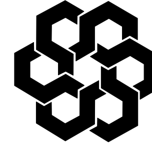

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Project: **IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of Financial Assets**

Subject: **Linked Presentation – Display (Agenda Paper 2E-3)**

PURPOSE

1. Agenda Paper 2E-1 discusses whether the Linked Presentation model (LP) is appropriate.

2. Agenda Paper 2E-2 discusses which transactions should an entity evaluate whether they meet the LP principle (scope of the LP model) and the principle that should be used in determining when transactions, falling within the scope of LP, qualify for LP treatment.

3. This paper discusses -

   - how and where to display a 'transferred asset' and the associated liability (the secured borrowing) i.e. whether on the face of financial statement or in the notes thereto.

- the interaction between LP display and the Board's Discussion Paper on Financial Statement Presentation.

4. The staff recommends that LP should be displayed in the notes to the financial statements.

5. If the Board agrees with the staff recommendation, then Agenda Paper 2E-4 would not be required. Agenda Paper 2E-4 deals with measurement of the linked items and recognition of gains or losses relating to the remeasurement of the linked items.

LINKED PRESENTATION - DISPLAY

6. There are two alternatives that the Board could pursue:

   a. Alternative A - display the related liability deducted from the asset on the face of the financial statement

   b. Alternative B - show the relationship between the asset and the related liability by presenting the liability deducted from the asset in the notes accompanying the statement of financial position

Alternative A

7. This alternative requires LP in the statement of financial position together with disclosures in the notes to the financial statements.

8. Under this alternative, the secured borrowing will be shown as a deduction from the gross amount of the financial assets it 'finances' on the face of the statement of financial position. The notes could provide additional information for users to ascertain the nature of the relationship between the linked items and the impact of the linked items on the risk exposure and/or performance of the entity.

9. This alternative requires guidance on measurement (initial and subsequent) and gain or loss recognition.

10. The obvious measurement alternatives are:

    a. measure both items at amortised or historical cost or measure the asset using the basis adopted prior to the transfer (and the liability using applicable measurement guidance);

    b. measure both items at fair value; or

    c. measure the items using the continuing involvement method.

11. It is obvious that measuring the asset and the liability at amortised or historical cost would yield a meaningless net figure. Although this may signal to users there is a relationship between the asset and liability, users would not be able to quantify the entity's net economic exposure to or net economic interest in the asset.

12. Measuring the asset and liability at fair value provides more relevant information than the historical cost alternative. This alternative provides some indication of the quantum of the transferor's net economic exposure or interest in the transferred asset. However, it is also not without its shortcomings. The fair value approach does not always yield a net figure that represents the transferor's net economic interest in the asset' nor its net economic exposure (see analysis in Agenda Paper 2E-4).

13. For example fair valuing the linked items will not yield an amount equal to the value of a call option (which is the transferor's net economic interest in the asset), if the transaction is a sale with an attached call option. Similarly the net amount provided by LP will not be equal to the value of the put option (which represents the transferor's net economic exposure to the asset).

14. The staff is doubtful if the fair value alternative (alternative (b) above) is worthwhile if the net figure may not represent the transferor's net economic exposure or interest. Hence the staff notes that asking preparers to provide such information may not pass a cost/benefits test.

15. The only alternative that consistently provides useful information is the continuing involvement method. This approach is essentially an attempt to bridge

the information gap between a risks and rewards (whole or nearly whole asset) derecognition model and the net economic exposure created by a transfer.

16. Under this approach the net figure displayed is the transferor's net economic exposure or interest in the transferred asset. This, however, comes at a high cost. This method requires fair value for the asset and 'fudging' of the measurement of the liability so as to yield the net economic exposure or interest (see analysis in Agenda Paper 2E-4).

17. One wonders why preparers should be asked to go through such tortuous (roundabout) computation to show the net economic exposure or interest. If the net economic exposure or interest is the statistic sought, then why not ask for the net economic exposure or interest (the derivative or retained interest) to be displayed instead. Flow Chart 1 on the other hand faithfully represents the net economic exposure (in many cases the fair value of the derivative).

