Project	**Financial statement presentation**
Topic	**Application of the cohesiveness principle**

Introduction

1. The purpose of this paper is for the IASB and the FASB (collectively, boards) to discuss how the cohesiveness principle should be applied to the statement of financial position (SFP), the statement of comprehensive income (SCI) and the statement of cash flows (SCF).

2. This paper addresses the following issues:

   (a) Issue 1: Whether all of the financial statements should be cohesive or just the SCI and SCF (paragraphs 7—21).

   (b) Issue 2: Whether the SFP should determine classification of items on the SCI and the SCF (paragraphs 22—26).

   (c) Issue 3: Application of the cohesiveness principle to items that have both operating and financing components (paragraphs 27—59).

Discussion paper proposals for cohesiveness

3. The discussion paper states that an entity should present information in its financial statements in a manner that portrays a cohesive financial picture of its activities (referred to as the **cohesiveness objective**). A *cohesive financial picture* means that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible. Financial statements that are consistent with the cohesiveness

This paper has been prepared by the technical staff of the FASB and the IASB for discussion at a public meeting of the FASB or the IASB.

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objective display data in a way that clearly associates related information across the statements so that the information is understandable.

4. To present a cohesive set of financial statements, an entity first classifies its assets and liabilities into sections and categories in the SFP and then similarly classifies any changes in those assets and liabilities in the SCI and the SCF. To the extent practical, an entity should disaggregate, label and total individual items similarly in each financial statement. Doing so should present a cohesive relationship at the line item level among individual assets, liabilities, income, expense and cash flow items.

Developments subsequent to publication of the discussion paper

5. The majority of respondents to the discussion paper agree that presenting financial information in a manner that better articulates the linkage of that information across the financial statements is a worthy goal. However, many respondents state that the cohesiveness objective should be applied in a pragmatic way, with many specifying that the cohesiveness objective should **not** be applied at the line item level.

6. At the July 2009 Joint meeting, the boards affirmed that cohesiveness should be a core presentation principle rather than an objective of financial statement presentation (IASB agenda paper 17E/FASB memorandum 63E). The boards also tentatively decided that the exposure draft would **not** require cohesiveness to be applied at the line item level.

Issue 1: Should all three statements be cohesive or just the SCI and SCF?

Constituent feedback

7. Analyst participants in the field test took the position that cohesiveness enhances the usefulness of the recast SCI and the SCF—that is, the disaggregation of information in those two statements was similar enough so that the cohesiveness principle could be applied at the line item level. However, the analyst participants rank cohesiveness fifth out of six in terms of overall usefulness in the proposed presentation model.

8. Some comment letter respondents note that each primary financial statement has a unique purpose. How information is most effectively displayed in each financial statement should be a by-product of fulfilling that statement's unique purpose. For those respondents, the unique purpose of each statement (and the presentation requirements necessary to fulfil that purpose) should override the application of the cohesiveness principle. Some of those respondents went a step further and suggested that the cohesiveness principle should be applied only to the SCI and the SCF. Their view is that the purpose of the SFP is sufficiently different from the SCI and the SCF to warrant exclusion from application of the cohesiveness principle.

What if only the SCI and SCF are cohesive?

9. Specifying that only the SCI and SCF must be cohesive means that items would be classified on those financial statements without reference to the SFP. That decision requires the modification of the section and category definitions agreed to at the October 2009 Joint meeting in order to eliminate references to how management 'uses its assets and liabilities.' The staff think that change would be fairly straightforward and would not necessarily change the items that would be included in the operating, investing or debt categories on either the SCI or the SCF. However, if the boards decide to proceed with applying cohesiveness to the SCI and the SCF only, we suggest relabeling the debt category to 'financing costs' in the SCI.

10. Aligning only the SCI and the SCF creates the following challenges:

    (a) management's classification decisions might be influenced by the effect an item of income, expense, gain or loss has on the operating income subtotal;

    (b) neither the SCI nor the SCF can be the sole basis for classification; and

    (c) the indirect reconciliation of <u>operating</u> income to cash flows from operating activities would not be possible.

