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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **17 May 2007, London**

Project: **Financial Statement Presentation**

Subject: **Classification by Diversified Entities (Agenda Paper 6B)**

INTRODUCTION

1. Consistent with one of the project's working principles, the proposed working format disaggregates financial information between **value creating activities** (business), and **the funding of that value creation** (financing and equity). The Boards' preliminary view is that an entity should classify its assets and liabilities as business or financing based on how it manages its activities or functions. In January, the Boards decided to include its preliminary view on how a consolidated reporting entity consisting of significantly different businesses (a diversified entity) should apply the classification guidance. For example, a financial institution may classify more financial instruments in the operating category than a manufacturing entity would. In discussing how banks should classify their assets and liabilities, the question arose as to how a consolidated reporting entity that includes both a manufacturing business (for example, cars) and a finance business (for example, car loans) should classify its financial instruments—in the same or different categories. That question leads to a variety of related questions.

2. A diversified entity may have similar types of assets and liabilities that function differently in each of its different business models. For example, a diversified entity may have three different businesses, each with a significant portfolio of financial instruments. In the first business, management views the financial instruments as key to financing its ongoing operations (financing). In the second business, the financial instruments may be considered integral to the value creating process (operating). While in the third business, the financial instruments create value but are not integral to the main value creating activities of the entity (investing).

3. The purpose of this memo is to analyze those questions; specifically, how a consolidated reporting entity that is comprised of significantly different businesses should:

   a. Apply the classification criteria to separate its value creating assets and liabilities from financing assets and liabilities (Issue 1)

   b. Present the financial information for those different businesses in its consolidated financial statements (Issue 2).

ISSUE 1: APPLICATION OF CLASSIFICATION GUIDANCE

4. The following alternatives are expressed in terms of the definitions in FASB Statement 131, *Disclosures about Segments of an Enterprise and Related Information* and IFRS 8, *Operating Segments* (provided below).

   a. An *operating segment* engages in business activities, has operating results that are regularly reviewed by the chief operating decision maker and has discrete financial information.

   b. A reportable segment is an operating segment or an aggregation of two or more operating segments that have similar economic characteristics and are similar in nature (products, service, production processes, customers, distribution, and regulatory environment). To be considered a reportable segment, quantitative thresholds must be met or management must deem the segment information useful to users of the financial statements.

5. The staff proposes three possible alternatives for determining how a diversified entity should classify its assets and liabilities:

a. <u>Alternative A:</u> the classification criteria would be set at the **consolidated reporting level**, thus all segments of the reporting entity would classify their assets and liabilities in the same manner.

b. <u>Alternative B:</u> the classification criteria would be set at the **reportable segment level**, and, thus at the consolidated level, similar assets and liabilities could be classified differently.

c. <u>Alternative C:</u> the classification criteria would be set at some **other lower level**, such as a reporting unit or an operating segment that is not a reportable segment.

Staff Analysis

6. As discussed earlier, similar assets and liabilities may fill different functions in different businesses. For example, a manufacturing business and a bank may each have loans payable. For the manufacturing business, management may view and manage the loans as financing liabilities; while for the bank, management may view and manage the loans as operating liabilities. A single uniform set of classification criteria at the consolidation level (Alternative A) would require all loans payable to be classified in the same category (either all as financing liabilities or all as operating liabilities). The advantages of Alternative A are that similar types of assets or liabilities would be grouped together and that classification of assets and liabilities would be less complex and therefore easier to understand, as there would be only one set of entity-wide classification criteria. However, Alternative A would not provide information based on the function of the asset or liability (that is, whether it is used for value creation or financing).

7. Classification criteria set at the reportable segment level (Alternative B) would better represent the way an asset or liability functions because reportable segments contain operating segments that are similar in nature and economic behavior. Thus, the assets and liabilities in those segments presumably are utilized in the same manner. A potential disadvantage of Alternative B is the cost to apply and maintain multiple sets of classification criteria. An entity would also have to clearly distinguish the reasons for the classification differences in its accounting policy disclosure. In addition, there would be potential costs associated with users of financial statements having to understand and appreciate the differences in a

diversified entity's classification policies and processes. Another possible disadvantage is that fungible assets and liabilities, such as cash, could be classified in more than one category, something that the Boards have previously expressed concern with.

8. The staff believes that classification criteria set at levels below the reportable segment level, as in Alternative C, would result in few if any classification differences from Alternative B because the components of the reportable segment are similar in nature and have similar economic characteristics.

Summary and Staff Recommendations

9. Setting classification criteria at the **consolidation level** will classify similar types of assets and liabilities together, even though they may not serve the same function and therefore may be viewed differently by both management and users of financial statements. Setting classification criteria at the **reportable segment level** allows management to better portray how an asset or liability functions within each of the different businesses.

10. The staff believes that the most useful financial information will be generated from asset and liability classifications that reflect the individual business models of a diversified entity. This is consistent with one of the key aspects of the Board's preliminary views to date—that classification should be consistent with how the asset or liability is viewed by management (how it is utilized). Therefore, the staff recommends that an entity classify its assets and liabilities at the reportable segment level (Alternative B). Classification at this level will provide the most useful information regarding the role of assets and liabilities within the business (reportable segment) and reflect how they are managed.