18. The staff notes that this approach is seen by preparers as difficult to understand and there are lots of application issues in IAS 39 in respect of the continuing involvement approach.

19. The staff understands that few preparers, users and auditors understand how this method is supposed to work. A couple of the IFRS guidance published by the Big Four firms emphasise this point clearly –

    "Continuing involvement is a unique model, and the IASB has provided limited guidance on how to apply it. There are challenges in interpreting this model, and it is not always easy to rationalise what it means" (a Big Four Derecognition Publication).

20. Moreover, it is questionable to require fair values (i.e. a remeasurement event) after the entity has concluded (based on the derecognition guidance) that the transaction does not qualify for sale accounting.

Alternative B

21. The second alternative is to adopt a disclosure only approach to LP. Under this alternative, the transferor would provide additional information in the notes to the

financial statements to illustrate when there is a unique relationship between the assets that failed the derecognition test and the associated liabilities.

22. Displaying the asset and liability linked in the notes to the financial statements would provide investors and other users of the financial statements with additional information to enable them to understand the relationship between those assets and liabilities.

23. An advantage of this alternative is that, by requiring LP in the notes to the financial statement, the issues regarding how to measure the linked items and recognition of gain or loss (see Agenda Paper 2E-1 for further discussions on measurement and gain or loss recognition) would be significantly reduced.

24. The staff notes that if this alternative is accepted by the Board, the Board would not have to discuss Agenda Paper 2E-4.

25. This approach is consistent with the flexibility provided under IAS 1, that an entity should disclose either in the statement of financial position (and the statement of financial performance) or in the notes, further classifications of the line items presented, classified in a manner that takes into account the nature of the amounts involved if separate presentation is relevant to an understanding of the entity's financial position or performance (IAS paragraphs 57 – 58, 77 - 78 and 85 -86)

26. Furthermore, the staff notes that if LP is not included in the statement of financial position, the mechanical issues (where to show the linked items if the asset and liability are not within the same category (see analysis of the impact of the Board's DP on financial statement presentation) that arise in applying LP on the face of the statement of financial position would no longer be an issue.

27. If LP were required to be included in the notes to the financial statements rather than in the statement of financial position, the following are some of the information that might be required to be disclosed:

(a) A tabular disclosure of the items that meet the LP principle. The tabular disclosure would provide the carrying amount and classification of the assets and liabilities within the statement of financial position.

(b) Description of the nature of the transactions and the relationship between the asset and liability.

(c) The fair values of the assets, liabilities, and retained net interest, which are shown as linked in the notes to the financial statements. Such disclosure would be broken out by line item in the statement of financial position.

(d) Description of other related contractual relationships between the transferor and the transferee, which have not been included in the LP.

28. To the extent that the above disclosures are captured by the existing and proposed amendments to IFRS 7 and consolidation disclosure requirements, the Board would only need to address how such information is presented (as opposed to mandating disclosure of such information).

Staff Recommendation

29. The staff believes Alternative B is the most efficient and useful means of informing users of the financial statements of the economic relationship between 'transferred assets' and the related liabilities.

30. Due to the obvious problems and flaws with Alternative A, the staff believes that alternative B is the only viable approach and recommends this approach to the Board.

Questions for the Board

31. If the Board agrees with the staff recommendation in paragraph 30, the subsequent paragraphs in this paper may not be required.

32. Does the Board agree with the staff recommendation in paragraph 30? If not, why not?

33. If not, what other principle do you think will be most appropriate, and why?

INTERACTION WITH FINANCIAL STATEMENT PRESENTATION DP

34. The approach adopted by the Board in the Discussion Paper on financial statement presentation is a significant departure from current practice.

35. Under the proposed approach, the statement of financial position would be grouped by major activities (operating, investing and financing), not by assets, liabilities and equity as it is today.

36. The DP requires, in particular, that an entity should:

    (a) present the statement of financial position elements (assets, liabilities and equity) on the basis of functional sections and categories.

