Project	**Financial Statement Presentation**
Topic	**Cohesiveness principle; section and categories; and the statement of financial position**

Introduction

This paper for discussion at the financial statement presentation (FSP) working group (WG) meeting addresses the IASB's and the FASB's (collectively, the boards) tentative decisions on the cohesive classification of items in the financial statements.

Staff Draft proposal

Classification approach

1. The Staff Draft proposes that an entity shall classify items in its financial statements (assets, liabilities, equity, income, expenses and cash flows) into sections, categories and subcategories on the basis of how those items relate to its activities. Although the Staff Draft proposes that management should classify assets and liabilities on the basis of the functions in which they are used by the entity, there is much less discretion involved in the classification process. Consequently, the term 'management approach' is not used to describe the proposed classification process.

Investing category and examples

2. The Staff Draft proposes that an asset or a liability that a reporting entity uses to generate a return and any change in that asset or liability shall be classified in the investing category. No significant synergies are created for the reporting

entity by combining an asset or a liability classified in the investing category with other assets of the entity. Examples of investing activities and related items that may be classified in the investing category include investments in associates or joint ventures.

Financing section

3. The Staff Draft proposes that the financing section shall include items that are part of an entity's activities to obtain (or repay) capital. The financing section should include only items that are commonly equated with the capital structure of an entity—debt and equity.

4. Assets should not be classified in the financing section. The boards were concerned that many users of financial statements attach an availability notion to cash presented in the statement of financial position (SFP), which may not be valid. The boards were also concerned that readers of the financial statements would interpret the inclusion of assets such as cash and marketable securities in the financing section as a move toward equating the financing section with a notion of net debt.

Classification of cash

5. The Staff Draft proposes that cash shall be classified in the operating category in the SFP. The boards propose that an entity should not be permitted to classify cash in more than one category in its SFP. Because of the fungibility of cash, the boards reasoned that it might be difficult, if not impossible, for an entity to identify some of its cash as having one function and some as having another function. Furthermore, the boards think that allowing cash to be classified on the basis of how management intends to use that cash in the future could result in the presentation of misleading, rather than useful, information.

Presentation of the SFP

6. As a result of presenting assets and liabilities together in sections, categories and subcategories, the SFP would no longer be classified on the basis of elements (assets, liabilities and equity). However, the Staff Draft proposes that an entity could choose to display the sections, categories and subcategories in the SFP using a multi-column approach that displays all the assets in one column and all

the liabilities in another column, which is more consistent with the traditional format for that statement.

Benefits of the proposals—what we heard

7. The cohesiveness principle is widely supported by users, who have clearly indicated that more useful information is available if financial statements are aligned by section and categories. The proposals would significantly improve the information and would promote more consistency in financial reporting generally. Many analysts felt that the sections and categories are consistent with the way in which they segregate reported financial information in order to analyse results.

8. Analysts especially cited the following potential benefits:

   a) The proposals would help to identify sustainable operating earnings and cash flow by separately presenting non-operating income and cash flows. That information is not always available today.

   b) The linkage across the financial statements and greater line item disaggregation caused by the new categorisation (for example, the disaggregation of ‘Other Assets’) would result in useful information.

   c) The categorisation of derivatives by activity (operating, investing, financing) would help them better understand a company’s derivatives strategy.

   d) The presentation could lead to new performance measurements based on net operating returns and assets.

   e) The categorisation would help them to evaluate reported non-GAAP measures. For example, they feel that items treated as ‘non-recurring’ (such as restructuring charges) would end up in the operating category.

   f) The separation of financing associated with a finance arm of the operations of a company from the general financing of the company would be a big advantage of the suggested presentation format.

   g) The new categorisation scheme would improve the statement of cash flows (SCF). There is a lot of information that should not be in cash flows from operating activities (eg tax-related flows) and there is some information that is missing (eg capex).

9. Most preparers also expressed support for the cohesiveness principle. Some preparers even expressed strong support, especially for the clear relation between assets and liabilities and the corresponding income and expense classification, which is perceived as an improvement compared to current IFRSs. However, some preparers do not think that the proposed cohesive structure, especially the structure of the SFP, will result in benefits compared to the current format.