11. If application of the cohesiveness principle is limited to the SCI and SCF, the staff think that presentation on the SCI would determine classification on the SCF. The staff assert that basing classification decisions on whether a particular

item of income, expense, gain or loss relates to business activities (ie either operating activities or investing activities) or financing activities is more subjective than basing classification decisions on how an asset or liability that gives rise to those effects is actually used. Consequently, management will have more discretion to use classification as a mechanism to present favourable operating results.

12. Additionally, using the SCI to determine classification on the SCF is not always possible because an entity may have cash flows that result from changes in SFP accounts—for example, the purchase of a building and the repayment of debt. Consequently, we would still need to develop classification criteria for cash flows that do not relate to an item of income, expense, gain or loss on the SCI. The staff think the criteria would default to how the asset or liability related to the cash flow would have been classified if the classification scheme was applied to the SFP.

13. In October, the boards tentatively agreed that the SCF would be presented using the direct method with an indirect reconciliation of *operating* income to operating cash flows. The indirect reconciliation starts with operating income from the SCI—that number is adjusted for non-cash revenue and expense items in operating income, changes in operating asset and operating liability accounts, and non-income producing activities that affect operating assets and liabilities (eg purchase of an operating asset). However, if the SFP is not categorised in the same way as the SCF, a user of financial statements would not be able to determine how the changes presented in the operating category of the SCF relate to changes in assets and liabilities on the SFP.

14. The indirect reconciliation is possible with a non-categorised SFP only if it reconciles *net* income rather than operating income. However, reconciling net income does not give a user of financial statements indirect information about operating cash flows that is necessary to understand the direct operating cash flows of an entity. Reverting back to an indirect reconciliation based on net income reduces the decision-useful information that would have been derived from an indirect reconciliation of operating income to operating cash flows.

Staff analysis

15. The boards agreed in April 2004 (and confirmed at multiple subsequent meetings) that the scope of the financial statement presentation project should extend beyond the SCI to include all of the required financial statements. Implicit in that scope decision is the commitment to consider the presentation of financial information in the *individual* financial statements as well as in the financial statements taken as a *whole*.

16. As a board member reminded the staff at the October 2009 Joint meeting, the financial statements portray the results of transactions entered into, not the transactions themselves. However, while users of financial statements often understand what an entity sells, where the entity sells it and who the entity sells it to, what often is missing is how all of the pieces fit together.

17. The staff understand that the three primary statements (ie the SFP, SCI and SCF) are not specifically designed to work together. The proposed presentation model attempts to reveal how all of the financial pieces of an entity fit together to tell a unified story by:

    (a) defining sections and categories that produce relevant and decision-useful segregations of disaggregated information in each of the financial statements; and

    (b) linking each statement through the alignment of categories and sections as well as line item descriptions.

18. The discussion paper makes an assumption that there are relationships between all components of the three primary statements and those relationships can be made transparent on a line-by-line basis. In theory, that concept makes sense. However, in practice, the shared nature of many assets and liabilities makes it impracticable to expect a consolidated SFP to reveal (at the line item level) the precise correlation between each financial statement—that is, how much of a change in an element on the SFP generates how much of an effect (either an activity or a flow) in the SCI and SCF.

19. The staff think that, if the boards are committed to the cohesiveness principle, the SFP should include the same sections and categories as the SCI and SCF. (Issue 1 in IASB agenda paper 8B/FASB memorandum 72B addresses a similar

topic). At their respective September 2009 meetings, both boards voted to retain the discussion paper proposal that an entity present its business activities separate from its financing activities (IASB agenda paper 14A, FASB memorandum 67A). The staff think that if the boards want users of financial statements to be able to distinguish an entity's business activities from its financing activities, they should be able to determine the assets and liabilities that give rise to those respective activities. If the SFP includes the same sections and categories as the SCI and the SCF, the relationship between assets and liabilities that work together to generate items of income, expense, gain or loss (and cash flows) will be clear and the financial statements will be complementary.