11. However, an issue that could potentially nullify the benefits of Alternative B is that upon consolidation, all reportable segments are aggregated together and the relationships between the assets and liabilities of a particular reportable segment are lost. The staff believes changes to segment reporting disclosures may be needed to support the proposed categorization scheme and related classification guidance. This presentation issue is addressed in Issue 2.

Question for the Boards

12. Should a diversified entity classify its assets and liabilities at the consolidation or reportable segment level?

Issue 2: Presentation Format and Segment Reporting

13. If the Boards agree that a diversified entity should classify its assets and liabilities at the reportable segment level, a related question is how the financial information should be presented on the face of the primary statements and in the segment note disclosure, if there are differences in classification between one or more reportable segments.

14. The staff has identified the following alternatives for how information could be presented in the primary financial statements if classification at the reportable segment level results in one or more reportable segments classifying similar assets and liabilities in different categories. Presentation is not an issue if there are no classification differences.

    a. Alternative A: only consolidated information would be presented, as it is today, on the face of the financial statements. The segment disclosure requirements would be modified to include summary financial information for the operating category of each primary financial statement. This summary information would be limited to the operating category, as financing activities are often centralized. The summary information would tie into the consolidated amounts.

    b. Alternative B: each primary financial statement would include segment information on the face of the financial statements for all categories of the working format (operating, investing, financing, discontinued operations, income taxes, and equity).

    c. Alternative C: only consolidated information would be presented, as it is today, on the face of the financial statements. A new primary statement would be introduced that would present operating category information by segment for the statements of financial position, comprehensive income, and cash flows.

Segment Reporting Requirements

15. Current segment reporting guidance requires disclosure of revenues, total assets, and profit (loss) by segment. However, segment information may be based on measurement methods that are inconsistent with the measurements used in the consolidated statements. Segment profit or loss is also not currently defined by the standards. Other required segment disclosures cover select information such as revenues from external customers, revenues from transactions with other operating segments, interest revenue and expense, depreciation, and so forth. Information about liabilities, cash flows, and research and development expenditures are not required by segment.

Staff Analysis

16. Alternative A is the most comparable to current reporting requirements. It would require a minimum amount of revisions to the segment reporting standards. However, the staff believes Alternative A is inconsistent with the disaggregation working principle. That is because classifying the assets and liabilities by reportable segment and then combining those amounts on the face of the primary financial statements will be **aggregating** line items for which **disaggregation** would enhance their usefulness in predicting future cash flows. Current segment reporting requirements would not provide this disaggregated information because the measurement basis in segment reporting does not have to be consistent with GAAP measurements used on the face of the primary statements.

17. Alternative B would require the segment information for the operating category to be disaggregated on the face of each of the primary statements. This alternative is consistent with the disaggregation working principle and places the segment detail in immediate proximity of the consolidated totals. A disadvantage of Alternative B is that the primary statements may be complex and unwieldy to use if an entity has a large number of reportable segments. This alternative would also require reportable segment information to be reported on measurement bases consistent with those used in each of the consolidated statements, thus potentially requiring a change to existing information systems. Additionally, guidance would have to be developed to determine how to allocate and report assets and liabilities that are shared centrally or between reportable segments.

18. Alternative C requires the addition of a new primary statement dedicated to presenting segment information for the operating category. [Sentence omitted from Observer Notes].

19. Under Alternative C, only operating category information would be provided in the new primary statement because the staff is of the view that operating category information is the most relevant and that the benefits of providing incremental information regarding the investment and financing activities would not outweigh the costs. Further, many entities obtain and manage financing centrally, which would ultimately be an allocation exercise for which insufficient GAAP guidance exists.

20. A benefit of Alternative C is that the new statement will help users better understand the flow of financial information from statement to statement without adding more detail to the existing primary statements. Less "visual clutter" could increase the usefulness of the statements as a whole.

21. A disadvantage of Alternative C is that, similar to Alternative B, the new statement will require reportable segment information to be reported consistent with the consolidated statements, thus potentially requiring changes to existing information systems.

Staff Recommendation

22. The staff recommends Alternative C. The inclusion of a new primary statement including some segment information would provide the information necessary to understand changes in the operating assets and liabilities of a diversified entity that could be used to predict future cash flows along with the consolidated statements. The prominence of the reporting segment information for the operating category in a primary statement reflects its importance in understanding the consolidated operations of a diversified entity. Further, this alternative provides a simplified and consistent mode of presentation that should enhance comparability across entities.

23. If the Boards agree with the staff recommendation, there are a number of other application issues that would need to be addressed if an entity is to present operating category information at the reportable segment level. One of the issues is how an entity should classify and present operating assets and liabilities that are

either centralized in an entity or shared between reporting segments. The staff is of the view that these issues do not need to be specifically addressed before issuing the discussion document.

Questions for the Boards:

24. How should a diversified entity present information in its financial statements if classification at the reportable segment level results in one or more reportable segments classifying similar assets and liabilities in different categories?

    a. Should minor modifications be made to the segment disclosures, as in Alternative A?

    b. Should the consolidated financial statements include segment information on the face, as in Alternative B?

    c. Should a new primary financial statement be added, as in Alternative C?

25. This memorandum has touched on possible changes to the presentation of segment information in the financial statements; one of which is recommended for diversified entities. Prior to issuing the discussion document do the Boards want to address other possible changes to the segment disclosures to make them more consistent with presentation in the primary financial statements?