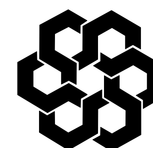

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International Accounting Standards Board

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: **17 May 2007, London**

Project: **Financial Statement Presentation**

Subject: **Presentation of Liquidity Information (Agenda Paper 6A)**

INTRODUCTION

1. In October 2006, the Boards tentatively agreed that entities that are not financial institutions should be required to classify the assets and liabilities in each of the categories on the statement of financial position into short- and long-term subcategories. An asset or liability would be classified as short-term if the shorter of (a) the contractual maturity or (b) the expected realization or settlement of the asset or liability is within one year. Otherwise, the asset or liability would be classified as long-term. In addition, the Boards tentatively agreed that an entity should present maturity information about its long-term assets and liabilities that have a contractual term (such as contractual receivables and lease obligations) in the notes.

2. In December 2006, 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 all entities, including "hybrids." Because of that discussion, the Boards acknowledged that they might change their prior decision to require entities that are not financial institutions to include short- and long-term subcategories on the statement of financial position.

3. In February, the staff distributed a Board paper that addressed including solvency in the liquidity principle and the application of that revised working principle. The IASB discussed that paper at its February meeting. The FASB discussed it at an education session in February. In light of Board comments at those meetings, this memorandum addresses the concepts of liquidity and solvency, the related working principle, and application of that working principle.

4. This memorandum addresses the concepts of liquidity and solvency, the related working principle (Issue 1) and the application of that working principle (Issue 2).

ISSUE 1—CHANGES TO THE LIQUIDITY WORKING PRINCIPLE

5. In February, the staff provided the Boards with the following proposed revisions to the liquidity working principle:

> Financial statements should present information in a manner that helps a user assess an entity's solvency (the ability to *pay debt and other borrowings from external sources* as they come due) by providing information about the liquidity of the entity's assets and liabilities (nearness to cash, the means to assessing solvency ~~or time to conversion to cash~~)

6. While the Boards agreed that solvency should be included in the working principle, they noted that solvency relates to more than just external debt and existing liabilities. In addition, Board members were of the view that liquidity and solvency should be on the same level, rather than liquidity being a subset of solvency (as suggested in the above working principle). This view is consistent with paragraph 16 of the IASB framework which considers liquidity, solvency, and capacity to adapt to changes in the environment in assessing an entity's financial position.

7. In addition, as described in paragraphs 8–10, the FASB asked the staff to consider adding two other aspects to the working principle:

a. The concept of capital adequacy which would address the Boards' observation that solvency is also affected by management's ability to pay returns on investments to investors and consider future growth.

b. The concept of financial flexibility[1], which addresses the ability of an entity to take effective action to alter amounts and timing of cash flows so that it can respond to unexpected needs and opportunities.

Capital Adequacy

8. At the February FASB education session, a Board member noted that investors consider an entity's ability to pay dividends to investors when analyzing an entity's liquidity. This Board member mentioned that disclosure information that would aid users in assessing an entity's objectives, policies, and processes for managing capital had recently been added to IAS 1, *Presentation of Financial Statements* (paragraphs 124A-C), and that it would be useful to incorporate the notion of capital adequacy into the liquidity principle.

Financial Flexibility

9. Also at the February FASB education session, a Board member asked the staff to consider incorporating the concept of financial flexibility into the working principle. That concept, first introduced in Concepts Statement 5, was also in an Exposure Draft that preceded AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*. The Exposure Draft described financial flexibility as "management's expected course of action when it is determined that it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking action." The types of items expected to be discussed in that disclosure include but were not limited to (a) borrowings either directly by banks and the like or indirectly by delaying payments to vendors, and (b) liquidating assets either by selling them or not replacing inventory as it is sold in the normal course of operations. That Board member

[1] The concept of financial flexibility is also discussed in paragraph 24(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, and defined in footnote 13 to that paragraph. Financial flexibility as used in this memo is consistent with its use in Concepts Statement 5,

suggested that while those disclosures were not included in the final SOP because of cost benefit concerns, the accounting environment has changed since 1994 and the disclosures would be helpful to users in assessing mismatches of asset and liability maturities and an entity's ability to continue to operate.