20. The staff think that there are ways to address the presentation challenges posed by assets and liabilities that generate both operating and financial effects in the SCI and the SCF without giving up totally on the goal of aligning the SFP, SCI and SCF at the category level. That is, we can identify the items for which the boards might want to make exceptions to the cohesiveness principle and address those items individually (see Issue 3).

Staff recommendation

21. The staff recommend that the exposure draft require an entity to apply the cohesiveness principle at the category level in the SFP, SCI and the SCF. The staff also recommend that the boards provide explicit guidance for classifying select liabilities that generate both operating and financial effects in the SCI and the SCF (see Issue 3).

Questions for the boards
Q1. The staff recommend that the exposure draft (a) state that an entity should apply the cohesiveness principle at the category level to the SFP, SCI and SCF and (b) provide explicit guidance for classifying select liabilities that generate both operating and financial effects in the SCI and the SCF. **Do the boards agree with that recommendation?**

Issue 2: Should the SFP determine classification on the SCI and SCF?

22. If the boards agree with the staff recommendation in Issue 1, we also need to address whether the SFP should determine classification on the SCI and the SCF. A number of respondents to the discussion paper question whether application of the cohesiveness principle should start with the SFP. Some respondents suggest that classification should be based on the SCI because management evaluates and manages an entity by reference to operating income or operating cash flows, not assets and liabilities.

23. The staff understand the concerns raised by constituents. However, we do **not** recommend moving away from a classification approach centred on the SFP. We think the message some of our constituents are sending us is that they do not define performance in a way that correlates with how assets and liabilities are organised (ie grouped into sections and categories) on the SFP.

24. The staff has spent a significant amount of time thinking about the feedback received on the proposed presentation model and how best to modify the model to be responsive to that feedback while preserving the spirit of the boards' original intent for the financial statement presentation project. While most respondents agree with the *concept* of cohesiveness, the *application* of that concept—and the resulting effect of that application on the presentation of disaggregated information in each of the financial statements—has caused respondents (and some board members) significant concern (see Issue 3).

25. The SFP is the cornerstone of not only the financial statement presentation project, but both boards' conceptual frameworks. Using something other than the SFP as the starting point for classification negates the SFP-based model of financial reporting embedded in each board's conceptual framework. The basis for that argument is foundational: assets, liabilities and equity are fundamental and logically prior to the concept of income and expense—that is, changes in one normally give rise to the other.

26. As a result, the staff recommend the exposure draft retain the requirement that the classification of assets and liabilities on the SFP determine the classification of items on the SCI and the SCF.

Questions for the boards
Q2. The staff recommend that the boards retain in the exposure draft the requirement that the SFP determine the classification of items on the SCI and the SCF. **Do the boards agree with that recommendation?**

Issue 3: Application of cohesiveness principle to items that may have both operating and financial components

27. Some comment letter respondents are concerned that application of the cohesiveness principle complicates the presentation of transactions where the primary function (ie use) is part of a business activity but the effects of the business activity do not have the same nature. Those respondents think decision-useful information is **not** provided when, to meet the requirements of the cohesiveness principle, all components of a business activity (ie the debits and credits) are presented together in the same section (or category) across all three financial statements.

28. The staff think that one of the reasons constituents suggest applying cohesiveness to only the SCI and the SCF (Issue 1) and/or using a financial statement other than the SFP to determine classification for all three financial statements (Issue 2) is that they disagree with how particular liabilities are presented in the discussion paper. Specifically, some constituents (and board members) think the financing section should include liabilities that are so long-term in nature that the funding of those liabilities becomes a financing decision for an entity (ie the liability is 'debt-like' in nature).

