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**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

**SAC Meeting:** **November, London**
**Project:** **Overview of Preliminary Model**
***(Agenda Paper 3a)***

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## INTRODUCTION

1. By the end of June 2007, the Boards had expressed their preliminary views on most of the substantive issues that will be addressed in Phase B of the financial statement presentation project. The Boards plan to issue an initial discussion document explaining their preliminary views in the first half of 2008.

## OVERVIEW OF PRELIMINARY MODEL

### Objective and Working Principles

2. The Boards' objective is to present information in the financial statements in ways that enable investors, creditors, and other financial statement users to:
   a. Understand an entity's present and past financial position
   b. Understand how past operating, financing, and other activities caused an entity's financial position to change and the components of those changes
   c. Use that financial statement information (along with information from other sources) to assess the amounts, timing, and uncertainty of an entity's future cash flows.

3. The working principles of financial statement presentation follow.

   Financial statements should:

   a. Portray a cohesive financial picture of an entity
   b. Separate an entity’s financing activities from its business and other activities and further separate financing activities between transactions with owners in their capacity as owners and all other financing activities
   c. Disaggregate line items if that disaggregation enhances the usefulness of that information in predicting future cash flows.
   d. Help a user assess an entity’s ability to:
      (1) Meet its financial commitments as they come due (including, but not limited to, its ability to raise capital and to use existing assets for generating future cash flows)
      (2) Invest in business opportunities.
   e. Help a user understand:
      (1) The basis on which assets and liabilities are measured
      (2) The uncertainty in measurements of individual assets and liabilities
      (3) What causes a change in reported amounts of individual assets and liabilities
      (4) The difference between cash-based accounting and accrual accounting
      (5) The effects of noncash activities during the period on an entity's financial position.

**The Working Format and Cohesiveness of the Financial Statements**

4. The Boards have agreed that the first working principle (financial statements should portray a cohesive financial picture of an entity) is the governing principle. Some think about this cohesiveness principle in terms of articulation or linkage—a cohesive financial picture will clarify the relationships between related items in the financial statements. The following table represents the format for classifying and presenting information within the financial statements excluding the notes (referred to as the working format).

| Statement of Financial Position | Statement of Comprehensive Income | Statement of Cash Flows |
|---|---|---|
| **Business** | **Business** | **Business** |
| ◆ Operating assets and liabilities<br>◆ Investing assets and liabilities | ◆ Operating income and expenses<br>◆ Investing income and expenses | ◆ Operating cash flows<br>◆ Investing cash flows |
| **Discontinued operations** | **Discontinued operations** | **Discontinued operations** |
| **Financing** | **Financing** | **Financing** |
| ◆ Financing assets<br>◆ Financing liabilities | ◆ Financing asset inc/exp<br>◆ Financing liability inc/exp | ◆ Financing asset cash flows<br>◆ Financing liability cash flows |
| **Income taxes** | **Income taxes** | **Income taxes** |
| **Equity** | **Statement of Changes in Equity** | **Equity** |

*Note: The Boards have not addressed totals, subtotals, or the order in which sections would be presented, nor have they finalized the labels of the categories and sections.*

5. Application of the cohesiveness working principle would result in an entity classifying its assets, liabilities, and equity items into one of the prescribed categories or sections in the statement of financial position and then similarly classifying changes in assets, liabilities, and equity items in the statement of comprehensive income and the statement of cash flows. The Boards are of the view that, ideally, the financial statements should be cohesive at the line-item level. Thus, to the extent practical, an entity would label line items similarly across the financial statements.

## Management Approach to Classification

6. The working format would separate the different functional activities of an entity and apply to all business entities, including financial institutions. Because functional activities vary from entity to entity, an entity would choose the classification that best affects management's view of what constitutes its business (operating and investing) and financing activities. Thus, a manufacturing entity may classify the exact same asset (or liability) differently from a financial institution because of differences in the businesses in which those entities engage. This management approach to classification will allow an entity's financial statements to communicate clearly about the various aspects of its activities.

7. An entity would be required to explain, as a matter of accounting policy, its bases for classifying assets and liabilities in the operating category, the investing category, and

the financing categories. The Boards anticipate that that disclosure would include a discussion of the type(s) of businesses in which the entity engages. Any change in the basis for classification would be viewed as a change in accounting policy and would be implemented through retrospective application to prior periods (consistent with FASB Statement No. 154, *Accounting Changes and Error Corrections*, and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

## Classification Guidelines

8. An entity consisting of different businesses would apply the classification guidance to its assets and liabilities at the reportable segment level (as that term is defined in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, and IFRS 8 *Operating Segments*). Thus, an entity may classify similar assets (or liabilities) differently because of differences in the businesses in which it engages.

