative B, that is, present related cash flows in the Acquisitions and Disposals section. Other basket transactions should follow Alternative A-3, that is, allocate cash flows to the various existing categories in a way an entity views as representationally faithful, provided that, for material basket transactions, an entity discloses in the notes to financial statements how the cash flows were allocated.

25. The staff is of the view that integrated basket transactions should include:
    (a) business combinations (that is, obtaining control of an acquiree);

(b) losing control of a consolidated subsidiary[1]; and
(c) changes in the interests in a jointly controlled entity for which proportionate consolidation is applied (IASB only).

26. The distinction between integrated basket transactions and other basket transactions is based on an analogy to *business combinations* and *asset acquisitions* in the existing Business Combination guidance. The joint Exposure Draft related to Business Combinations issued in June 2005 (the "Business Combinations ED") defined a *business* as an "integrated set of activities and assets"[2] and a *business combination* as a "transaction or other event in which an acquirer obtains control of one or more businesses"[3].

27. Starting with business combinations, the staff added transactions that result in the loss of a control of a consolidated subsidiary in order to achieve symmetry in accounting. The staff also expanded the scope of integrated basket transactions to include changes in interests in a jointly controlled entity for which proportionate consolidation is applied (IASB only).

28. The staff is of the view that cash flows related to integrated basket transactions should not be allocated to the various existing categories but presented in the Acquisitions and Disposals section because the assets and liabilities involved in an integrated basket transaction are, by definition, integrated. An entity makes its decisions to invest in or to dispose of the assets and liabilities as a single transaction because the transaction cannot be further broken down. In the case of other basket transactions, an entity has the liberty to break down the basket transaction into more than one transaction that would not be a basket transaction.

29. Moreover, allocating the cash flows and related income expense (including gains and losses) related to integrated basket transactions to the various existing categories may mislead users of financial statements because they would not be

[1] Under the forthcoming final standard on the accounting for noncontrolling interests, any change in ownership interest in a consolidated subsidiary that would not result in a loss of control would be viewed as an equity transaction and thus is likely that it would not meet the definition of a basket transaction.
[2] The pre-ballot draft of the forthcoming final standard on Business Combinations include the same definition in paragraph 3(d).

[3] The pre-ballot draft of the forthcoming final standard on Business Combinations include the same definition in paragraph 3(e).

able to discern whether the assets and liabilities were disposed of as part of an integrated set of assets and liabilities or on a piecemeal basis.

30. In paragraph 18, the staff identified the disadvantages of Alternative A-3. The staff is of the view that those disadvantages would be substantially mitigated because only basket transactions that are not integrated would apply Alternative A-3. That is, Alternative A-3 would be applied only to basket transactions that can be further broken down into transactions that are not basket transactions and thus there should be little difficulty in attributing the cash flows to related assets and liabilities.

Staff Analysis and Recommendation

31. Alternative A would continue to achieve cohesiveness across financial statements. However, the staff is of the view that because an integrated basket transaction deals with an integrated set of assets and liabilities, the cash flows related to this type of basket transaction should not be allocated to the various existing categories.

32. Alternative B would create many exceptions to the cohesiveness principle, which is the governing principle in the proposed working format. The staff is of the view that any exception would need to have good reasons and that exceptions should be limited to the extent possible.

33. On balance, the staff recommends Alternative C. Cash flows related to integrated basket transactions should not be allocated to the various existing categories, and the unallocated, single cash flow amount for integrated basket transactions should be classified in a separate Acquisitions and Disposals section. While this would create an exception to the cohesiveness principle, the exception would be limited to integrated basket transactions only.

34. For basket transactions other than integrated basket transactions, the staff is of the view that Alternative A-3 should be adopted. That is, the Boards should:

    a. not prescribe how the cash flows should be allocated to the various categories but to permit an entity to choose how to allocate cash flows and,

    b. require disclosure in the notes to financial statements of how the cash flows were allocated for material basket transactions.

By limiting the application of Alternative A-3, the resulting information provides more useful information than applying Alternative A-3 to all basket transactions.

Questions for the Boards:

1. **Should cash flows related to basket transactions be allocated to each category in the statement of cash flows?**
2. **If not, how should the unallocated, single amount be classified in the statement of cash flows?**

Issue 1(b): Classification in the Statement of Comprehensive Income

35. The next issue for the Boards is whether the income and expenses (including gains and losses) related to a basket transaction should be allocated to each category the assets (or the combination of assets and liabilities) are classified in. Because "day one" gains or losses generally are not recognized, this issue primarily relates to the derecognition of assets and liabilities.