Pensions

29. The staff understand that some users of financial statements consider a net pension liability to be a financing item. Further, all of the components of the periodic pension cost (with the exception of the service cost) are considered by

those financial statement users to be financial in nature.[1] Some also view plan contributions (cash flows) as an operating item (payment of deferred compensation) but others view plan contributions as financing items (settlement of the net liability). The staff note that even if the pension asset and pension obligation are presented separately on the SFP (that is, on a gross rather than a net basis), this issue would not be resolved.

30. The challenge of applying cohesiveness to a net pension liability (or asset) arises for two reasons. First, the service cost relates to an asset—the employee service—that is not recognised on the SFP because it is consumed immediately. If the employee service was momentarily recognised on the SFP, it would be classified as an operating asset. The staff think that viewing pensions as the following two transactions could resolve that presentation/classification dilemma:

    (a) an operating asset for employee service is consumed immediately and gives rise to an operating cost (service cost).

    (b) a liability arises from the deferred funding of those services, the liability is a form of financing and the related periodic pension costs are financing costs.

31. Second, the net pension liability described in 30(b) does not meet the financial statement presentation definition of an item to be included in the financing section of the financial statements. Further, application of the cohesiveness principle requires that an asset or liability that gives rise to items of income, expense, gain or loss be classified in the same category. In the context of the financial statement presentation project, the net pension liability must be shown in the financing section of the SFP to align the liability with its related periodic pension costs that are classified as financing costs.

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[1] A reminder about terminology: just because an item is financial does not mean it meets the definition to be classified in the financ<u>ing</u> section of the financial statements. That is, financial and financ<u>ing</u> cannot be used interchangeably.

Asset retirement obligations

32. For many types of long-lived tangible assets, ownership involves not only a right to use the asset but also an obligation that must be fulfilled at the end of the asset's service life. For example, an entity that owns and operates a landfill will have legal obligations, such as covering the land with topsoil and planting vegetation when sections of the landfill become full, and legal obligations after the end of the asset's service life, such as monitoring the ground water and air quality. Those obligations are referred to as asset retirement obligations (AROs).

33. As soon as an entity is able to make a reasonable estimate of the costs it will incur as a result of those AROs, the entity reports the fair value of the estimated costs, with the fair value determined using a discounted cash flow approach. The face value of the AROs is reported as a liability, with the balancing offset being an increase in the carrying value of the asset. Afterward, the amount added to the asset's carrying value is accreted systematically into profit or loss. The amount reported as a liability increases each year with the passage of time because it is based on the discounted present value of future cash flows. The increase in the amount of the liability is recognised as an operating expense.

34. For financial analysis, and particularly credit analysis, some analysts make adjustments to the SFP to reflect the debt-like nature of AROs. Specifically, many credit analysts consider the AROs as debt and treat the related financial statement items in a manner consistent with debt. To treat AROs as debt, a credit analyst typically increases the amount of the entity's debt by the amount of the AROs, adjusted for such offsetting items as dedicated retirement fund assets and any tax savings that the entity is likely to utilise (anticipated tax savings reduce any deferred tax asset). Consistent with treating the AROs as debt, an analyst would reclassify the accretion amount (which is similar to an interest accrual) to interest expense on the SCI and all cash flows associated with the ARO would be reclassified to the financing section of the SCF.

Possible alternatives

35. Currently, neither a net pension liability nor an ARO meets the definition of an item to be included in the debt category. As a reminder, the boards tentatively decided at the October 2009 Joint meeting to define the debt category to include liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising capital. If the boards express a preference for either Alternative 2 or Alternative 3 described below, the definition of both the debt category and the financing section will require substantial modification.

36. The staff propose the following alternatives for applying the cohesiveness principle to a net pension liability (or asset) and an ARO (along with its associated trust fund, if any):

Alternative 1: A net pension liability (or asset) and an ARO (along with its associated trust fund, if any) are presented in the operating category in all three financial statements (as proposed in the discussion paper).

