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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**17 October 2007, London**
Project:	**Financial Statement Presentation**
Subject:	**Issues related to application of the cohesiveness principle (Agenda Paper 8B)**

1. The purpose of this memorandum is to address the following issues related to the application of the cohesiveness principle:

   a. The classification of **dividends payable** on common shares in the statement of financial position and the classification of related payments in the statement of cash flows (Issue 1)

   b. The classification and presentation of **foreign currency translation adjustments** (Issues 2a and 2b)

   c. The presentation of single transactions that involve multiple assets (or a combination of assets and liabilities) that would be classified in more than one category under the working format (**basket transactions**) (Issue 3).

ISSUE 1: CLASSIFICATION AND PRESENTATION OF DIVIDENDS PAYABLE

2. Currently, a common dividend payable is classified as a liability. Under the working format, this liability is likely to be classified as a financing liability in the statement of financial position. The cohesiveness principle would suggest that the payment of dividends (the settlement of the liability) would be classified in the financing section

in the statement of cash flows. However, because most dividend payments (or at least the declaration of the dividend) relate to a transaction with owners in their capacity as owners, one might expect the dividend payment to be classified in the equity section of the statement of cash flows. At the October 2007 Board meetings, the staff would like to discuss how the Boards want to address this potentially counterintuitive result (classification of dividends payable in the financing section, particularly in the "change" statements).

Interaction with the FASB's Liabilities and Equity Project

3. The Financial Statement Presentation (hereinafter referred to as "F/S/P") project team and the Liabilities and Equity (hereinafter referred to as "L&E") project team issued a joint memorandum dated August 2, 2007, for the FASB to discuss this issue at an education session. The memorandum was issued for the FASB only because it addressed the classification and presentation of dividends payable in the context of the approaches being pursued in the L&E project, which the FASB is more familiar with than the IASB. The analysis in that memorandum concluded that dividends payable on common shares would be classified as equity under the ownership and ownership-settlement approaches (as the dividend payable is a form of redemption requirement) being considered in the L&E project.

4. At the August 8, 2007 FASB Education Session, some FASB members questioned that conclusion, noting (for example) that the dividend obligation might go to a former shareholder rather than a current shareholder (making it a liability). The FASB concluded that additional analysis was required before it could conclude on the classification of dividends payable. It was noted, however, that even though one might intuitively expect the dividend payment to be classified in the equity section, intuition was not a reason not to follow the cohesiveness principle.

5. The L&E team is of the view that broad input should be sought on the issue as part of the FASB's forthcoming L&E preliminary views document. That is, the L&E preliminary views would include a question to determine whether a dividend payable is a legal obligation that the entity has little or no discretion to avoid (which is a key characteristic of a liability in the current conceptual framework).

Staff Analysis and Recommendation

6. The staff recommends that the initial discussion document on the F/S/P project illustrate common dividends payable and the related cash flows based on how the liability is viewed under current GAAP—as a (financing) liability—and on the cohesiveness principle. The discussion document can mention that the classification of dividends payable related to certain types of equity instruments (including common shares) may change due to the outcome of the L&E project. But it should also state that the Boards are of the view that dividends payable and related cash flows should be classified consistently in the financial statements (because of the cohesiveness principle) regardless of whether the L&E project changes the classification of dividends payable (from a liability to equity).

QUESTION FOR THE BOARDS

Q1. Do the Boards agree that for purposes of the F/S/P initial discussion document, the classification of common dividends payable and related changes in the financial statements should be based on the current classification of dividends payable as a liability and the cohesiveness principle?

ISSUE 2: CLASSIFICATION AND PRESENTATION OF FOREIGN CURRENCY TRANSLATION ADJUSTMENTS

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

    a. The IASB decided that FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures[1] should be classified in the operating category within the business section in the statement of comprehensive income, and FCTAs related to equity method investments should be classified in the same category in which the equity method investment is classified in the statement of financial position.

[1] Proportionate consolidation of joint ventures is not permitted under U.S. GAAP. On September 13, 2007, the IASB issued Exposure Draft 9, *Joint Arrangements*, which proposes eliminating the option to account for joint ventures using this method.

b. The FASB wanted 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. In June, the FASB agreed with the staff's analysis, which concluded that allocating FCTAs to individual assets and liabilities in the statement of financial position reconciliation might be too complex and costly to justify in terms of the related usefulness (the analysis was based on the reconciliation from the beginning to the ending statements of financial position).

