Project	**Financial Statement Presentation**
Topic	**Definitions and Management Approach**

Introduction

1. This paper discusses the following preliminary views of the IASB and the FASB [collectively, the boards] in the context of respondents' feedback to the discussion paper *Preliminary Views on Financial Statement Presentation*: the definitions for the financial statement sections and categories and management's approach to classification of items within those sections.

2. The staff is developing alternatives for those topics for presentation to the boards in September 2009. The alternatives under consideration are presented in paragraphs 32—50 of this paper.

Financial statement format as described in the discussion paper

Defining the financial statement sections and categories

3. The discussion paper indicates that financial information should be presented in the financial statements in two broad sections—**business** and **financing—**and that the business section should be further disaggregated into the **operating** and **investing categories**.

4. The boards decided on business and financing as the two main financial statement sections so that a user will be able to distinguish between and entity's value-creating activities (business) and the funding of that value creation (financing). A business and financing classification scheme allows users to better evaluate the underlying business of an entity, irrespective of how that business is financed. Further, how an entity is operated and how those operations are financed are two distinct management decisions. Separating those activities allows for comparison and evaluation of both decisions.

5. Based on the board's preliminary views in the discussion paper, the financial statements **might** be presented as follows (hereafter, referred to as the working format):

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business • Operating assets and liabilities • Investing assets and liabilities	***Business*** • Operating income and expense • Investing income and expense	***Business*** • Operating cash flows • Investing cash flows
Financing • Financing assets • Financing liabilities	***Financing*** • Financing income • Financing expense	***Financing*** • Financing asset cash flows • Financing liability cash flows
Income taxes	***Income taxes*** on continuing operations (business and financing activities)	***Income taxes***
Discontinued operations	***Discontinued operations,*** net of tax	***Discontinued operations***
	Other comprehensive income, net of tax	
Equity		***Equity***

6. In developing the sections for the financial statements, the boards agreed that:

   (a) An entity should classify operating assets and liabilities (the operating category) into short-term and long-term categories.

   (b) In selecting the order for presenting sections and categories within sections, an entity should:

      (i) chose the order that produces the most understandable depiction of its activities; and

      (ii) allow for presentation of meaningful subtotals and totals.

   (c) An entity should present the sections and categories in the same order in all three statements.

Management approach to classification

7. The working format separates the different functional activities of an entity. Because functional activities vary from entity to entity, an entity would choose the classification that best reflects management's view of what constitutes its business (operating and investing) and financing activities. That **management approach to classification** should provide decision-useful information about the various aspects of an entity's activities.

8. An entity would be required to explain, as a matter of accounting policy, its bases for classifying assets and liabilities in the operating, investing and financing categories. The boards propose that disclosure would include a discussion of the type(s) of businesses in which the entity engages. Any change in the basis for classification would be viewed as a change in accounting policy and would be implemented through retrospective application to prior periods (consistent with FASB Statement No. 154, *Accounting Changes and Error Corrections*, and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

Business section

9. The business section of the statement of financial position would include all assets and liabilities that management views as part of the entity's continuing business activities. Business activities are those conducted with the intention of creating value, such as producing and delivering goods or providing services.

Operating category

10. The operating category would 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. An entity would include operating assets and liabilities in the same category Also, if an entity cannot clearly identify an asset or liability as relating to a specific category, the entity should presume that the asset or liability relates to its operating activities.

Investing category

11. The investing category includes business assets and business liabilities 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.

Financing section

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

13. In determining whether a financial asset or liability is part of the financing of the business, management would consider whether the item is interchangeable with other sources used to fund its business activities. The financing section would normally **exclude** assets and liabilities related to transactions with customers, suppliers and employees because transactions of that nature usually relate to an entity's operations. The financing section would normally **include** liabilities that originated from an entity's capital-raising activities because capital is usually raised as a means to fund operating activities.

Summary of respondent feedback from comment letters

Separating business activities from financing activities (DP question 2)

14. The majority of respondents believe that the separation of business activities from financing activities **does** provide decision useful information, particularly in the statement of comprehensive income (SCI) where users find it helpful to distinguish between the primary activities of the entity and all other activities the entity may engage in.