    (b) present a cohesive set of financial statements by aligning the line items, their descriptions and the order of presentation of information in the statements of financial position, comprehensive income and cash flows.

37. The proposed approach impacts the LP concept in 3 main ways:

    (a) If, in the absence of an LP concept, the linked items ought to have been shown in different sections of the statement of financial position, because of the linked presentation provision, the entity would have to decide in which of the sections the linked items should be shown.

    (b) to achieve cohesiveness, where items are linked in the statement of financial position, the same approach would have to be applied to the statement of financial performance and the cash flow statement for the effects of the linked items.

    (c) there would be differences between the classification of similar transactions (transfer of financial assets) by entities operating in different sectors of the economy (e.g. between a manufacturing company that transfers financial instruments that it holds and a financial services company that trades in those financial instruments)

(a) Determining where the linked items should be presented

38. Under the proposed approach if, in the absence of an LP concept, the linked items would have been in different sections of the statement of financial position, because of the linked presentation provision, the entity would have to decide in which of the sections the linked items should be shown.

39. For instance a manufacturer that creates value by converting raw materials into goods for sale, the assets and liabilities that this manufacturing entity might classify in the operating category would include accounts receivable.

40. If the entity engages in a transfer of those receivables and the transaction fails the practical ability to transfer test, the transaction would be accounted for as a secured borrowing and may qualify to be presented linked.

41. The related liability that is to be deducted from the account receivable qualifies to be shown under the financing section as it could be argued that it is part of the financing of the entity's business.

42. Hence one of the key difficulties preparers might encounter would be whether to present the linked items in the operating section or the financing section in such circumstances and what criteria would be used for making that determination (and the basis for that criteria).

43. Moreover, in the example above, some might argue that both items should ordinarily be classified under operating section whilst others may argue that the financing belong to the financing section. The staff notes there are persuasive arguments for both treatments.

44. Furthermore, under the proposed DP, classification is based on management intent or judgement. This potentially means entities that engage in identical transactions would classify the linked items in different sections.

45. The above problem is compounded by the guidance in the DP that only financial assets and liabilities can be classified in the financing section. If the LP model is ever extended to non-financial items, classifying both linked items in the financing section would not be allowed.

46. The staff however notes that the DP guidance is not expected to override specific presentation guidance in specific IFRSs (standards). Hence the Board could mandate how the linked items should be presented in the financial statements.

(a) Cohesiveness between the various financial reporting statements

47. There would be a need to present the associated cash flow and gain or loss elements in the respective statements linked and in the same categories, just as in the statement of financial position.

48. The staff therefore propose the following linked presentation approach for the statement of financial performance and the cash flow statement:

    a. The transferor should present together in the statement of financial performance (1) the profit and loss effect of the related liability, (2) the profit and loss effect of the transferred asset and the net effect (i.e. the difference in value between the profit and loss effects of the financial asset and financial liability).

    b. The transferor should present together in the statement of cash flow (1) the cash flow effect of the related liability (2) the cash flow effect of the transferred asset and the net effect (i.e. the difference in value between the cash flow effects of the financial asset and financial liability).

(c) Differences in classifications based on the nature of the transferor's business

49. Paragraph 2.27 of the DP provides that –

    'An entity should classify its assets and liabilities in the business section and in the financing section in a manner that best reflects the way the asset or liability is used within the entity.'

50. The assets and liabilities that generate net cash inflows for financial services entities are likely to be different from those of other business entities because of the underlying differences in how they create value.

51. This is because the source of profitability for a financial services entity is usually the management of financial assets and financial liabilities. In contrast, for other

types of entities, income from financial assets is often not significant and expenses on financial liabilities are generally not directly related to operating activities.

52. An entity that creates value by providing financial services to others might include in its operating category cash, commercial paper, available-for-sale securities, trading portfolio assets and liabilities, deposits, loans and insurance liabilities.

53. In contrast, a manufacturing entity that does not provide financial services might decide to include the following in its financing assets and financing liabilities categories: cash, bank loans, bank overdrafts, bonds and other traded debt, and related accrued interest, plus financial instruments held to hedge those items.