10. Similar disclosures are currently required for what is defined as *liquidity risk* in paragraph 39(b) of IFRS 7 *Financial Instrument: Disclosures,* and addressed in more detail in paragraph IG31. IFRS 7 defines liquidity risk as "the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities", which is essentially the same concept as financial flexibility, as described in paragraph 9. The IFRS disclosures are described below.

> An entity shall disclose:
> a. a maturity analysis for financial liabilities that shows the remaining contractual maturities: and
> b. a description of how it manages the liquidity risk inherent in (a). [Paragraph 39]
>
> Paragraph 39(b) requires the entity to describe how it manages the liquidity risk inherent in the maturity analysis of financial liabilities required in paragraph 39(a). The factors that the entity might consider in providing this disclosure include, but are not limited to, whether the entity:
>
> a. expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank);
> b. expects some of its undrawn loan commitments not to be drawn;
> c. holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs;
> d. has committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) that it can access to meet liquidity needs;
> e. holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;
> f. holds deposits at central banks to meet liquidity needs;
> g. has very diverse funding sources; or
> h. has significant concentrations of liquidity risk in either its assets or its funding sources. [Paragraph 31 of the Implementation Guidance]

Possible Revisions to the Working Principle

11. The following description of solvency, from on the American Banker's Association glossary, incorporates the concept of capital adequacy and financial flexibility and appears to address the concepts that Board members thought were lacking in the February revisions to the working principle.

> Solvency is an entity's ability to meet financial commitments as they come due and to take advantage of business opportunities. In the short-term it is a function of liquidity, in the long-term it is a function of capital adequacy.

12. If the Boards are of the view that solvency should be included in the project's working principles, the staff recommends that the liquidity working principle be revised to incorporate the above definition of solvency as follows:

> Financial statements should present information in a manner that helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash~~or time to conversion to cash~~) and an entity's solvency (its ability to meet its financial commitments as they come due, to continue to raise capital for operations, and to take advantage of future business opportunities).

Questions for the Board (Issue 1)

13. Do Board Members want to change the working principle to incorporate the concept of:
    a. An entity's ability to meet financial commitments as they come due?
    b. Continuing to raise capital for operations?
    c. Raising capital to take advantage of future business opportunities?
    d. If so, do Board members agree with the wording of the revised working principle?

ISSUE 2—APPLICATION OF THE REVISED WORKING PRINCIPLE

Scope of Recommendations

14. The quantitative disclosures recommended in Issue 2a primarily address the liquidity aspect of the revised working principle. Issue 2b primarily addresses the qualitative disclosures necessary to achieve the revised working principle. While the staff is of the view that its recommendations related to qualitative and quantitative disclosures

are responsive to the Boards' requests, the staff is also concerned that the recommendations either don't take those disclosures far enough, or take them too far.

15. Part of that concern is due to the fact that the staff considered these issues primarily in the context of IFRS 7 (based on the IASB's request that we compare/contrast with IFRS 7 and IAS 1 requirements). One could argue that to fully achieve the working principle, the issue should be looked at more holistically and consideration should be given to what information about risk is, or should be, disclosed about assets and liabilities other than financial instruments (such as leases and pensions) and whether risks in addition to liquidity risk should be addressed.

16. The staff's recommendations include providing information in the notes to financial statements about financial flexibility and capital adequacy, which some might argue goes beyond what the basic financial statements should be addressing because it addresses forward-looking information. At the FASB education session, one Board member questioned whether this project should require disclosures related to capital adequacy and financial flexibility, as that could lead to providing information about an entity's ability to continue as a going concern, which is currently the purview of another project. The staff reminds the Boards that while the purpose of the project is presentation, the Boards agreed that it might need to add or modify the notes to financial statements when a project objective cannot be achieved on the face of the financial statements. While that is why the staff recommends note disclosures for this issue, the staff is concerned that the extent of the qualitative information may be too much. Board members should read the following sections on possible quantitative and qualitative disclosures with the above concerns in mind.

