Project: **Financial Statement Presentation**

Topic: **Classification: section and category definitions**

Introduction

1. The purpose of this paper is for the IASB and the FASB (collectively, the boards) to finalise their deliberations on the section and category definitions for use in the exposure draft. Those definitions are the foundation of the presentation model—that is, how management applies the definitions to the facts and circumstances of an entity will determine where information is displayed on the face of the financial statements.

Background

2. At their respective September 2009 meetings, each board considered respondent feedback to the section and category definitions proposed in the discussion paper as well as possible alternatives for those definitions (see IASB agenda paper 14A/FASB memorandum 67A).

Tentative decisions

3. Both boards tentatively decided to retain the discussion paper proposal that an entity be required to present financial statement items in sections that distinguish between business activities (value-creating activities) and financing activities (funding of that value creation) in each of the financial statements.

4. Both boards tentatively decided to retain an approach to classification within the **business section** that is based on how a reporting entity organises its activities and how it uses its assets and liabilities. In a change from the discussion paper, the boards tentatively decided that there will not be an operating or investing category

within the business section. Rather, additional groupings of information within the business section (that is, categories) will reflect the facts and circumstances of that entity and will be left to management's discretion. Both boards expressed willingness to reconsider that decision after reviewing the proposed drafting of the business section definition for the exposure draft.

5. In a change from the discussion paper, the boards agreed to be more specific in defining the **financing section**. Both boards tentatively decided to define the financing section as liabilities that arise as part of an entity's capital raising activities. However, the boards differ as to whether treasury assets (specifically, cash) should be included in the financing section. The IASB Board tentatively decided that treasury assets **should not** be shown in the financing section; the FASB Board tentatively decided that the financing section **should** include a category for treasury assets.

Developments subsequent to the September deliberations

6. The staff interpreted the decisions reached by both boards in September as being <u>very</u> tentative—that is, the staff need to do more work on the definitions in order for the boards to reach a converged decision. To accomplish that work, we enlisted the help of a small group of board members in drafting the definitions of the business section and the financing section. During that exercise, we confirmed the following:

   (a) We do not have a common understanding of what the term *financing* means.

   (b) Obligations that are operating in nature but also have financing components are problematic from a classification perspective (eg pensions). How those obligations (and their effects) are displayed in each of the financial statements appears to be a significant factor in determining how some board members are willing to define the financing section.

Proposed definitions

7. Appendix A contains proposed drafting for the definitions of the business section and the financing section. That drafting **does not** necessarily represent a consensus position of the board members that provided feedback on the proposed drafting.

The proposed drafting differs from the September 2009 tentative board decisions as follows:

(a) the business section has two defined categories: operating and investing

(b) the financing section includes a treasury category

(c) the equity section is brought into the financing section as a separate category within that section.

Operating and investing categories in the business section

8. The proposed drafting includes two defined categories in the business section: an operating category and an investing category. We chose to define categories because:

(a) board members were convincing in their argument that an unintended consequence of the September 2009 decision on this topic may be that decision-useful information (particularly in the SCF) is lost if we do not define an operating category; and

(b) financial statement analysis (specifically, an analyst's determination of whether something is comparable) is helped if discipline is applied to how a reporting entity determines the items that belong in different categories within the business section.

Treasury category in the financing section

9. The proposed drafting includes a treasury category in the financing section. We chose to include a treasury category in the financing section because:

(a) the FASB Board reached a tentative decision in September to include a treasury category in the financing section; and

(b) in the interest of reaching a converged decision, the staff thought it would be helpful for both boards to see what the treasury category definition might look like in drafting.

10. The majority staff position is that a treasury category should **not** be included in the financing section for the following reasons:

(a) Idle cash (ie the cash line item on the SFP as at a reporting date) is neither value-creating nor financing—it is a store of value.

(b) Many financial statement users attach an 'availability notion' to cash presented on the face of the SFP. Juxtaposing cash (and other short-term financial assets) with debt could mislead rather than inform financial statement users.

(c) We acknowledge that, conceptually, the items that would be included in the treasury category (ie cash and short-term financial assets held as a substitute for cash) are the opposite of debt.[1] Consequently, those items (treasury and debt) could logically be presented in proximity to each other. However, we think that the conceptual understanding of treasury category items just described is not held widely in practice.

11. If the boards agree with the majority staff position **not** to include a treasury category in the financing section, the staff intend to re-write the proposed drafting in appendix A to require a reporting entity:

(a) to present cash in the operating category of the business section; and

(b) to present in the business section the short-term financial assets that would have been presented in the treasury category. As currently drafted in appendix A, the short-term financial assets that would have been included in the treasury category might meet the definition of items to be included in the investing category. Whether those financial assets meet the definition of items to be included in the investing category depends on the business model of the entity (ie do those financial assets generate a revenue stream for the entity or do those financial assets generate non-revenue income). If the boards want <u>all</u> short-term financial assets to be presented in the operating category along with cash, the investing category could be limited to long-term items.

Equity category in the financing section

12. The staff propose to define the financing section to include items that are part of a reporting entity's activities to obtain (or repay) capital. We decided to include equity as a separate category in the financing section because equity is a source of capital to a reporting entity.

13. The effect of including equity as a category within the financing section is that a cohesive presentation of the financing section across the three primary financial statements will not be achieved. Each category in the financing section would be

[1] Another example of conceptual 'opposites' is accounts payable and accounts receivable.

required to be shown with a subtotal on the face of the SFP and the SCF. However, the financing section in the SCI will include only activities associated with the debt category.