8. In this memorandum, the IASB will be asked to reconsider its previous decision regarding the classification of FCTAs. The FASB will be asked to decide on its preliminary view regarding the classification of FCTAs in the statement of comprehensive income. The staff's hope is to have the two Boards reach the same conclusion. However, if the Boards reach different conclusions, the staff would like to expose the views of both Boards in the forthcoming initial discussion document and seek input from constituents. Similar to the memorandum prepared for the March 2007 Board meetings, FCTAs will be discussed separately for (a) investments in consolidated subsidiaries and proportionately consolidated joint ventures and (b) equity method investments.

9. The following discussion is written in terms of the OCI presentation alternative preferred by the FASB under which OCI items are presented in an OCI subcategory of the operating, investing, or financing categories (wherever the asset or liability that gives rise to the item is classified). However, the alternatives and recommendations are equally applicable to the OCI presentation alternative preferred by the IASB under which OCI items would be presented in a separate OCI section. Under that latter alternative, all OCI items are to be classified in the appropriate subcategory (operating, investing financing) within the OCI section.

ISSUE 2a: FCTAs Related To Consolidated Subsidiaries and Proportionately Consolidated Joint Ventures

10. The staff considered the following alternatives for classifying FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures in the statement of comprehensive income:

Alternative 1: Allocate FCTAs to the categories in which assets and liabilities of the subsidiaries and joint ventures are classified in the statement of financial position.

Alternative 2: Do not allocate FCTAs but classify them in:

(A): the operating category within the business section

(B): a new FCTAs section[2].

As noted previously, the IASB preferred Alternative 2-A in March 2007.

Staff Analysis

Alternative 1

11. Alternative 1 requires the allocation of FCTAs to various categories. The advantage of this Alternative is that perfect cohesiveness would be achieved. That is, changes in assets and liabilities (due to translation adjustments) classified in a specific category in the statement of financial position would be presented in the corresponding category in the statement of comprehensive income.

12. As noted in paragraph 7b, in a memorandum for the June 2007 Board meetings the staff concluded that it might not be cost beneficial to allocate FCTAs to individual line items. The staff's conclusion would not change if the allocation requirement were relaxed and FCTAs were to be allocated to each category rather than to each line item.

Alternative 2

13. Under Alternative 2, an entity would not allocate FCTAs to various categories. While no allocation would lead to compromising the cohesiveness principle, the staff is of the view that this exception to the cohesiveness principle can be justified for the following reasons:

    a. FCTAs do not exist in terms of functional currency cash flows and have no direct effect on reporting/presentation currency cash flows. Moreover, it can be viewed that FCTA is a mechanical "by-product" of the translation method adopted in FASB Statement No. 52, *Foreign Currency Translation,* and IAS 21 *The Effects of Changes in Foreign Exchange Rates.* Those who hold that view note that

[2] Under the alternative in which OCI items would be presented in a separate OCI section, this would be a new subcategory within the OCI section.

FCTAs did not arise under the translation method that was used prior to the adoption of Statement 52. If the overall objective of this project is to develop a model that provides information that is useful in predicting future cash flows, the nature of FCTAs limit their usefulness.

b. FCTAs can be viewed as effects on the equity (net assets) of the consolidated subsidiary or the proportionately consolidated joint venture, rather than its individual assets and liabilities. Based on this view, FCTAs should be presented as a single amount and should not be allocated to each asset or liability that gives rise to equity (net assets).

14. The disadvantage of not allocating FCTAs is that perfect cohesiveness would not be achieved. Some may hold the view that the cohesiveness principle should not be pursued if perfect cohesiveness cannot be achieved, because any exception to the cohesiveness principle would distort the subtotals in the statement of comprehensive income.

Alternative 2-A and Alternative 2-B

15. The difference between Alternative 2-A and Alternative 2-B arise from the classification of the unallocated amount in the statement of comprehensive income. In Alternative 2-A, FCTAs would be classified in the operating category within the business section; in Alternative 2-B, they would be classified in a new section.

16. The major advantages of Alternative 2-A are that it is easy to implement and that it does not add a new section in the statement of comprehensive income. It can also be viewed as a practical expedient because it is likely that, even when FCTAs are allocated to or classified in various categories, a large portion of FCTAs would be presented in the operating category.

17. The disadvantage of Alternative 2-A is that the operating category would include FCTAs that relate to assets and liabilities of subsidiaries and joint ventures that are classified in categories other than the operating category. The staff notes that one of the recasting companies indicated that the operating income subtotal would be distorted if all FCTAs were classified in this category.