Issue 2a: Quantitative Disclosures

Prior Staff Recommendation

17. In February, the staff recommended that an entity provide the following quantitative information in the financial statements to help a user assess the liquidity of an entity's assets and liabilities:

a. Details of the maturities of its **long-term** assets and liabilities with contractual terms.

b. Details of the maturities of its **short-term** assets and liabilities with contractual terms as described below:

   (1) If an entity manages its needs for cash based on a horizon shorter than one year, the maturity information should be provided for more than one time band

   (2) If an entity does not manage its needs for cash based on a horizon shorter than one year, the maturity information may be provided either on the face of the statement of financial position or in the notes. However, if the entity presents the information in the statement of financial position, each of its assets and liabilities should be classified as either short-term or long-term.

18. The staff also recommended that an entity that manages its needs for cash based on a horizon shorter than one year present the maturities of all of its assets and liabilities having contractual terms based on either:

    a. ***the shorter of*** (1) the contractual maturity or (2) the expected realization or settlement of the asset or liability; or

    b. (1) the contractual maturity ***and*** (2) the expected realization or settlement of the asset or liability, provided that it is consistent with the entity's liquidity management activities. Under this approach, any major differences between (1) and (2) should be explained.

    Entities that do not manage cash based on a horizon shorter than one year should present maturity information based on the shorter of (a) the contractual maturity or (b) the expected realization or settlement of the asset or liability.

19. In addition, the staff recommended that the amounts presented in the maturity disclosure be based on expected, undiscounted future cash flows and that the maturity disclosure should reconcile the differences between total undiscounted cash flows and the amount presented on the statement of financial position.

Board Input on February Recommendations

20. The IASB was in general agreement with the staff's recommendations at the February meeting. They asked the staff to revise their recommendations so that it was clear how the information is similar to or different from the requirements in

IFRS 7. At the February education session, FASB members appeared to agree with the direction of the staff's recommendations. However, most did not support using the notion of managing cash on a horizon of shorter than one year to determine which entities should provide short-term maturity information in more than one time band. Board members noted that most entities could be viewed as managing cash over a period of less than a year. The FASB asked that the staff develop different criteria.

When Should An Entity Provide More Information About Short-Term Maturities?

21. In order to identify characteristics of entities for which users would want short-term maturity information in more than one time band, the staff spoke with several users from rating agencies. Those users stated that multiple bands of short-term maturity information would be useful when the nature of the business is such that maturities of assets and liabilities can change quickly, creating mismatches that would adversely affect the entity's ability to meet its obligations in the short-term. For example:
    a. When an entity is highly leveraged and a significant amount of its contractual assets and liabilities are short-term
    b. When there is a more than a remote chance that an entity's long-term obligations could become due in the short-term and could adversely affect the business. For example, a material adverse change clause or an acceleration clause could cause those obligations to come due in less than one year and the entity may not have the funds available to meet those obligations. Alternatively, such a clause could result in the entity being unable to pay its vendors for raw materials.

Staff Recommendations

22. The staff recommends that an entity provide the following quantitative information in order to help a user assess the liquidity of an entity's assets and liabilities:
    a. Details of the maturities of its contractual long-term assets and liabilities

b. Maturity information about its contractual short-term assets and liabilities, as described below

   (1) When the nature of an entity's business is such that maturities of assets and liabilities can change quickly, creating mismatches that would adversely affect the entity's ability to meet its obligations in the short-term, it should **provide maturity information in more than one time band** in the notes to the financial statements.

   An entity should use its judgment to determine the appropriate time bands. For example, and entity might determine that the following time bands are appropriate: less than one month; more than one month and not more than three months; and more than three months and not more than one year.

   (2) When an entity is not of that nature (see (1) above), it should **identify its short-term contractual assets and liabilitie**s either in the notes to financial statements or on the statement of financial position.

   An asset or liability is short-term if the shorter of the contractual maturity or expected maturity is one year or less. If an entity presents the information on the statement of financial position, all of its assets and liabilities must be presented as either short-term or long-term (that is, it must present a classified statement of financial position).

c. An entity should present the maturities of all it assets and liabilities having contractual terms by **either** the shorter of (1) the contractual maturity or (2) the expected realization or settlement of the asset or liability **or** (1) the contractual maturity **and** (2) the expected realization or settlement, provided that the expected realization or settlement is consistent with the entity's liquidity management activities. Under the second approach, any major differences between (1) and (2) should be explained.

d. The amounts presented in the maturity schedules should be based on expected and undiscounted future cash flows. The maturity schedules should reconcile the differences between total undiscounted future cash flows and the amounts presented in the statement of financial position.