SFP	SCI	SCF
BUSINESS	***BUSINESS***	***BUSINESS***
Operating	**Operating**	**Operating**
Net pension liab (asset)	Service cost Component 1 Component 2 Component 3	Cash flows for pensions
ARO	Accretion expense	Cash flows for AROs
Trust fund for ARO		
FINANCING	***FINANCING***	***FINANCING***

Alternative 2: A net pension liability (or asset) is presented in the debt category of the SFP and the associated interest expense is presented in the debt category of the SCI. An ARO (along with its associated trust fund, if any) is presented in the debt category of the SFP and the associated accretion amount is presented in the debt category of the SCI. All cash flows related to the net pension liability (or asset) and the ARO (along with its associated trust fund, if any) are presented in the debt category of the SCF.

SFP	SCI	SCF
BUSINESS	***BUSINESS***	***BUSINESS***
Operating	**Operating**	**Operating**
	Service cost	
FINANCING	***FINANCING***	***FINANCING***
Debt	**Debt**	**Debt**
Net pension liab (asset)	Component 1 Component 2 Component 3	Cash flows for pensions
ARO	Accretion expense	Cash flows for AROs
Trust fund for ARO		

Alternative 3: The same scenario as described in Alternative 2 <u>except</u> that cash flows related to the net pension liability (or asset) are presented in the *operating* category of the SCF.

SFP	SCI	SCF
BUSINESS	***BUSINESS***	***BUSINESS***
Operating	**Operating**	**Operating**
	Service cost	Cash flows for pensions
FINANCING	***FINANCING***	***FINANCING***
Debt	**Debt**	**Debt**
Net pension liab (asset)	Component 1 Component 2 Component 3	
ARO	Accretion expense	Cash flows for AROs
Trust fund for ARO		

Alternative 4: An additional category is created in the business section labelled 'financing arising from operating activities.' That category would be reflected on the SFP and the SCI but **not** the SCF; the category would be defined such that a net pension liability (or asset), AROs, vendor financing arrangements and lease obligations would be presented in that category.[2] All related effects from those items would be classified in the 'financing arising from operating activities' category in the SCI. However, related cash flows would be presented in the operating category on the SCF.

[2] The Leasing team has elected to apply the boards' tentative decisions on FSP to their in-process work on lease accounting in a paper scheduled for presentation in January. The Leasing team's recommendations for the presentation of lease components may be influenced by the tentative decisions reached in December on both cohesiveness and the scope exception proposed in the paper *Scope—non-core and short-term leases* (IASB agenda paper 4F/FASB memorandum 58).

SFP	SCI	SCF
BUSINESS	***BUSINESS***	***BUSINESS***
Operating	**Operating**	**Operating**
		Cash flows for pensions
		Cash flows for AROs
Financing arising from operating activities	**Financing arising from operating activities**	n/a
Net pension liab (asset)	Service cost Component 1 Component 2 Component 3	
ARO	Accretion expense	
Trust fund for ARO		
FINANCING	***FINANCING***	***FINANCING***

Alternative 1—Present all components in the operating category

37. In Alternative 1, an entity would classify its assets and liabilities using the definitions of the sections and categories the boards tentatively agreed to at the October 2009 Joint meeting (see Appendix A for the working definitions). A net pension liability (or asset) and an ARO (and its associated trust fund, if any) would be classified in the operating category for the following reasons:

    (a) neither a net pension liability nor an ARO meet the definition of an item to be included in the debt category (ie neither are borrowing arrangements for the purpose of raising capital);

    (b) the primary use of a net pension liability (or asset) is deferred compensation (ie it is foremost a transaction with employees);

    (c) the most useful presentation of an ARO is in the same category as the long-lived asset that gave rise to that liability (ie the right to use the asset is linked to the obligation to retire the asset at the end of its service life; the linked presentation of those items places each in context and provides decision-useful information).

38. Alternative 1 is based on the position that both a net pension liability (or asset) and an ARO are closely related to the revenue-generating activities of an entity. As a result, Alternative 1 is consistent with the boards' tentative decisions to a) require separation of business activities from financing activities and b) present revenue-generating activities in the operating category.