15. Some respondents are concerned that separating business activities from financing will negatively impact the usefulness of the statement of financial position (SFP). Those respondents are most concerned about the lack of **total assets** and **total liabilities** subtotals and the possibility that similar or identical assets and liabilities will be presented in different sections (or categories) of the SFP. Consequently, those respondents think distinguishing between business activities and financing activities on the SFP may add to the complexity of that statement without making the information contained in the SFP more decision useful.

16. Many respondents indicate that the distinction between business and financing activities lacks relevance for a financial services entity, as most business

activities for that type of entity are financial in nature. Consequently, the proposed presentation model may lead to an arbitrary allocation of activities between the business and financing sections for a financial services entity, leading to reduced comparability in the presentation of financial results of otherwise similar entities.

17. Several respondents are concerned that the proposed presentation model uses the SFP as the starting point for classification decisions (ie the separation of business activities from financing activities begins with consideration of how the assets and liabilities are used in the business). Those respondents think that classification decisions should begin with the SCI (ie classification should be concerned primarily with changes in assets and liabilities) to provide decision-useful information.

Defining the business section and its two categories: operating and investing (DP question 9)

18. Respondents are mixed as to whether the **operating** and **investing categories** are defined so that their meanings are both understandable and operational. In particular, the majority of respondents request another label for the **investing category.** Those respondents note that the term *investing* has a variety of meanings and is currently used in the statement of cash flows (SCF) in a way that differs from its usage in the discussion paper.

19. Many respondents do not support classifying assets and liabilities (and therefore items of income and expense) that cannot be clearly distinguished as operating, financing or investing as operating by default. Those respondents consider the **operating income** subtotal to be one of the more useful subtotals in the proposed working format. Consequently, those respondents are concerned that the operating income subtotal may be made less useful if the operating category is a default category for items that are hard to classify.

20. Several respondents suggest that instead of splitting the business section into operating and investing categories, those categories should be re-labelled to **core** and **non-core business categories**. Respondents think those labels provide a better description of the types of items to be presented in those categories within the business section.

21. Some respondents express concern that there is too much subjectivity involved in determining the appropriate classification (ie operating, investing or financing) of particular items that may lead to inconsistent classification amongst similar entities or for similar items within the same entity. Those respondents request more detailed descriptions of the classification categories and further clarity regarding the parameters to be used in determining the appropriate classification of financial statement items.

Defining the financing section and its two categories: financing assets and financing liabilities (DP question 10)

22. The majority of respondents think that the financing section **should not** be limited to financial assets and financial liabilities as defined in International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP). Those respondents indicate that management may view some non-financial assets and non-financial liabilities (eg government grants, pensions and some leases) as being part of the entity's financing activities. Consequently, those non-financial assets and non-financial liabilities should not be prohibited from presentation in the financing section.

23. Some respondents request that the financing section be explicitly tied to a measure called **net debt**. Those respondents prefer that the financing section of the SFP contain all the elements that comprise net debt. For those not familiar with the concept, net debt refers to the items an entity manages as debt and the resources management views as available to service those debts. Respondents that support linking the concept of net debt to the financing section subtotal on the SFP expect the following to be included in that section: bank and other borrowings, lease liabilities, preferred stock classified as a liability, net derivative financial positions, cash, cash equivalents and marketable securities. WG paper 5 contains additional detail on the net debt measure in paragraphs 39—42.

24. Other respondents think that the financing section should be limited to third-party providers of funding that have no other relationships with the entity. That approach to classification excludes from the financing section any transactions with customers, employees, vendors, lessors and other related parties.

Management approach to classification of assets and liabilities (DP question 5)

25. Respondents are mixed on the role a **management approach** to classification of assets and liabilities should have in financial statement presentation. Respondents that **support** a management approach to classification think that classifying assets and liabilities in a manner that best reflects the way the asset or liability is used within an entity produces relevant information for users of the financial statements. Those respondents think that a management approach to classification will emphasise the differences between entities and provide users with a better foundation on which to make comparisons between entities and assessments of their relative performance.