18. The major advantage of Alternative 2-B is that the new section would highlight that the classification of FCTAs in the statement of comprehensive income is an exception to the cohesiveness principle. If the Boards are willing to provide an exception to the cohesiveness principle, the staff is of the view that such an exception should be made prominent in the statement of comprehensive income. Moreover, given the reasons stated in paragraph 13 of this memorandum, it seems sensible to isolate FCTAs from other components of comprehensive income rather than classifying them into any of the existing categories.

Staff Recommendation

19. While Alternative 1 is attractive in the sense that perfect cohesiveness is achieved, the staff is of the view that it is unlikely that the benefits from providing the information would outweigh the costs. If allocating FCTAs (Alternative 1) is not cost-beneficial, the only other alternatives are those that do not achieve perfect cohesiveness.

20. Because not allocating FCTAs would be an exception (and possibly the only exception) to the cohesiveness principle, the staff recommends that that exception be highlighted and isolated in the statement of comprehensive income. Thus, the staff recommends that FCTAs be presented in a separate FCTA section in the statement of comprehensive income (Alternative 2-B) rather than in the operating category.

21. The staff acknowledges that its recommendation is different from the IASB's preference for presenting FCTAs in the operating category (Alternative 2-A). Because classifying FCTAs in the operating category is likely to distort operating income, the staff would like the IASB to reconsider its prior decision.

QUESTION FOR THE BOARDS

Q2. How should foreign currency translation adjustments related to consolidated subsidiaries and proportionately consolidated joint ventures be classified in the statement of comprehensive income?

Issue 2b: FCTAs Related to Equity Method Investments

22. The staff considered the following alternatives for classifying FCTAs related to equity method investments in the statement of comprehensive income:

Alternative 1: Classify FCTAs in the category in which the equity method investment is classified in the statement of financial position.

Alternative 2: Classify FCTAs in a new FCTAs section.

Staff Analysis

23. As noted previously, the IASB preferred Alternative 1 in March 2007. The major advantage of Alternative 1 is that it is consistent with the cohesiveness principle. If the Boards agree with the staff recommendation to permit an exception to the cohesiveness principle for FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures, Alternative 2 would result in a wider scope of exceptions to the cohesiveness principle.

24. The major advantage of Alternative 2 is that the two types of FCTAs would be presented consistently. Generally, the procedures used for the application of the equity method should be similar to the procedures used for consolidation. Accordingly, it could be argued that FCTAs related to equity method investments should be presented consistently with FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures. On the other hand, the staff notes that the recently issued IAS 1 *Presentation of Financial Statements* (revised 2007), requires OCI items related to equity method investments to be disclosed separately from OCI items related to the consolidated entity (U.S. GAAP is silent on this issue). This requirement may suggest that different presentation for OCI items related to equity method investments can be justified.

Staff Recommendation

25. On balance, the staff recommends that FCTAs be classified in the category in which the equity method investment is classified in the statement of financial position (Alternative 1). The staff is of the view that exceptions to the cohesiveness principle should be kept to a minimum. Accordingly, an exception to the cohesiveness principle should only be provided for FCTAs related to consolidated subsidiaries and

proportionately consolidated joint ventures (as recommended in Issue 2a). The cohesiveness principle should be applied to equity method investments and, therefore, FCTAs related to equity method investments should be classified in the category in which the equity method investment is classified in the statement of financial position. The staff recommendation is consistent with the IASB's expressed preference in March 2007.

QUESTION FOR THE BOARDS

Q3. How should foreign currency translation adjustments related to equity method investments be classified in the statement of comprehensive income?

ISSUE 3: BASKET TRANSACTIONS

26. For the June 2007 Board meetings, the staff prepared a memorandum related to basket transactions (Memorandum #52A or Agenda Paper 3A). Basket transactions are single transactions that involve the purchase or disposal of multiple assets (or a combination of assets and liabilities) that would be classified in more than one category under the working format. A typical basket transaction would be a business combination in which the acquirer acquires 100% of the equity instruments of the acquiree in cash.

27. At the FASB education session held on June 13, 2007, FASB members asked the staff for more analysis, including considerations regarding presentation of gains and losses in the statement of comprehensive income. At the June 2007 IASB Board meeting, the staff sought input as to how the memorandum can be improved and did not ask for decisions. This memorandum results from the rework done by the staff based on the Boards' input in June.

