Project **Financial Statement Presentation**

Topic **Financial services entity issues**

Introduction

1. As noted in the comment letter summary (see the appendix to WG paper 1), many respondents to the October 2008 discussion paper *Preliminary Views on Financial Statement Presentation* (discussion paper) think the proposed presentation model does not provide decision-useful information when applied to the financial statements of a financial services entity.[1] Those respondents think financial services entities should be exempt from many of the changes proposed in the discussion paper. In particular, those respondents think the distinction between business activities (how the entity creates value) and financing activities (how the entity funds that value creation) is not meaningful for a financial services entity. Several of those respondents also think that the statement of cash flows has little relevance for a financial services entity.

Background

2. Over the course of this project, financial services entities have requested their own presentation model. As explained in the discussion paper:

> In setting the project scope, the Boards initially considered whether the presentation requirements for entities that provide primarily financial services (such as banks, building societies, credit unions, stock brokerages, asset management firms, insurers, and similar businesses) should differ from those for other types of entities. The assets and liabilities that generate net cash inflows for those entities are likely to be different from those of other business entities

[1] A *financial services entity* is an entity that provides primarily financial services, such as a bank, an asset management firm, and an insurer.

> because of the underlying differences in how they create value. 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 generally are not directly related to operating activities. [paragraph 2.78]

3. After considering feedback provided by the Financial Institutions Advisory Group (FIAG), the boards agreed that the proposed presentation model should apply to all business entities. As stated in paragraph 2.79 of the discussion paper:

> The Boards' preference for requiring an entity to explain, as a matter of accounting policy, its bases for classifying assets and liabilities was important to advisory group members when they expressed support for having the same classification scheme and guidelines for all business or for-profit entities. The Boards would expect a financial services entity to classify many of its financial assets and financial liabilities (for example, cash, bank loans, and bank overdrafts) in the operating category even though they are financial in nature. 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.

The financial services entity perspective

Proposed classification scheme

4. When providing feedback on the presentation of information within the financial statements of financial services entities, respondents state that the majority of activities of that type of entity would be classified in the **operating category**. Consequently, the proposed business section categories (operating and investing) will not provide decision-useful information for users of financial statements for that type of entity.

5. Additionally, non-financial sector entities would most likely classify debt raised in capital markets in the financing section. However, a financial services entity is likely to classify those same items in the business section rather than the financing section. Said differently, value-creating activities for a financial services entity involve the exchange of financial contracts. Consequently, items that constitute the financing activities of a non-financial sector entity are the business activities of a financial services entity. Further, many respondents state

that the line between business and financing activities is not always apparent for a financial services entity. Therefore, a requirement to make that distinction could result in a financial services entity making an arbitrary allocation of items to those sections.

Discussion questions
Question 1: How would you recommend disaggregating the business section so that decision-useful information is provided by the financial statements of a financial services entity? **Question 2:** For a financial services entity, is the most important distinction centred on being able to distinguish near-term effects (ie trading) from long-term effects (ie non-trading)?

Statement of cash flows

6. As noted in WG paper 5, financial services entity respondents state that the statement of cash flows (SCF)—both the direct and indirect format—does not provide decision-useful information and therefore, should be optional for their industry.

7. Respondents observe that a financial services entity typically manages its liquidity needs on a daily basis, whereas the SCF gives an annual synopsis of an entity's inflow and outflow of cash. In other words, the SCF does not provide an accurate depiction of corporate liquidity risks, as the clearing and settlement of payment transactions to customers does not trigger any increased liquidity for a bank although the direct-method SCF would suggest that it does.

8. Financial services entity respondents state that tabular information about liquidity and other disclosures on the contractual maturities of obligations and derivative instruments provide a better understanding of their future cash flows than a SCF. Several respondents also note that the provisions in IFRS 7 *Financial Instruments: Disclosures* about liquidity risk will provide insight into future cash flows and liquidity risks within the banking sector. Those respondents are of the view that analysis of a financial services entity's statement of financial position and its capital position is more beneficial than analyzing its statement of cash flows.

9. If the proposed presentation model requires financial services entities to present a SCF, financial services entities prefer presenting operating cash flows using an indirect method because it would be less costly to prepare than a direct-method SCF. Financial services entities want to spend as little resources as possible on a financial statement that does not provide any incremental decision-useful information and therefore is prepared purely for compliance reasons.

Discussion questions
Question 3: The staff considered an alternative that would exempt an entity from presenting a SCF if certain conditions were met (e.g., manages liquidity needs on a daily basis). If you think the boards should pursue an alternative like that, what should the exemption criteria be? **Question 4**: If you think a financial services entity should not have to present a SCF, what information should an entity of that nature present instead?

Ratios

10. Many respondents think that the proposed presentation model will **not** make it easier to calculate financial ratios. Those respondents note that many of the ratios used by financial services analysts are based on regulatory or risk management methodologies—those ratios are not defined accounting measures. Additionally, calculation of those types of ratios are not facilitated by the sections and categories proposed in the discussion paper. Examples of popular measures that may **not** benefit from the proposed presentation model include: capital adequacy ratios, liquidity risk management ratios, and market risk methodologies, such as value at risk that measures the risk of loss on a specific portfolio of financial assets. Respondents note that the information required to calculate those measures may become **more** difficult to find using the proposed presentation model because the necessary information may be disaggregated and presented in unfamiliar or unexpected places in the financial statements.

Discussion question
Question 5: Are there other aspects of the proposed presentation model that might not “work” for a financial services entity that the boards should be aware of?