26. Respondents that **do not support** a management approach to classification are concerned about the subjective nature of management's judgment. Consequently, those respondents think that the management approach to classification as described in the discussion paper will reduce comparability between entities, including those that are in the same industry. Those respondents prefer an approach to classification that results in consistent and uniform classification of assets, liabilities and items of comprehensive income across entities (eg all pension obligations are classified as financing activities).

27. Many respondents observe that the management approach described in the discussion paper does not have the same meaning as the management approach that is described in IFRS 8 *Operating Segments* and SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information*. Those respondents interpret management approach (as it is defined in the discussion paper) to have a stricter meaning than the management approach that is described in IFRS 8 and SFAS 131. Those respondents request that the distinction be formalised in the exposure draft, perhaps by re-labelling the **management approach** to classification to **business model approach**.[1]

[1] The business model approach is based on the business model approach to classification described in the IASB's exposure draft *Financial Instruments: Classification and Measurement* (July 2009). [See paragraphs BC31—BC34 in that ED (as well as paragraph 34 in this paper) for more information.]

Summary of participant (preparer) feedback from the field test

28. The survey results of the preparer participants in the field test indicate that the majority thought the **financing section** and the **investing category** were not appropriately defined. The financing section, financing asset category and financing liability category had a clustering of responses that suggested the items were too strictly defined. The investing category results indicate that preparers thought this category was too loosely defined.

29. Preparers identified the management approach to classification as the most useful aspect of the proposed model. Survey results indicate preparers thought the management approach to classification enhanced their ability to communicate the financial results of their company on the SFP and the SCI.

Alternatives to the proposals in the discussion paper

30. After considering the respondent feedback from the comment letters and the survey results of the preparer participants in the field test, the staff has developed several alternatives for the application of a management approach to classification and defining the sections and categories of the financial statements.

31. The alternatives are grouped as follows:

    (a) **Issue 1: management approach.** Paragraphs 32—37 describe two alternatives for the management approach to classification.

    (b) **Issue 2: section and category definitions**. Paragraphs 38—50 describe three alternatives for defining possible sections and categories for financial statement presentation. Each alternative retains the requirement to distinguish between business activities (value-creating activities) and financing activities (funding of that value creation) in each of the financial statements.

Issue 1: Alternatives for the management approach to classification

Alternative 1A: Require classification based on a reporting entity's business model.

32. The staff continue to think that an approach to classification based on how a reporting entity organises its activities and uses its assets and liabilities will provide the most decision-useful presentation of that information for users of the financial statements. That approach should help users of the financial

statements understand an entity's business model, which is information that the boards' are consistently told is essential for enabling users to use the financial statements effectively.

33. The staff think that management will usually have substantial—perhaps even total—discretion as to how the assets and liabilities are used in the business. However, once that discretion is exercised, management should have little (if any) flexibility as to how the assets and liabilities are classified in the SFP. Consequently, classification of assets and liabilities (and their related items of comprehensive income) **would be based on the business model used by the entity**.

34. The notion of looking to an entity's business model for classification purposes is used in IAS 39 *Financial Instruments: Recognition and Measurement*. Additionally, the IASB Board notes the following in paragraph BC32 and BC33 of its July 2009 exposure draft *Financial Instruments: Classification and Measurement*:

> …[A]n entity's business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way that an entity is managed…

Alternative 1B: Use the business model approach to classification described in alternative 1A. However, provide definitions for the financing section and the investing category that are ***less*** *open to interpretation than those provided in the discussion paper.*

35. At the heart of alternative 1B is the idea that a pragmatic approach to classification is needed to ensure that users of the financial statements are better able to understand the relationships between the numbers reported in the financial statements. One way to accomplish that is to provide definitions for the **financing section** and the **investing category** that are **less** open to interpretation than those provided in the discussion paper. Agreeing on what items should be presented in the financing section and investing category may reduce the risk that items are presented incorrectly in that section and category.