10. Some analysts that we spoke with felt that the categorisation is consistent with the way that they segregate information, but not that the proposal would meaningfully improve their analysis. This is because they believe that they can already use their knowledge of the companies in which they are invested, or which they are performing research, to identify which activities are operating, investing and financing. They say they would continue to rely on firm-specific methodologies rather than on new presentation guidelines. This could lead to some rearranging by the analysts of presented information.

Cost of the proposals—what we heard

11. The implementation costs of the cohesiveness principle are considered by preparers to be moderate. Most preparers noted that the costs that would be incurred consist of remapping their consolidation systems to divide already existing accounts into sections and categories. Some preparers noted that there would be a need to create some new accounts in the general ledger and subsystems to capture some information that they currently do not capture today (for example, operating, investing and financing derivatives may be in one general ledger account today).

12. The related costs are seen as one-time implementation costs. Besides mapping efforts, the preparers mentioned the costs of training and education sessions, internally (eg management and staff) as well as externally (eg analysts, investors and other user groups). US-listed companies also addressed the cost within the context of reporting financial information in Extensible Business Reporting Language (XBRL).

13. Companies raised the question of whether the IFRS for SMEs would be amended to correspond to the requirements of an FSP standard. Companies are concerned about additional costs at the group level if the presentation requirements in full IFRSs and IFRS for SMEs are different.

14. Some analysts questioned whether the costs of changing the structure of the financial statements would be worth the benefit. For the analysts, the most significant cost would be that their models are based upon decades of history in some cases; and thus historical comparability would be lost under a new structure. As a result of this concern, some analysts encouraged the staff to pursue a model for the SFP based on the current customary presentation (ie, assets first, followed by liabilities and equity), with the categorisation of the assets or liabilities either on the face of the financial statements or in the accompanying notes.

Opposing and alternative views on the categorisation

15. Preparers and users raised concerns about the proposed application of the cohesiveness principle, especially on the SFP. Users were also concerned about the changes to the composition of the financing section compared to the discussion paper (eg treasury assets would no longer be in the financing section).

16. The majority of preparers voiced concerned about the relative loss of flexibility in the classification of items from the discussion paper (DP) to the Staff Draft. They think that even though the DP's flexibility gave management an appropriate amount of discretion in categorising items in the SFP. They think the Staff Draft is in contrast overly prescriptive in requiring more standardised classification and that the financial statements will lose relevance.

Financing section, operating finance subcategory and the placement of cash

17. During the outreach meetings with constituents in various European locations, prepares indicated their preference for the financing section to reflect an entity's treasury function. This would be consistent with the function-based classification approach. Because in a number of European countries the key figure in managing the treasury function is 'net debt', which is well understood

by both preparers and users in those locations, there was support in these countries for aligning the financing section with this notion. Notwithstanding the fact that the term ‘net debt’ is not defined in IFRSs, and the list of items constituting the net debt may vary between different countries, there was a widespread consensus that it should be based on the interest-bearing assets and liabilities, including cash. Equity should not be part of the financing section.

18. Many preparers, apart from financial service entities, disagree with the classification of cash as an operating asset, and they also disagree with having lease and pension liabilities included in the business section. In this context, they suggest allowing management more discretion in defining the categories without losing the notion of cohesiveness.

19. Some analysts felt that the creation of a subcategory for operating finance items was a pragmatic solution to showing these items as operating costs and liabilities on the SCI and SFP respectively and as financing items on the SCF. They felt that analysts would make an adjustment to move these items to the financing section for the purpose of analysing leverage.

20. Other analysts view the creation of an operating finance subcategory as an unnecessary complication. Each has their own specific method of dealing with these items and felt that a standardised method would not be helpful to them. They felt that items such as leases and pensions should always be presented as financing costs (except pension service costs, which should be in operating), financing liabilities and financing cash flows (to the extent that that cash flow is for the settlement of a net deficit in the funding of the plan). Consequently, they disagreed with the proposed subcategory and would rather violate the cohesiveness principle to get these items into their preferred categorisation.

21. Other users were indifferent about the presentation of these items together in a subcategory and said they would continue to move these types of liabilities on an item-by-item and/or company-by-company basis to wherever they seemed best fitted. For example, one rating agency analyst treats both leases and underfunded pensions as financing, and they treat pension contributions as financing only to the extent that the contribution exceeds service cost.