Additional work to be done on the proposed definitions

14. At future meetings, the boards will consider:

    (a) whether the proposed classification model should be:

        (i) required on the face of the SFP or;

        (ii) applied either to a reporting entity's segment note or provided in some other note.

    (b) whether cash should be presented in one category on the SFP or whether it should be allocated between categories. (This issue arises if the boards decide to create a treasury category.)

    (c) whether a third category should be created in the business section to include items that have mixed classification functions (ie both business and financing components). Examples include pensions, asset retirement obligations and leases. The <u>preliminary</u> staff leaning is **not** to require a separate category in the business section (on the face of the SFP) that includes those items. However, an exemption from cohesiveness could be provided such that specific components of the item are shown in different categories of the business section and other components are shown in the financing section on the face of the SCI. For example, the pension service cost and related items (ie past service cost and curtailments) could be required to be shown in the operating category; the interest cost on the unfunded portion of a pension scheme (along with fair value changes in the liability) could be shown in the financing section; and the return on plan assets (less the interest cost on that part of the liability covered by the assets) could be shown in the investing category.

15. The staff plan to address topics (a) and (b) in November. We expect to address topic (c) in either December or January 2010.

Staff recommendations

16. The staff recommend that the exposure draft:

    (a) retain an operating and investing category in the business section of each of the financial statements. Those categories require a reporting entity to make a distinction between business activities that are active in nature (operating category) and business activities that are passive in nature (investing category) [see paragraphs 8—12 in appendix A];

(b) define the financing section to include items that are part of a reporting entity's activities to obtain (or repay) capital. A reporting entity will be required to group its financing activities into categories that reveal how related resources and claims are used to provide capital to the entity. That capital structure may consist of two categories: debt and equity.

(c) define the debt category to include liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising (or repaying) capital [see paragraphs 17—19 in appendix A].

(d) define equity in accordance with existing requirements in either IFRS or US GAAP [see paragraph 20 in appendix A].

Questions for the boards

17. A point of clarification prior to voting on the staff recommendations: the proposed drafting—if agreed to by the boards—will be used as the basis for the boards' ongoing FSP deliberations. Consequently, the proposed definitions for the business and financing sections will continue to evolve.

Questions for the boards
1. The staff recommend that the exposure draft **not** include a treasury category in the financing section. **Do the boards agree with that recommendation?**
2. The staff recommend that the business section include at least two defined categories: operating and investing**. Do the boards agree with that recommendation?**
3. The staff recommend that equity be a category in the financing section. **Do the boards agree with that recommendation?**
4. The staff recommend that the exposure draft include the drafting proposed in appendix A. If the boards agree with the staff recommendation in question 1, the proposed drafting will be amended to reflect that decision. **Do the boards agree with that recommendation?**

Appendix—proposed drafting

Structure

Introduction

1 [*place holder*]

Separating value-creating activities from financing activities

2 A reporting entity shall present information about its value-creating activities separately from information about the way it finances those value-creating activities.

3 A reporting entity can meet the requirement in paragraph 2 by presenting in each of its financial statements its value-creating activities in a **business section** and its financing activities in a **financing section**.

4 A reporting entity shall classify its assets and liabilities into sections in a manner that best reflects the way the asset or liability is used by the reporting entity. A reporting entity with more than one business model shall, in its consolidated financial statements, classify its assets and liabilities in the business and financing sections on the basis of the way those items are used in each of its reportable segments.

The business section

5 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.

6 The business section provides transparency about the reporting entity's business model and the value-creating activities the reporting entity engages in to execute its business model. A reporting entity shall make transparent its business model by grouping its business activities into categories that reveal how related assets and liabilities are used to generate income for the reporting entity. A reporting entity shall

present separately business activities that are *active* in nature from business activities that are *passive* in nature.

7 When a reporting entity presents assets and liabilities in separate categories in the business section of the statement of financial position, it shall present changes in those assets and liabilities and the cash flow effects of those assets and liabilities in the same category in the statement of comprehensive income and the statement of cash flows.

Operating

8 Assets used in business activities that are active in nature shall be presented together in a separate category titled **operating**. A business activity is active in nature if it:

(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 net resources of the reporting entity. That process also includes the application of employee and management expertise.

9 Liabilities that arise from business activities that are active in nature also shall be presented in the operating category. Those liabilities arise from business activities that are recurring. Consequently, those liabilities are likely to be replaced by similar obligations within a reporting entity's operating cycle.

10 Any derivative held as part of a reporting entity's business activities that are active in nature 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

11 Assets and liabilities that are used in business activities that are passive in nature shall be presented in a separate category titled **investing**. A business activity is passive in nature if it:

(a) generates non-revenue income; and

(b) no significant synergies are created from combining assets.

12 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

13 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.

14 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 three categories of financing activities: treasury, debt and equity.

Treasury

15 The **treasury category** shall include cash and short-term financial assets (or financial liabilities) that are held (or arise) as a substitute for cash. Those financial assets provide a source of funding that is not tied to a specific value-creating activity—that is, those financial assets provide funding that is available generally to all business units in the reporting entity. Additionally, those financial assets are held by the reporting entity until management makes the decision to deploy them in the value-creating activities of the reporting entity.

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

Debt

17 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.

18 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.

19 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

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