54. A manufacturer might also have a portfolio of bonds held for trading purposes that is not related to its central business purpose. The manufacture might classify that asset in the investing or financing assets category.

Conclusion

55. The staff does not see LP to be problematic within the approach proposed by the Board in the DP. The staff notes that items such as allowance for doubtful debts, accumulated depreciation and allowance for loan losses are presented linked with the related assets in the DP. Hence in principle LP should not pose any problems.

56. However the staff notes that if this approach is pursued, the Board would need to provide more guidance in determining where to show the linked items if the items would have been classified in different categories in the absence of LP.

APPENDIX 1 – Extracts from Financial Statement Presentation Discussion Paper

Paragraph 2.19 of the DP provides that –

> *'An entity should present information about the way it creates value (its business activities) separately from information about the way it funds or finances those business activities (its financing activities).*
>
> *(a) An entity should further separate information about its business activities by presenting information about its operating activities separately from information about its investing activities.'*
>
> *(b) An entity should present information about the financing of its business activities separately depending on the source of that financing. Specifically, information about non-owner sources of finance (and related changes) should be presented separately from owner sources of finance (and related changes).'*

The DP also provides the following guidance in determining the elements that ought to be classified in the various functional sections –

> *'The* ***business section*** *should include assets and liabilities that management views as part of its continuing business activities and changes in those assets and liabilities. Business activities are those conducted with the intention of creating value, such as producing goods or providing services.* ***The business section would normally include assets and liabilities that are related to transactions with customers, suppliers and employees (in their capacities as such) because such transactions usually relate directly to an entity's value-creating activities****.'* (paragraph 2.31) emphasis added

*'The **operating category** within the business section should include assets and liabilities that management views as related to the central purpose(s) for which the entity is in business. An entity uses its operating assets and liabilities in its primary revenue—and expense-generating activities. All changes in operating assets and liabilities should be presented in the operating category in the statement of comprehensive income (unless existing standards require a change to be recognised as an item of other comprehensive income) and the statement of cash flows.'* (paragraph 2.32)

*'The **investing category** within the business section should include business assets and business liabilities, if any, that management views as unrelated to the central purpose for which the entity is in business. An entity may use its investing assets and liabilities to generate a return in the form of interest, dividends or increased market prices but does not use them in its primary revenue- and expense-generating activities. All changes in investing assets and liabilities should be presented in the investing category in the statement of comprehensive income (unless existing standards require a change to be recognised as an item of other comprehensive income) and the statement of cash flows.'* (paragraph 2.33)

*'The **financing section** should include a **financing asset category** and a **financing liability category**. **Financing assets and financing liabilities are financial assets and financial liabilities (as those terms are defined in IFRSs and US GAAP) that management views as part of the financing of the entity's business and other activities. In determining whether a financial asset or financial liability is part of an entity's financing activities, management should consider whether the item is interchangeable with other sources used to fund its business activities**. For example, an entity could acquire equipment using cash, a lease or a bank loan. The financing section would normally include liabilities that originated from an entity's capital-raising activities (for example, a bank loan or bonds) because capital is usually raised to fund value-creating (business) activities…….'* (paragraph 2.34) emphasis added

57. The DP specifically requires preparers, in paragraphs 2.15 and 2.29, –

'To present a cohesive set of financial statements, an entity should align the line items, their descriptions and the order in which information is presented in the statements of financial position, comprehensive income and cash flows.' (paragraph 2.15)

'To present information in a cohesive manner, an entity should present changes in its assets, liabilities and equity items in the same section and category in the statement of comprehensive income and the statement of cash flows that the asset or liability is classified in the statement of financial position. In other words, the classification of assets and liabilities in the statement of financial position

determines the classification of changes in those assets and liabilities in the statements of comprehensive income and cash flows. For example, an entity would classify its revenues, expenses, gains, losses and cash flows related to operating assets and liabilities in the operating category in the statements of comprehensive income and cash flows.' (paragraph 2.29)