22. A national standard-setter disagreed with the proposal that equity should be included as a category in the financing section, because classifying equity as its own section would make it easier to understand the clean-surplus relationship between equity and comprehensive income and the asset deficiency.

Investing category

23. Some analysts were concerned about potential ‘gaming’ by companies using the proposed definition of the investing category. They could see how a bank might use the proposed definition of the investing category to place an under performing asset in investing, thus presenting the poor results to investors as unimportant to understanding the entity’s operating results.

24. Many preparer indicated that they would classify strategic investments as operating assets.

25. A national standard-setter stated that using synergy as the distinction between operating and investing as in the Staff Draft is better than the focusing on core or non-core as suggested in the discussion paper (even though he had a concern about the use of management judgment).

26. Auditors stated that there would have to be procedures for auditing management’s judgement about what amounts are reported in which section or category. However, they noted that the categorisation could be second-guessed by regulators and might create a lack of comparability across entities.

Statement of financial position

27. Generally, preparers questioned the need to apply the section and category structure to the SFP.

28. Many preparers and users raised concerns regarding the complexity and readability of the SFP. With reference to the examples, as published in the implementation guidance of the Staff Draft, they recommend fewer headers and subtitles in the SFP. In this context, a preparer question the short-term, long-term disaggregation and whether there is a need to have this information in the SFP.

Financial services entities

29. Financial services entity analysts said that the proposed structure would only make sense for the SFP of a financial services entity if the result was that almost all line items would appear in operating, because operating, investing and financing activities are all considered the core operating activities of a bank. This is consistent with the feedback received from financial services entities.

30. Because they see most of the assets, liabilities and the flows of the entity being categorised in the operating category, financial service entities said that categorising the SFP and applying the cohesiveness principle is of little benefit to their financial statements.

31. A bank preparer proposed that the financing section should comprise primarily capital transactions and transactions with a subordinated feature that would meet capital requirements, in the same way as with the current practice. For example, subordinated long-term debts are debts with a special contract requiring the fulfilment of the obligation to be subordinated to other debts when an entity goes into default. They are viewed differently from senior long-term debts because they are managed as an integral part of capital, primarily to meet the regulatory capital requirements. Consequently, they are interchangeable with equity and are classified as (debt) financing. It was argued that the financing section should be limited to fund-raising for capital such as subordinated long-term debt, while other long-term debt should be classified as operating. It would be inappropriate for banks to classify corporate bonds and debt loans in financing because such a presentation would not reflect the economic reality of banks.

32. One analyst believed that the biggest improvement we could make to categorising assets and liabilities would be to organise assets against the liabilities that fund them (duration matching).

33. Some insurance companies think that it would be difficult to clearly separate operating activity from investing activity, because the investments of the entity are synergistic with its insurance operations. They believe that the boards should develop a presentation format specific to financial services entities that

would allow them to present operating activity and investing activity in a single category.

Possible alternatives

34. The issues identified regarding cohesiveness and categorisation of the SFP and other financial statements into sections and categories can be summarised as follows:

    (a) There is a preference by some to have more freedom for management's approach and less prescription on how to use the sections and categories.

    (b) There is a lack of incremental benefit to the categorisation of assets and liabilities in the SFP.

    (c) Categorisation of the SFP adds unnecessary clutter and complexity as well as changes to a statement that most are comfortable with.

    (d) There are varied opinions on the items that should be included within the operating finance subcategory.

    (e) It was argued the financing section should contain treasury assets and equity should be excluded.

    (f) Some additional guidance needs to be provided for the categorisation of items in the sections and categories.

35. To address the concerns in paragraphs 34(b)-34(c), the staff have developed alternative presentations for the SFP that would present assets and liabilities consistently with how they are currently presented while preserving the categorisation of the assets and the liabilities. See Appendix A for one of the alternatives.

36.

Discussion questions
1. Should it be up to the discretion of management to determine what should be classified in each category and the composition of items for each category?
2. Are there alternatives regarding the presentation of the SFP according to the cohesiveness principle (ie, assets first, followed by liabilities and equity with the categorisation of the asset or liability disclosed either in the financial statements or in their accompanying notes)?