36. The cohesiveness principle strongly suggests that the classification in the statement of comprehensive income and the statement of cash flows be aligned to the extent possible. Accordingly, the staff recommends that the income and expenses related to basket transactions should be classified in the same manner as the cash flows. That is,

    a. Income and expense should be allocated to the various existing categories in the statement of comprehensive income if the cash flows are allocated to the various existing categories in the statement of cash flows

    b. Income and expense should be presented in the Acquisition and Disposals section in the statement of comprehensive income if the cash flows are not allocated and the single cash flow amount is presented in the Acquisition and Disposals section in the statement of cash flows.

Question for the Boards:

3. **Should income and expenses related to basket transactions be classified in the statement of comprehensive income in the same manner as the cash flows are classified in the statement of cash flows?**

ISSUE 2: FOREIGN CURRENCY TRANSLATION ADJUSTMENTS—CLASSIFICATION IN THE STATEMENT OF COMPREHENSIVE INCOME

Previous Board Decisions

37. At their respective March 2007 Board meetings, the Boards discussed the presentation of other comprehensive income (hereinafter referred to as "OCI") in the statement of comprehensive income, including the presentation of foreign currency translation adjustments (hereinafter referred to as "FCTAs").

38. At its March 2007 Board meeting, the IASB did not reach a consensus regarding the presentation of OCI in the statement of comprehensive income. Nonetheless, the IASB agreed that more than one alternative should be included in the discussion document, including one that would present OCI separately from other income and expense items, and instructed the staff to develop possible alternative presentations.

39. The IASB also decided that FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures should be classified in the **operating** category and FCTAs related to equity method investments should be classified in the same category in which the equity method investment is classified.

40. At its March 2007 Board meeting, the FASB reaffirmed the decision made in December 2006 to require the presentation of OCI in a subcategory within the functional category to which the events or transactions relate. A subcategory within the functional categories would distinguish items of income and expense that are components of OCI from those that are not. The FASB also indicated its preference to discuss how FCTAs would be presented in the possible statement of financial position reconciliation before discussing the presentation of FCTAs in the statement of comprehensive income.

41. In this issue, the IASB will be asked to reconsider its previous decision regarding the classification of FCTAs in light of its decisions in Issues 1(a) and 1(b) regarding a possible new Acquisitions and Disposals section and the FASB will be asked to decide on its preliminary view regarding the classification of FCTAs.

Classification in the Statement of Comprehensive Income

42. All of the Alternatives related to the presentation of OCI considered thus far would require an entity to classify OCI in one of the categories or sections in the working format. Even for Alternatives that require a separate OCI section to be presented, an entity will be required to classify the OCI items into operating, financing, and the like within that section.

43. Similar to the memorandum prepared for the March 2007 Board meeting, FCTAs will be discussed separately for (a) investments in consolidated subsidiaries and proportionally consolidated, jointly controlled entities (IASB only) and (b) equity method investments.

Investments in Consolidated Subsidiaries and Proportionally Consolidated, Jointly Controlled Entities

44. Sales or liquidations of investments in consolidated subsidiaries and proportionally consolidated, jointly controlled entities ventures that give rise to FCTAs would most likely meet the definition of integrated basket transactions that would give rise to the Acquisitions and Disposals section (recommended in Issue 1). Because FASB Statement No. 52, *Foreign Currency Translation*, and IAS 21 *The Effects of Changes in Foreign Exchange Rates*, require that FCTAs be recycled and reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs, the staff is of the view that FCTAs should also be presented in the Acquisitions and Disposals section in the statement of comprehensive income.

Equity Method Investments

45. Sales or liquidations of equity method investments would most likely not meet the definition of integrated basket transactions that would give rise to the "Acquisitions and Disposals" section. Accordingly, the staff is of the view that FCTAs related to equity method investments should be presented in the category in which the investment is classified in the statement of financial position. This recommendation is consistent with the tentative decision made by the IASB in March 2007.

Questions for the Boards:

4. How should foreign currency translation adjustments be presented in the statement of comprehensive income for investments in consolidated subsidiaries and proportionately consolidated, jointly controlled entities?

5. How should foreign currency translation adjustments be presented in the statement of comprehensive income for equity method investments?