39. Those that support Alternative 1 state that the debt-like nature of a net pension liability (or asset) and an ARO does not mean those items should be displayed in the financing section of the financial statements. Those that support Alternative 1 also think users of financial statements view the financing section as financing from external resources—which a net pension liability and an ARO are not.

40. Further, proponents of Alternative 1 note that the amounts involved in a net pension liability (or asset) and an ARO are sufficiently large to stand out on the SFP. A financial statement user that considers a net pension liability and an ARO to be debt can make the adjustment as part of their analysis of an entity. Further, an analyst calculating debt coverage ratios is likely to make two sets of calculations—the first set excluding a net pension liability and an ARO and a second set including those items—because reality lies somewhere in between those two sets of calculations.

Alternative 2—Present all components in the financing section as part of the debt category

41. Alternative 2 requires an entity to present a net pension liability (or asset) in the debt category of the SFP and the associated interest expense in the debt category of the SCI. An ARO (along with its associated trust fund, if any) is presented in the debt category of the SFP and the associated accretion amount is presented in the debt category of the SCI. All cash flows related to the net pension liability (or asset) and the ARO are presented in the debt category of the SCF.

42. In order for Alternative 2 to be operational, the exposure draft would need to state that the service cost must be disaggregated from all other periodic pension costs and shown in the operating category of the SCI. The basis for that conclusion is that the service cost relates to an asset that is not recognised in the SFP—that is, the service cost is **not** related to the net pension liability (or asset).

43. The staff note that agreeing to separately present the service cost component of a periodic pension cost on the SCI (rather than in the notes) opens the boards up to addressing (in the context of the financial statement presentation project) how other components of periodic pension cost should be classified in the SCI—specifically, the return on plan assets. An argument can be made that the return

on plan assets should be presented in the investing category on the SCI. Cohesiveness would require that the assets that give rise to the return be presented in the same category on the SFP. Consequently, a pension could <u>only</u> be displayed gross on the SFP, not net.

44. Alternative 2 also requires a net pension asset (ie a pension that is in a surplus position) to also be shown in the debt category as a financing asset. Similarly, a trust fund associated with an ARO would also be shown in the debt category as a financing asset. That is particularly important because some entities, such as utilities, often have trust funds in excess of their ARO.

45. Alternative 2 presents interest expense (and other components of periodic pension cost) in the financing section of the SCI, a result that is consistent with the feedback we received from many respondents to the discussion paper. Proponents of Alternative 2 think that cohesiveness is achieved across all three statements when service cost is in the operating category (consistent with the immediately consumed employee service asset) and the other components of periodic pension cost are cohesive with the associated net pension liability (or asset).

46. Alternative 2 requires the presentation of all cash flows associated with the net pension liability (or asset) and the ARO (along with its associated trust fund, if any) to be presented in the debt category of the SCF. That is consistent with how traditional debt payments are classified. However, it should be noted that some users of financial statements view the contributions to a pension plan as funding both an operating activity (service cost) and a financing activity (interest, asset returns and actuarial gains/losses). The operating characteristic of plan contributions generally is thought to outweigh the financing characteristic.

47. Other issues the boards should consider related to Alternative 2 are described below:

    (a) Putting the net pension liability (or asset) in the debt category of the financing section reopens the door to classifying other liabilities in the financing section (ie vendor financing arrangements).

(b) If the boards favour Alternative 2, the working definition of the financing section and the debt category will need to be revisited at a subsequent meeting. Classifying a net pension liability (or asset) and an ARO in the debt category changes the substance of both that category and the financing section by co-mingling debt-like liabilities with liabilities that are considered to be 'true' debt.

Alternative 3—Present all components in the financing section as part of the debt category except the cash contributions to a pension plan

48. Alternative 3 is the same as Alternative 2 except that plan contributions are presented in the operating category, not the debt category of the SCF. Those that support Alternative 3 consider contributions to a pension plan to have a use that reflects (primarily) deferred compensation. They note that most other cash flows related to compensation are classified in the operating category. They also note that Alternative 3 results in classification of contributions for defined benefit and defined contribution plans in the same category whereas Alternative 2 would have a different classification result on the SCF (cash flows for a defined benefit plan would be classified in the debt category; cash flows for a defined contribution plan would be classified in the operating category).