36. One approach is to assume that the most decision-useful information is provided when all effects from a single transaction are presented within the same section (or category). However, if that presumption can be rebutted, the alternative

presentation that results in the most decision-useful information should be applied. In that instance, management would be required to explain why classifying all effects from a single transaction within the same section (or category) would **not** provide the most decision-useful information to users of the financial statements.

37. For example, classification of items like post-employment benefits and investments in associates and joint ventures can be difficult when attempting to achieve meaningful presentation of that information in an entity's consolidated financial statements. Some respondents argue that consistent reporting of those types of items across entities is important for comparative financial statement analysis. Consequently, a management approach to classification (as described in the discussion paper) would **hinder** financial statement analysis across entities.

Discussion questions—management approach to classification
Question 1: Many respondents to the FSP DP view the management approach as a 'free choice' (ie complete discretion) for classification decisions. Do you think that explicitly tying classification decisions to the business model of an entity will result in the neutral presentation of information within the financial statements of that entity?
Question 2: What problems might management encounter when trying to implement a **business model approach** to classification?

Issue 2: Alternatives for defining the sections and categories of the financial statements

Alternative 2A: Retain the basic format from the FSP discussion paper but redefine the operating category, investing category and financing section.

38. Alternative 2A retains the basic format of the FSP discussion paper with the following changes:

(a) The operating category and the investing category are re-labelled to be **operating business activities** and **non-operating business activities**.

(b) The operating business activities and non-operating business activities categories do not include consideration of whether those activities relate to the central purpose(s) for which the entity is in business. The discussion paper describes a split into categories based on that principle as separating **core** business activities from **non-core** business activities.

(c) The financing section is defined to reflect **net debt**.

39. The proposed categories might be defined as follows:

    (a) **Operating business activities**. An activity whereby profit is generated through the combination of different resources, including potentially unrecorded intangibles, into a business unit together with the application of expertise by employees and management.

    (b) **Non-operating business activities**. An activity primarily involving single assets generating returns where there are no significant synergies from combining assets. Those assets are held to produce either recurring or capital gains; it is expected that those assets provide returns without undergoing any sort of transformation process.

40. It is the ability to earn recurring profits through the combination of assets and other resources in a business venture that is the main driver of value in most entities (**operating business activities**). For those operating business activities, capital providers are primarily interested in profits and cash flows, and the perceived ability of an entity to maintain and grow those. For such operating business activities, the focus of financial reporting should be on the transactions of the business and on the resulting profits and cash flows.

41. In contrast, for some business activities, including investments in securities, little value is created through the combination of different resources, and it is the individual asset itself that adds to shareholder value (**non-operating business activities**). Examples of items that would be included in that category are interest, dividends, rents, royalties and changes in fair value.

42. Further, the **financing section** might be defined in such a way that the subtotal of the financing section on the SFP reflects a measure called **net debt**. Consequently, the financing section would be broadened to include non-financial assets and non-financial liabilities. As a reminder, the financing section is defined in the discussion paper such that financ<u>ing</u> assets and financ<u>ing</u> liabilities mirror financial assets and financial liabilities as defined in IFRS and US GAAP. On that basis, particular types of leases (as well as derivatives) are excluded from the financing section. However, those items might be required for inclusion in the financing section to get to a net debt measure.

43. Another approach for the financing section might be to allow non-financial assets and non-financial liabilities within the financing section but stop short of explicitly tying the financing section of the SFP to net debt. That definition of the financing section would rely more heavily on the management approach (or business model approach) to classification than the definition described in paragraph 42.

44. One of the most difficult issues to deal with when using a business/financing basis for classification is the analysis of liabilities. Most would classify debt raised in the capital markets as financing. However, all liabilities are, in effect, a source of financing and could be reported as such. To differentiate between operating liabilities (that would subsequently be reported in the **operating business activities category**) and financing liabilities (that would subsequently be reported in the **financing section**), those liabilities might be defined as:

    (a) **Operating liabilities.** Liabilities arising from operating transactions that are likely to be replaced by similar obligations within an entity's operating cycle, and where the level of the liability is primarily dependent upon the level of business activity. Examples include trade payables, recurring product warranties and other short-term provisions.

