IASB/FASB Meeting January 2010

FASB - Education Session January 13, 2010

IASB agenda reference	**7B**
FASB memo reference	**73B**

Project	**Financial Statement Presentation**
Topic	**Financial services entity issues**

Introduction

1. The purpose of this paper is for the IASB and the FASB (collectively, boards) to discuss whether or to what extent the exposure draft on financial statement presentation should be applied by a financial services entity.

2. The boards have already addressed many of the issues raised by financial services entities as those issues are not unique to the financial services industry. Those issues include:

   (a) **Line-by-line cohesiveness:** The boards tentatively decided that an entity should apply the cohesiveness principle at the category level, not the line-item level.

   (b) **Short-term liquidity disclosures:** The boards tentatively decided that disclosure of short-term contractual maturity information should not be required as part of this project.

   (c) **Reconciliation schedule:** The boards tentatively decided not to require the reconciliation schedule, but rather require analyses of the changes in significant line items from the statement of financial position (SFP).

This paper has been prepared by the technical staff of the FASB and the IASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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(d) **Category definitions:** The boards tentatively decided to include most financial assets in the business section rather than the financing section. Including assets and liabilities associated with revenue-generating activities in the operating category should make it clearer to a financial services entity that its financial instruments should be classified in the operating category.

3. The only remaining issue outstanding is whether a direct method statement of cash flows (SCF) should be required for financial services entities. That issue is addressed in the remainder of this paper.

4. At the January 2010 joint meeting, the boards will address whether all entities should be required to disaggregate income and expense items by both function and nature (the discussion paper proposes that service entities such as a bank would not have to disaggregate by function) (see IASB agenda paper 7A/FASB memorandum 73A).

Direct method statement of cash flows

5. Financial services entity respondents to the discussion paper made comments similar to those made by other respondents about it being extremely costly to prepare a direct method SCF. However, those entities communicated additional concerns with a direct method SCF that are exclusive to financial services entities, in particular, banks.

6. One common response was that the fund (cash) flows in and out of a bank do not depict the actual operations of a bank. There are several examples of this, including the following:

   (a) Mortgage paid by funds on deposit: A mortgage that is paid by funds that are already on deposit with a bank would not be presented in the SCF as "cash received on mortgage receivable." That is because these funds had flowed in previously as part of a customer's deposit. The entry for payment of a mortgage would be a decrease of the mortgage

receivable and a decrease of the liability for funds on deposit with cash moving internally; however, there would be no increase in the reporting entity's cash.

(b) Fee income: The "cash flows" from many of the fees a bank generates do not happen at the time of the transaction. That is because fees are added to the balance of a loan or deducted from a balance already on deposit with the bank. Again, cash may move internally between accounts, however, the reporting entity did not experience a cash inflow or outflow.

(c) Withdrawals: A withdrawal from a bank is not a "cash outflow" transaction initiated by the bank. Rather, it relates to a customer withdrawing funds, which reduces an asset and a liability on the bank's books. Presenting this particular outflow on an SCF does not communicate anything to a user of the bank's financial statements that the SFP doesn't already communicate (that is, a reduction in funds on deposit).

7. Another common response is that cash inflows for a bank are different from the cash inflows of other entities such as a manufacturer or a retailer. A bank will recognize a corresponding liability from a cash inflow from a customer deposit. However, when a retailer receives cash from a customer it typically will relieve a receivable that was the result of revenue generation; there is no corresponding liability and the retailer can do whatever it wants with the cash.

8. That difference leads to the viewpoint that an SCF for a financial services entity is not meaningful. Based on the fundamentals of the underlying transactions, a user of the bank's financial statements does not have the same stake in those flows as a user of a retail entity's financial statements. Simply put, cash received from a customer of a retail entity is available to the entity whereas cash deposited in a bank by a customer is not available to the entity.

9. Finally, banks assert that they manage liquidity daily and to present the cash flows from a previous period in the SCF does not accurately reflect how a bank manages its liquidity risk.

10. Although preparers of financial statements made most of the comments about the SCF not being useful, the users of a financial services entity's financial statements that we spoke to confirmed those views. In their comment letters and in conversations with the staff, those users state that they typically do not use the SCF in their analyses. Users of a financial services entity's financial statements appear to be far more interested in the details of the SFP.

11. Another reason users of financial statements might not use the SCF in their analysis is that the current categorization in the SCF isn't meaningful. The staff think the changes to the sections and categories as defined by this project and as referenced in paragraph 2(d) respond to this issue.

12. The analyst portion of the field test found that users of financial statements who reviewed Bank Corp's financial statements stated that the direct method SCF was the second most useful aspect of the discussion paper. Based on follow-up conversations with those analysts, it appears that the analysts were indicating general support for a direct method SCF, not that there was a particular benefit to the direct method SCF presented by a bank.

Staff analysis

13. The limitations of the SCF described above are not solely related to the indirect versus direct presentation. Rather, they relate to the information itself not being representative of what is actually happening with the business in which a financial services entity is engaged.

14. However, these comments are made based on the SCF as it is presented today. The staff think there may be meaningful information to be presented in a bank's SCF if those flows reflect the substance of the transactions to which the bank is a

party, and are not just a reflection of when cash comes in the door and when cash goes out the door.

15. One way to accomplish this would be to require the activities of a financial services entity to be reflected in the SCF as if they are settled by external funds, regardless of whether the settlement is funded from an in-house account. This would provide a direct method SCF that not only presents the inflows and outflows of cash but the change in the *character* of the cash within the entity. To clarify, the cash at a bank changes character when it goes from being the depositor's cash to the bank's cash (for example, after a bank deducts a fee or deducts a mortgage payment from an account as explained in paragraphs 6(a) and 6(b)).

16. The staff think that a direct method SCF prepared as described in paragraphs 14 and 15 would clarify which cash flows are to the benefit of the bank and its shareholders (and other stakeholders). Those modifications to how a financial services entity presents its SCF should address the reasons why respondents think a direct method SCF would not be useful for a bank (see paragraphs 6−8).

17. Although those modifications might improve a direct method SCF for a financial services entity, the modifications do not address the cost issues raised by financial services entity respondents. In fact, the staff think that the modifications may increase the cost of preparing a direct method SCF because a financial services entity would have to track the changes in the character of cash that is on hand.

Staff recommendation

18. The staff think that the views expressed by users of financial statements regarding the information in the SCF are based on the inadequacies of how cash flow information is presented in the SCF today. At this point in the project, the staff recommend that a financial services entity not be exempt from the requirement to present a direct method SCF. The staff also recommend that in preparing a direct method SCF, a financial services entity should present cash inflows and outflows so that the SCF reflects the substance of its transactions (that is, as if they were

settled by external funds). The staff suggest that the exposure draft specifically seek input on the costs and benefits of this type of direct method SCF from preparers, auditors, and users of financial services entity financial statements.

Question 1

The staff recommend that a financial services entity be required to present a direct method SCF and present cash inflows and outflows so that the SCF reflects the substance of its transactions (that is, as if they were settled by external funds). **Do the boards agree with this recommendation**?