To Allocate or Not To Allocate

28. The fundamental decision the Boards need to make is whether the effects of basket transactions (revenues, expenses, and gains and losses in the statement of comprehensive income, and cash flows in the statement of cash flows) should be classified in more than one category. If so, the effects would need to be allocated to those categories. Thus, the question is phrased "should the effects of basket

transactions be allocated or not?" This "one to many" issue is not an issue under current U.S. GAAP or IFRSs because the effects of transactions that involve multiple assets and liabilities are often presented on one line in the change statements. The introduction of the working format (various categories) and the cohesiveness principle (consistent classification across all statements) gives rise to this issue.

Allocation

Advantages

29. The major advantage of allocating the effects of basket transactions is that cohesiveness would be achieved. At their respective July 2006 Board meetings, the Boards agreed that the cohesiveness principle should be the governing principle in developing the working format. A strict application of the cohesiveness principle would require that the effects currently presented in one line in the change statements that relate to assets and liabilities classified in more than one category in the working format be allocated to those categories.

30. Another advantage, in the staff's view, is that allocation is likely to reduce structuring opportunities (compared to a no-allocation approach). Consider an example where an entity acquires operating assets and investing assets in exchange for cash. If these assets were acquired in two transactions (that is, an acquisition of operating assets and an acquisition of investing assets), operating cash flows would be presented for the acquisition of operating assets and investing cash flows would be presented for the acquisition of investing assets. If these assets were acquired in a single transaction and the cash flows were required to be allocated, cash flows would be allocated to both the operating and investing categories. However, if these assets were acquired in a single transaction and the cash flows were not required to be allocated, the cash flow, in its entirety, would be classified in the operating or investing (or possibly a third) category.

Disadvantages

31. Some may hold the view that allocation would result in "artificial" results (for example, a single cash flow from a single transaction would appear in multiple line items in the statement of cash flows) and thus allocation would not result in

information that is representationally faithful. However, the staff notes that information may not be representationally faithful if there is room for structuring opportunities, which could be the case if the effects are not required to be allocated.

32. Another disadvantage is that allocation is likely to give rise to incremental costs (particularly for preparers) because currently, allocation is not required. The staff notes that these perceived costs need to be compared with the perceived benefits from providing information based on allocation.

Allocation Methods

33. A requirement to allocate the effects of basket transactions is likely to raise cost concerns (particularly from the preparer community). However, allocation may be needed in only limited cases because not all transactions that involve multiple assets (or a combination of assets and liabilities) meet the definition of basket transactions. For example, if an entity classifies all of the assets and liabilities involved in a transaction in a single category (say, the operating category), that is not a basket transaction and thus would not require allocation of the effects to multiple categories.

34. The staff has been working on developing an allocation method for the effects of basket transactions; however, the staff will need more time to develop an allocation method that is ready for Board discussion. For the purposes of issuing the initial discussion document, the staff recommends that the document ask whether constituents agree that the effects of basket transactions should be allocated and if so how that allocation should be done. In other words, the initial discussion document would not include the Boards' view as to how to allocate the effects of basket transactions, only its view on whether allocation is preferred over non-allocation.

No Allocation

Advantages

35. One of the advantages of not allocating the effects of basket transactions is that the effect from a single transaction is presented as a single line item in the financial statements. As discussed in paragraph 31, some may hold the view that presenting the effects of a single transaction in multiple line items results in "artificial" presentation.

36. Another advantage of not allocating the effects of basket transactions is that it would be less costly for preparers than an allocation approach.

Disadvantages

37. The major disadvantage of not allocating the effects of basket transactions is that cohesiveness would not be achieved. That is, the connection between items in the statement of financial position and items in the change statements would be obscured.

38. The staff notes that a decision to not require allocation of the effects of basket transactions is likely to raise the question of whether cohesiveness should continue to be the governing principle. Under the cohesiveness principle, the classification in the statement of financial position dictates the classification in the statement of comprehensive income and cash flows. In other words, classification primacy is given to the statement of financial position.

Application of the Cohesiveness Principle

39. If the cohesiveness principle raises application issues, an alternative might be to modify that principle by giving classification primacy to the change statements (assuming that the statement of comprehensive income and the statement of cash flows are aligned, they would be treated with equal primacy) rather than the statement of financial position. Under this alternative, an entity would classify the line items in the change statements into the various categories (operating, investing, financing, and the like). This alternative would have the following consequences, which may be appealing to some:

    a. Changes in a specific asset or liability would not be required to be classified in a single category. For example, changes in long-term liabilities (such as pensions or asset retirement obligations) related to the time value of money may be classified in the financing category and other changes may be classified in the operating category.

    b. Cash flows related to the settlement of dividends payable may be classified in the equity section, regardless of whether the dividends payable is classified as a liability or equity. (The presentation of dividends payable is discussed in Issue 1 of this memorandum.)