    (b) **Financing liabilities.** Liabilities, the existence and level of which is largely a financing decision, even though they may arise in conjunction with the recognition of an operating expense. Such liabilities would not generally automatically change when there is a change in the level of business activity in the way that, for example, trade payables do. Interest accruing on those liabilities must be reported under the financing section in the SCI.

Alternative 2B: Narrowly define the financing section and investing category.

45. Alternative 2B retains the basic format of the FSP discussion paper with the following changes:

    (a) The **operating category** is defined as any activity associated with an entity's primary activities. That includes transactions with customers, employees, vendors, lessors and other related parties and strategic investments.

    (b) The **investing category** is defined as business activities unrelated to the primary activities of the entity.

(c) The **financing section** is restricted to third-party providers of non-owner capital that have no other relationships with the entity. Transactions with customers, employees, vendors, lessors and other related parties are **excluded** from the financing section.

Implications of alternative 2B

46. The definitions proposed in paragraph 45 have a number of implications for specific types of transactions. In particular, **all pension plan assets and obligations** would be shown together in the **operating category** of the SFP. Even though pension plan assets and obligations would be shown in the operating category, they could be presented separately as a sub-section, after other operating assets and operating liabilities.

47. Additionally, non-strategic equity investments and investment property would be presented in the **investing category** in the SFP. Rental income and dividends received from non-strategic investments would be presented in the investing category in the SCF. Dividend income and fair value changes (investment property, investment in equity securities) as well as rental income from investment property and any gain on sale of investment in equity securities would be presented in the investing category in the SCI.

48. The rationale for the presentation proposed in alternative 2B is demonstrated with the following example. If one entity was to buy another entity, the purchasing entity may not need the non-core operations (since they are strictly unrelated to the core operations) that it is investing in. Consequently, the purchasing entity may not need to carry over the debt that is in the financing category (because the purchasing entity could choose to apply different leverage to the business by cancelling the current debt and issuing new debt). The items that are in the operating category would all need to be brought over to the new entity or some level of disruption of the operating business would be caused. To demonstrate: an airline could not operate without its leased aircrafts and a retail chain that primarily leases its retail space could not generate revenues without its leased stores. If the purchasing entity abruptly froze the acquiree's pension plan that choice would likely cause some level of discontent among the employees of the business under acquisition. Consequently, all aspects of the pension plan should be in the operating category.

Alternative 2C: Provide no labels for categories in the business section. Instead, an entity is left to decide how information within the business section may be disaggregated meaningfully so that the facts and circumstances of that entity are best reflected in its financial statement.

49. **Alternative 2C** relies on a management approach (or business model approach) to classification at a level higher than what is proposed in the discussion paper. The benefit to the approach described in alternative 2C is that all entities will be able to apply the presentation model without tripping over pre-defined labels for categories within each of the sections. For example, a financial services entity may decide that its value creating activities are best described by the categories of **trading activities** and **non-trading activities** within the business section.

50. It should be noted that **alternatives 2A and 2B** could be modified to provide a solution similar to **alternative 2C**. In that scenario, the boards might provide guidance on distinguishing between types of activities within the business section but stop short of explicitly labelling the different activity types.

Discussion questions—section and category definitions

Question 3: Which alternative do you prefer: **alternative 2A** or **alternative 2B**? Why?

Question 4: Could either **alternative 2A** or **alternative 2B** be applied to a financial services entity? If not, how would either model need to be modified?

Question 5: If the boards narrowly define the financing section and the investing category (as in **alternative 2B**), would it be necessary to retain a management approach to classification in the exposure draft?

Question 6: Do you think that the approach in **alternative 2C** is operational? Some have argued that the boards <u>must</u> require specific labels for each section and category. Those individuals think that the absence of 'approved' labels will result in reduced comparability among entities. Additionally, those individuals are also concerned that XBRL development will be negatively affected.