23. [Paragraph omitted from Observer Notes].

24. As IFRS 7 requires disclosure of maturity information about financial liabilities, there would be some overlap with its requirements and the above recommended disclosures.

Questions for the Board (Issue 2a)

25. Should the financial statements include detailed information about maturities of contractual long-term assets and liabilities?

26. Should the financial statements include maturity information about short-term contractual assets and liabilities as described in paragraph 22b? Specifically, is the criteria for determining which entities should provide multiple bands of maturity information appropriate (that is, those for which the nature of their business is such that maturities of assets and liabilities can change quickly, creating mismatches that would adversely affecting the entity's ability to meet its obligations in the short-term)?

27. Do Board members agree with the staff's recommendations in paragraph 22c regarding whether the maturity information should be presented based on expected or contractual maturities (or both)?

28. Do Board members agree that the amounts presented in the maturity schedules should be based on expected and undiscounted future cash flows and that the disclosure should reconcile as needed the undiscounted amounts and the amounts presented in the statement of financial position (paragraph 22d)?

Issue 2b: Qualitative Disclosures

29. The quantitative disclosures recommended above primarily address the liquidity aspect of the revised working principle. The staff is of the view that the solvency aspects (capital adequacy and financial flexibility) of the revised working principle are best addressed qualitatively rather than quantitatively. Thus, this section primarily addresses qualitative disclosures related to both the liquidity and the solvency aspects of the revised working principle.

Capital Adequacy

30. As noted in paragraph 8 of this memorandum, IAS 1 was recently amended (paragraph 124A–124C) to require an entity to disclose information that enables users of the financial statements to evaluate an entity's objectives, policies, and

procedures for managing capital. Those disclosures (provided below) were proposed in the context of ED7, *Financial Instruments: Disclosures*. However, respondents to ED7 questioned the relevance of those disclosures in a standard dealing with financial instruments. In response, the IASB included those disclosures in a standard that had more general relevance than IFRS 7—namely IAS 1. The Basis for Conclusions of IAS 1 states that an entity's level of capital and how it manages capital "are important factors for users to consider in assessing the risk profile of an entity and its ability to withstand unexpected adverse events. The level of capital might also affect the entity's ability to pay dividends." Thus the staff is of the view that disclosure of the following information would achieve the capital adequacy aspect of the working principle.

124A. An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

124B. To comply with paragraph 124A, the entity discloses the following:

(a) qualitative information about its objectives, policies and processes for managing capital, including (but not limited to):
   (i) a description of what it manages as capital;
   (ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
   (iii) how it is meeting its objectives for managing capital.

(b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).

(c) any changes in (a) and (b) from the previous period.

(d) whether during the period it complied with any externally imposed capital requirements to which it is subject.

(e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

These disclosures shall be based on the information provided internally to the entity's key management personnel.

124C. An entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, and those entities may also operate in several

> jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity shall disclose separate information for each capital requirement to which the entity is subject.

Financial Flexibility

31. As noted in paragraph 10 of this memorandum, paragraph 39(b) of IFRS 7 requires a description of how an entity manages the liquidity risk inherent in its financial liabilities. The related implementation guidance (paragraph IG31) includes items that should be considered in providing that description. Some of the items listed relate to an entity's ability to manage its liquidity risk through selling its assets and/or delaying its payment of its liabilities, as well as methods an entity might use to meet its financial commitments, such as available credit lines.

32. The staff is of the view that a similar disclosure requirement for financial assets as well as financial liabilities would provide information about an entity's financial flexibility as well as information about the liquidity of an entity's assets and liabilities (nearness to cash).

33. Liquidity disclosures are also required in paragraph (a)(1) of Item 303 of Regulation S-K. Item 303 requires an entity in its Management's Discussion and Analysis (MD&A) to "identify any known demands, commitments, events or uncertainties that result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused liquidity assets." Thus, disclosure of this type of information is required to some extent under both U.S. GAAP and IFRS.