Alternative 4—New category in the business section

49. Alternative 4 recognises that some liabilities have uses that straddle the line between operating and financing. Alternative 4 creates an additional category in the business section labelled 'financing arising from operating activities.' That category would be reflected on the SFP and the SCI but **not** the SCF; the category would be defined such that a net pension liability (or asset), AROs, vendor financing arrangements and lease obligations (possibly) would be presented in that category. All related effects from those items would be classified in the 'financing arising from operating activities' category in the SCI. However, related cash flows would be presented in the operating category on the SCF.

50. Similar to Alternative 1, Alternative 4 presents all aspects of a net pension liability (or asset) and an ARO in the business section. Analysts that view items

in the new category as debt-like could easily make adjustments to their leverage ratios because those items would be segregated in a separate category of the SFP (and disaggregated).

51. In Alternative 4 only the SFP and the SCI would be cohesive at the category level. The business section of the SCF would be cohesive with the business section of the SFP and the SCI—but not at the category level.

Staff analysis

52. The staff note that, while we spent significant time considering financial statement users' views in the light of each alternative, when it came to making the staff recommendation, we decided to set those views aside. Simply put, for every analyst that told us a net pension liability or ARO is correctly presented in the debt category, there was another analyst that presented a counter argument for correctly presenting those liabilities and their related effects in the operating category of each financial statement. For many, classification of debt-like items in the financing section depends on a) an individual's perspective as an analyst and b) what the analyst is ultimately trying to accomplish.

53. The staff also note that Alternatives 1 and 4 are not consistent with the IASB's decisions on the presentation of the components of periodic pension cost in the context of its pension project. In that project the IASB has decided to present service cost as an employment cost, interest cost as a financing cost and remeasurements in the other comprehensive income section of a single SCI. Alternatives 2 and 3 are consistent with that decision. Should the boards decide on Alternatives 1 or 4, the IASB will need to consider the implications for the proposals in the forthcoming pensions exposure draft.

54. The staff dismiss Alternative 3 and Alternative 4 for the following reasons:

    (a) **Alternative 3.** If a net pension liability is classified in the debt category on the SFP, the payments on that debt-like liability should be classified in the same category on the SCF as traditional debt (as described in Alternative 2).

    (b) **Alternative 4**. Creating another category on the SFP and the SCI further complicates both financial statements. While the 'financing

arising from operating activities' category might be helpful on the SFP, the staff is not convinced that category provides decision-useful information on the SCI. That is, financial statement users are likely to prefer costs associated with the 'financing arising from operating activities' category and the debt category to be grouped into one category on the SCI labelled 'financing costs.' Consequently, the staff do not think creating an additional category on the SFP furthers the application of the cohesiveness principle.

55. Staff views are mixed for Alternative 1 and Alternative 2. Proponents of **Alternative 1** might agree that:

    (a) all interest expense should not be required to be shown in the financing section of the SCI;

    (b) just because an item is financial in nature does not automatically qualify that item to be presented in the financing section of either the SFP, SCI or SCF;

    (c) in the case of an ARO, accretion expense is not the same as interest expense;

    (d) a liability that is debt-like is not interchangeable with traditional debt; and

    (e) as long as information is sufficiently disaggregated, a user of financial statements can exercise judgment and rearrange data to fit his or her needs.

56. Proponents of **Alternative 2** might agree that:

    (a) long-term liabilities provide a financing function for an entity;

    (b) all interest expense should be shown in the financing section of the SCI (and the liability that gives rise to that interest expense must also be shown in the financing section of the SFP); and

    (c) the level of subjectivity required in the measurement of a net pension liability and an ARO is such that the remeasurement of either obligation should not be included as part of operating profit or loss.