### Business Section

9. The business section of the statement of financial position would include all assets and liabilities that management views as part of the entity's continuing business activities.

#### *Operating Category*

10. The operating category would include assets and liabilities that management views as integral to the business activities it is currently engaged in and unrelated to financing those activities. Assets and liabilities that are integral to an entity's business would be those that management views as related to producing and delivering goods or providing services (for example, accounts receivable, inventory, equipment, accounts payable, pension obligations, and, for a financial services business, deposits and loans). An entity would include operating assets and liabilities in the same category.

#### *Investing Category*

11. The investing category would include assets and liabilities that management views as related to the entity's investing activities. The term *investing* is used in the economic sense—committing money or capital with the expectation of earning a financial return. Examples of assets that an entity might classify in the investing category

include real estate purchased solely for the purpose of earning a return (and the entity is not in the real estate business); an investment in a joint venture or an associate that is not related to the entity's business; or a speculative investment such as artwork.

**Financing Section**

12. The financing section of the statement of financial position would include only financial assets and financial liabilities that management views as part of the financing of the entity's business activities (referred to as *financing assets and liabilities*).

13. In determining whether a financial asset or liability is part of the financing of the business, management would consider whether the item is interchangeable with other sources of financing and whether the item could be characterized as independent of specific business activities. For example, the financing section would normally *exclude* assets and liabilities related to transactions with customers, suppliers, and employees because transactions of that nature usually relate to an entity's operations. The financing section would normally *include* liabilities that originated from an entity's capital-raising activities because capital is usually raised as a means to fund operating activities (for example, money market funds, a bank loan, bonds).

14. As financial assets and liabilities are generally part of the operations of a financial services business, the financing section of a bank, for example, could include fewer types of financial instruments than that of a retail business. While a financial institution would most likely classify cash as an operating asset and a bank overdraft as an operating liability, an entity that is not a financial institution would usually classify those items in the financing section.

**Other sections**

15. The **Equity section** in the statement of financial position would include all equity items. Changes in equity items would be presented in the equity section of the statement of cash flows and in the statement of changes in equity.

16. All *income taxes*, including taxes related to transactions with owners, would be presented separately in an **Income Taxes section**.

a. Income taxes would not be allocated to continuing operations, discontinued operations, and so forth (that is, all items, including discontinued operations and other comprehensive income (OCI) items would be presented on a pre-tax basis).

b. The notes to financial statements will include information to assist users in analyzing income tax information due to this change in presentation. (The Boards have yet to discuss possible disclosure requirements.)

17. Discontinued operations would be presented separately in the **Discontinued Operations section**. Guidance on reporting a discontinued operation and the additional disclosures for components that have been or will be disposed of should be separated from the financial statement presentation project.

## DISCUSSION QUESTIONS

1) Based on the working principles developed by the Boards (refer to paragraph 3),

   a. **Do you think they are complete? If not what principle would you add?**

   b. **Do you agree that cohesiveness should be the governing principle in deciding how information should be presented in the financial statements?**

2) As illustrated in the table following paragraph 4, **Assets** and **Liabilities and equity** would no longer be the primary sections on the statement of financial position, nor would there be totals for assets and liabilities on that statement. Rather, the statement of financial position would be formatted such that all **Business assets *and* liabilities** would be in one section, all **Financing assets *and* liabilities** would be in another section, and all **Equity** items would be in another section. (Total assets and total liabilities would be disclosed in the notes to financial statements.)

   a. **Does separating an entity's "value-creating" activities (business section) from the funding of that value creation (financing and equity sections) provide more useful information than separating an entity's assets from its liabilities?**

3) As described in paragraph 6, the Boards support a management approach to financial statement presentation. That is, entities are to classify their assets and liabilities in the operating, investing, and financing categories in a manner that reflects how management views their business(es).[1] Thus, while the classification and application guidance applies to all industries, the Boards fully expect that the financial statements of entities in different industries will look different.

   a. **Do you support a management approach to classification?**

   b. **Is there additional classification guidance that should be provided?**

[1] Assets, liabilities, and equity items are to be classified in the other sections (discontinued operations, equity, and income tax) based on their accounting treatment rather than management's view of the item.