Staff Recommendations

Capital Adequacy

34. If the Boards are in agreement that the working principle should be revised to include the concept of solvency, the staff recommends that an entity disclose capital management information as described in the following paragraphs. Note: the following requirements are the same as those added to IAS 1 (paragraphs 124 A-C). Thus, the staff recommendation is for the IASB to confirm that it wants to retain those requirements and for the FASB to agree to add those disclosure requirements.

    a. Qualitative information about an entity's objectives, policies, and processes for managing capital, including (but not limited to):

        (1) A description of what it manages as capital

        (2) When an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital

        (3) How it is meeting its objectives for managing capital.

    b. Summary quantitative data about what an entity manages as capital. Some entities regard some financial liabilities (for example, some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (for example, components arising from cash flow hedges).

    c. Any changes in the above qualitative and quantitative data from the previous period.

    d. Whether during the period an entity complied with any externally imposed capital requirements to which it is subject.

    e. When the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

35. Paragraph 124C of IAS 1 notes that an entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, and those entities may also operate in several jurisdictions. IAS 1 states

that "when an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity should disclose separate information for each capital requirement to which the entity is subject." The staff recommends that the financial statement presentation document include a similar requirement.

Financial Flexibility

36. If the Boards are in agreement that the working principle should be revised to include the concept of solvency, the staff recommends that the Boards consider requiring an entity to disclose information about its liquidity risk management as described in the following paragraphs. Those disclosures are similar to what is in IFRS 7, except that they would cover financial assets as well as financial liabilities (words not in IFRS 7 are underlined).

37. Qualitative information about an entity's objectives, policies, and processes for managing liquidity risk inherent in financial assets and liabilities, including a description of an entity's ability to meet its expected future cash outflows over the near term. The factors that an entity might consider in providing this disclosure include, but are not limited to, whether the entity:

    a. Expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank)
    b. Expects some of its undrawn loan commitments not to be drawn
    c. Holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs
    d. Has committed borrowing facilities (for example, commercial paper facilities) or other lines of credit (for example, stand-by credit facilities) that it can access to meet liquidity needs
    e. Holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities
    f. Holds deposits at central banks to meet liquidity needs;
    g. Has very diverse funding sources or

h. Has significant concentrations of liquidity risk in either its assets or its funding sources.

38. As mentioned earlier in the memo, the staff is concerned that some of the suggested disclosures either go too far or don't go far enough. The staff's main concern is with the qualitative information that might be disclosed about liquidity risk management (financial flexibility), as described in the paragraph above. This disclosure is consistent with one aspect of IFRS 7; however, IFRS 7 relates to only financial liabilities. The Boards could decide not to add a liquidity risk disclosure requirement in this project because, while it would be useful information, there is probably more that should be considered to fully address the issue (such as risk related to nonfinancial instruments, for example, leases and pension obligations). Alternatively, the Boards could decide that it is appropriate to address this issue in this project and direct the staff to look at the issue more broadly. The staff recommends that the Board not add this disclosure requirement.

39. As noted previously disclosure of information about liquidity risk management is currently required under both IFRS 7 and Rule 303 of Regulation S-K. The fact that this information is presented in the MD&A leads the staff to the view that it may be more akin to forward-looking information, which is normally considered outside of the scope of the financial statements.

40. [Paragraph omitted from Observer Notes].

Questions for the Board (Issue 2b)

41. Do IASB Board members agree to retain IAS 1 paragraphs 124A–C and do FASB Board members agree to include those disclosures in the financial statement presentation document (refer to paragraphs 34 and 35)?

42. Do Board members want to require disclosure of information about liquidity risk management? If so, should that requirement in this document be limited to financial assets and financial liabilities as described in paragraph 37 or be broadened (which would require more staff work)?

SUMMARY

43. In summary, in order to provide information that will help a user **assess the liquidity** of an entity's assets and liabilities; an entity could provide

    a. Maturity information about its long-term and short-term contractual assets and liabilities. Certain entities, such as financial institutions, would need to provide detailed maturity information about their short-term contractual assets and liabilities. Other entities would only need to distinguish short-term assets and liabilities from long-term assets and liabilities, either on the face or in the notes (refer to paragraph 22)

    b. Qualitative information about liquidity risk management, as described in paragraph 37 (this would include some information about financial flexibility).

44. In order to provide information to help a user **assess an entity's solvency**, an entity could provide:

    a. qualitative information about its capital management policies (paragraph 34.a)

    b. quantitative information about its capital (paragraph 34.b) and

    c. qualitative information about its liquidity risk management (paragraph 37).