Staff recommendation

57. On balance, the staff support **Alternative 1**—that is, a net pension liability (or asset) and an ARO should be classified in the operating category on the SFP. Application of the cohesiveness principle requires that the related activities and flows generated by changes in those liabilities should be classified in the operating category on the SCI and SCF.

58. We think that Alternative 1 is most consistent with the idea that the financing section should include only those items that are interchangeable with other sources of financing (that point is expressed in the discussion paper). Further, Alternative 1 is consistent with the boards' recent tentative decisions on the definitions of the financing section and the debt category.

59. The staff recommend that the exposure draft retain the discussion paper proposal to present a net pension liability (or asset) and an ARO in the operating category of the SFP. Application of the cohesiveness principle requires the activities and flows that result from changes in those liabilities to be presented in the operating category of the SCI and the SCF.

Questions for the boards
Q3. The staff recommend that the exposure draft retain the discussion paper proposal to present a net pension liability (or asset) and an ARO in the operating category of the SFP. Application of the cohesiveness principle requires the activities and flows that result from changes in those liabilities to be presented in the operating category of the SCI and the SCF. **Do the boards agree with that recommendation?**

Appendix A: Working definitions

A1. The following paragraphs reflect the boards' tentative decisions made at the October 2009 joint meeting on the section and category definitions.

The business section

A2. The **business** section shall include items that are part of a reporting entity's ongoing, value-creating activities. The business section shall include the effects of transactions related to the production of goods or provision of services that are associated with the revenue-generating activities of the entity. The business section shall report the effects of transactions with customers, suppliers and employees (in their capacities as such) because such transactions usually relate directly to a reporting entity's value-creating activities.

Operating

A3. Assets and liabilities used in business activities shall be presented together in a separate category titled **operating** if the business activity:

(a) is part of a reporting entity's day-to-day business activities; and

(b) the business activity generates revenue through a process that requires the interrelated use of the resources of the reporting entity. That process also includes the application of employee and management expertise.

A4. Operating liabilities arising from business activities are likely to be replaced by similar obligations within a reporting entity's operating cycle.

A5. Any derivative that arises from or is linked to part of a reporting entity's operating business activities shall be presented in the operating category. For example, a derivative held to offset currency or commodity price risk in a reporting entity's business activities would be reported within the operating category, regardless of whether that derivative is an asset or a liability at the reporting date.

Investing

A6. Assets and liabilities used in business activities shall be presented together in a separate category titled **investing** if the business activity generates income not related to sales of products or services and if no significant synergies are created from combining “investing” assets .

A7. Items related directly to assets and liabilities classified in the investing category, such as interest income and dividend income, shall also be classified in that category. A derivative held as part of a reporting entity’s investing activities, regardless of whether it is an asset or a liability at the reporting date, shall also be presented in the investing category.

The financing section

A8. The financing section shall include items that are part of a reporting entity’s activities to obtain (or repay) capital. The financing section provides transparency about a reporting entity’s capital structure and the financing activities the reporting entity engages in.

A9. A reporting entity shall make transparent its capital structure by grouping its financing activities into categories that reveal how related resources and claims are used to provide capital to the reporting entity. That capital structure may consist of two categories of financing activities: debt and equity.

Debt

A10. The debt category shall include liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising capital. That borrowing arrangement is usually transacted on an arm’s-length basis on market terms.

A11. A reporting entity may enter into a borrowing arrangement with its own suppliers or customers as a mutually beneficial arrangement. If such a borrowing arrangement is entered into primarily to facilitate a supplier arrangement for the provision of a specific good used in production or the

provision of a specific service, that borrowing arrangement shall be classified in the operating category.

A12. Items related directly to liabilities classified in the debt category, such as interest payable and fees, shall also be classified in that section. A derivative held as part of an entity's debt financing, regardless of whether it is an asset or a liability at the reporting date, shall also be presented in the debt category.

Equity

A13. A reporting entity should refer to existing accounting standards when classifying items in the equity category.