40. Moreover, this alternative is consistent with how entities currently classify items in the statement of cash flows (that is, for each line item an entity determines whether

to classify it in the operating, investing, or financing category). However, the cohesiveness principle is more in line with the "asset and liabilities" view in income recognition.

41. Some may question the usefulness of the information provided under the cohesiveness principle when that principle cannot be applied perfectly. It can be argued that any exception to the cohesiveness principle would distort subtotals and, therefore, the cohesiveness principle would not provide the information with the usefulness that is intended. As discussed in Issue 2a of this memorandum, the staff is of the view that FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures should not be allocated and thus it is unlikely that perfect cohesiveness could be achieved in a cost-beneficial manner.

Presentation under No Allocation

42. If the Boards are of the view that the effects of basket transactions should not be allocated, the question that follows is how that unallocated amount should be presented in the financial statements. The staff considered the following alternatives:

Alternative 1:	Classify the effects in the operating category in the business section.
Alternative 2:	Classify the effects in the category that reflects the activity that is likely to be the predominant source of those effects.
Alternative 3:	Classify the effects in a new Basket Transactions section.

43. Alternative 1 is analogous to the IASB's preference to present FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures in the operating category (Alternative 2-A in Issue 2a). It also can be viewed as a practical expedient because it is likely that, even when the effects are allocated to or classified in various categories, a large portion would be presented in the operating category.

44. Alternative 2 is consistent with the current classification of items in the statement of cash flows. Paragraph 24 of FASB Statement No. 95, *Statement of Cash Flows,* 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.

The staff notes that Alternative 2 is consistent with the alternative view of the cohesiveness principle described in paragraph 39, that is, an approach that would give classification primacy to the change statements rather than the statement of financial position.

45. Alternative 3 would view basket transactions as an exception to the cohesiveness principle by introducing a new section only on the statement of comprehensive income. Consistent with the staff's recommendation on presentation of FCTAs related to consolidated subsidiaries and proportionately consolidated joint ventures (in Issue 2a), these exceptions would be presented in a prominent manner and isolated from other categories.

Staff Analysis and Recommendation

46. Application of the cohesiveness principle should enable users to understand the connection between the statement of financial position and the change statements. The staff is of the view that introducing this principle into the presentation of financial statements will result in a significant improvement in financial reporting.

47. At the same time, it is likely to be difficult to achieve perfect cohesiveness due to cost benefit considerations related to the allocation of FCTAs. The question is whether one exception to the cohesiveness principle should lead to the conclusion that the cohesiveness principle should be abandoned and whether classification primacy should be given to the changes statements rather than the statement of financial position.

48. The staff is of the view that, while it may not be possible to apply it perfectly, the cohesiveness principle should be applied to the extent possible. Acknowledging that perfect cohesiveness may not be achieved, the exceptions should be kept to a minimum and the exceptions should be presented in a prominent manner. Currently, the only exception other than the effects of basket transactions that the staff is considering relates to the classification of FCTAs for consolidated subsidiaries and proportionately consolidated joint ventures (as discussed in Issue 2a). The staff is of the view that users of financial statements would still find the cohesiveness principle useful with those exceptions.

49. The staff is of the view that even with an exception or two, application of the cohesiveness principle would still be an effective way to communicate the connection between the statement of financial position and the change statements. If classification primacy is given to the change statements, the connection between the statement of financial position and the change statements will be obscured.

50. For those reasons, **the staff recommends that the effects of basket transactions be allocated to the multiple categories that the related assets and liabilities are classified in.** Moreover, the staff recommends that the forthcoming initial discussion document ask whether constituents agree with allocating the effects of basket transactions and, if so, how that allocation should be done

51. If the Boards prefer not to allocate the effects of basket transactions, the staff recommends Alternative 2 (that is, the effects would be classified in the category that reflects the activity that is likely to be the predominant source of those effects).

QUESTION FOR THE BOARDS

Q4. Should the effects of basket transactions be allocated to the multiple categories the related assets and liabilities are classified in?

- **a. If so, should the Boards develop an allocation method prior to the issuance of the initial discussion document?**
- **b. If not, how should the effects of basket transactions be presented in the financial statements?**