3. Do the WG members think that the financing section, operating-finance subcategory, treasury assets, or guidance on the categorisation of particular items should be re-examined?

Appendix A

STATEMENT OF FINANCIAL POSITION			
		As of December 31,	
		20X1	20X2
BUSINESS			
Operating Assets			
	Cash	74,102	61,941
	Accounts receivable	922,036	527,841
	Inventory	679,474	767,102
	Prepaid advertising	86,552	78,150
	Total short-term operating assets	**1,762,164**	**1,435,034**
	Property, plant, and equipment, net	2,838,660	3,064,200
	Goodwill and other intangible assets	189,967	189,967
	Total long-term operating assets	**3,028,627**	**3,254,167**
Total operating assets		**4,790,791**	**4,689,201**
Investing Assets			
	Short-term investments	1,100,000	800,000
	Available-for-sale securities	473,600	485,000
	Total short-term investing assets	**1,573,600**	**1,285,000**
	Equity method investment in Company A	261,600	240,000
	Investment in Company B at Fair Value	46,750	39,250
	Total long-term investing assets	**308,350**	**279,250**
Total investing assets		**1,881,950**	**1,564,250**
TOTAL BUSINESS ASSETS		**6,672,741**	**6,253,451**
INCOME TAX			
	Deferred tax asset	46,226	89,067
TOTAL INCOME TAX ASSETS		**46,226**	**89,067**
DISCONTINUED OPERATION			
	Assets of discontinued operation	856,832	876,650
TOTAL DISCONTINUED OPERATION ASSETS		**856,832**	**876,650**
Total short-term assets		**4,192,596**	**3,596,684**
Total long-term assets		**3,383,203**	**3,622,484**
TOTAL ASSETS		**7,575,799**	**7,219,168**

BUSINESS		
Operating Liabilities		
Advances from customers	182,000	425,000
Accounts payable, trade	612,556	505,000
Wages, salaries, and benefits payable, and share-based compensation liability	212,586	221,165
Total short-term operating liabilities	**1,007,142**	**1,151,165**
Total long-term operating liabilities	**3,848**	**1,850**
Total operating liabilities	**1,010,990**	**1,153,015**
Operating Finance Liabilities		
Short-term portion of lease liability and interest payable on lease liability	50,000	50,000
Total short-term operating finance liabilities	**50,000**	**50,000**
Accrued pension liability	293,250	529,500
Long-term portion of lease liability	261,325	296,500
Decommissioning liability	29,640	14,250
Total long-term operating finance liabilities	**584,215**	**840,250**
Total operating finance liabilities	**634,215**	**890,250**
TOTAL BUSINESS LIABILITIES	**1,645,205**	**2,043,265**
INCOME TAX		
Income taxes payable	72,514	63,678
TOTAL INCOME TAX LIABILITIES	**72,514**	**63,678**
DISCONTINUED OPERATION		
Liabilities of discontinued operation	400,000	400,000
TOTAL DISCONTINUED OPERATION LIABILITIES	**400,000**	**400,000**
FINANCING		
Debt		
Short-term debt and interest payable	702,401	512,563
Dividends payable	20,000	20,000
Total short-term debt	**722,401**	**532,563**
Total long-term debt	**2,050,000**	**2,050,000**
Total debt	**2,772,401**	**2,582,563**
Equity		
Common stock (par .01, 100,000 shares authorized and issued both years; 76,149 and 73,000 shares outstanding December 31, 20X1 and 20X0, respectively)	761	730
Additional paid-in capital	1,514,839	1,506,770
Retained earnings	1,100,358	648,289
Accumulated other comprehensive income	158,081	138,373
Treasury stock	-88,360	-164,500
Total Equity	**2,685,679**	**2,129,662**
TOTAL FINANCING	**5,458,080**	**4,712,225**
Total short-term liabilities	**2,252,057**	**2,197,406**
Total long-term liabilities	**2,638,063**	**2,892,100**
TOTAL LIABILITIES	**4,890,120**	**5,089,506**
TOTAL LIABILITIES AND EQUITY	**7,575,799**	**7,219,168**