STAFF PAPER

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IASB® Meeting

Agenda paper 21–21E (November 2016)

Project	**Primary Financial Statements**
Paper topic	Scope of the project— Other primary financial statements and segment reporting

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Purpose of paper

1. This Agenda Paper outlines the staff's recommendations concerning:
   - (a) the statement of cash flows;
   - (b) the statement of financial position;
   - (c) segment reporting;
   - (d) the development of templates for the primary financial statements for particular industries; and
   - (e) the development of a principle for aggregating and disaggregating information in the primary financial statements.
2. The staff's recommendations for improving the statement(s) of financial performance are included in Agenda Paper 21A.
3. Our recommendations in this paper as well as our recommendations in Agenda Paper 21A could be included in a Discussion Paper as part of the Board's Primary Financial Statements project.
4. Our recommendations are based on what we learned in our initial research on the scope of the Primary Financial Statements project that we presented to the Board at its November 2016 meeting.

Staff recommendations

5. The staff recommend that the forthcoming Discussion Paper should explore the:

   (a) elimination of options for the classification of the cash effects of interest and dividends in the statement of cash flows.

   (b) alignment of the operating section across the statement of cash flows and the statement(s) of financial performance.

   (c) starting point of the indirect reconciliation of cash flows. Our view is that this reconciliation should have a consistent starting point and that this could be 'operating profit' from the statement(s) of financial performance.

   (d) development of templates for the primary financial statements for a small number of industries.

   (e) development of a principle for aggregating and disaggregating items in the primary financial statements.

6. We recommend that the Discussion Paper should not explore improvements to the statement of financial position, segment reporting or to the presentation of discontinued operations.

Structure of this paper

7. This Agenda Paper is set out as follows:

   (a) **Section 1:** improvements to the statement of cash flows (paragraphs 8–26);

   (b) **Section 2:** improvements to the statement of financial position (paragraphs 27–29);

   (c) **Section 3:** improvements to segment reporting (including the presentation of discontinued operations as part of the segment note) (paragraphs 30–32);

   (d) **Section 4:** developing templates for the primary financial statements for particular industries (paragraphs 33–37); and

   (e) **Section 5:** developing a principle for aggregating and disaggregating information in the primary financial statements (paragraphs 38–46).

<u>Section 1.</u> Improvements to the statement of cash flows

8. The users that we contacted and the evidence that we reviewed did not suggest major revisions to the structure or content of the statement of cash flows. We heard that this is because the main focus of their analysis is the statement(s) of financial performance. However, users suggested some improvements to the statement of cash flows to eliminate some diversity in practice and achieve consistency with the statement(s) of financial performance. We describe these proposed improvements below:

   (a) *<u>Section 1.1:</u>* removing the options for classifying cash flows from interest and dividends (paragraphs 11–16);

   (b) *<u>Section 1.2:</u>* aligning the operating section across the statement of cash flows and the statement(s) of financial performance (paragraphs 17–21); and

   (c) *<u>Section 1.3:</u>* having a consistent starting point for the indirect reconciliation of cash flows (paragraphs 22–26).

9. The UK Financial Reporting Council (FRC) published a Discussion Paper, Improving the Statement of Cash Flows in October 2016, which discusses some proposals to improve the statement of cash flows. The comment period deadline for this is 28 February 2017. A summary of these proposals can be found in Appendix A of this paper.

10. We are not proposing that the Board explore all the changes suggested in the FRC's Discussion Paper. Instead, our proposal is to focus on targeted changes to the statement of cash flows that were suggested by our research and outreach. However, our plan is to follow closely the feedback received on the FRC's Discussion Paper because it might help us to identify other potential changes in addition to the ones we describe below.

1.1 Removing the options for classifying cash flows from interest and dividends

What did we learn?

11. We learned that:

(a) many users support the removal of options for reporting dividends and interest in the statement of cash flows. They said the variation among entities is often not meaningful and only makes comparative analyses difficult.[1]

(b) academic studies identified diversity in practice on the classification of the cash effects of interest and dividends in the statement of cash flows.[2]

(c) many entities (in the sample of financial statements that we reviewed) classify interest and dividends in different sections of the statement of cash flows.[3]

How could the Discussion Paper address the classification of interest and dividends in the statement of cash flows?

12. We note that paragraphs 31 –34 in IAS 7 *Statement of Cash Flows* allow flexibility on the classification of interest paid or received and dividends paid or received as either part of operating, investing or financing activities.

13. We think that the Discussion Paper could explore the removal of options for the classification of interest and dividends in the statement of cash flows by prescribing the classification for these items. In our view this will reduce diversity in practice and will make the statement of cash flows from different entities more comparable.

14. However, removing options may mean we have to revise the definitions of operating, investing or financing activities in IAS 7, because these definitions are broad and lead to inconsistencies in classification. Take, for example, the case of interest paid. This cash outflow can be classified as either:

(a) an operating activity—because operating activities are described in paragraph 14 of IAS 7 as the cash effects of 'transactions and other events that enter into the determination of profit or loss'; or

(b) as a financing activity—because financing activities are described in paragraph 6 of IAS 7 as those 'that result in changes in the size and composition of the contributed equity and borrowings of the entity'.

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[1] Refer to paragraph 30 of Agenda Paper 21D of November 2016.

[2] Refer to slide 7 of Agenda Paper 21C of November 2016.

[3] Refer to paragraphs 60–61 of Agenda Paper 21A of November 2016.

Paragraph 33 of IAS 7 further refers that interest paid represents a cost of obtaining financial resources that changes the composition of the borrowings of an entity.

15. The Discussion Paper should also explore whether prescribing a particular classification for interest and dividends might be appropriate for financial and non-financial institutions because what is considered 'financing' for a non-financial institution is often considered 'operating' for a financial institution. For example, interest received and paid are commonly considered to be operating cash flows for banks and other financial institutions. However, non-financial entities might view them in a different way (ie as part of investing or financing activities). The project could explore also classifying interest and dividends in a separate category (for example interest paid could be classified in a category called 'cash flows from servicing debt').

16. We may also need to explore aligning the proposed classification in the statement of cash flows with the classification of the corresponding item(s) reported in the statement(s) of financial performance. For example, if interest paid is considered a financing cash flow, then interest expense should be considered a financing item.

Section 1.1: Question for the Board
1.1.1 Does the Board support our recommendation to explore eliminating the options for the classification of interest and dividends in the statement of cash flows?

1.2 Aligning the operating section across the statement of cash flows and the statement(s) of financial performance

What did we learn?

17. We learned that:

(a) users think that there should be consistency between how an entity defines its operating profit and its cash flows from operating activities as this will improve their understanding of the extent to which operating profit is converted to cash; and[4]

(b) some academic studies favour in general the alignment of the primary financial statements and more particularly, the alignment of key subtotals such as 'operating profit'. [5]

How could the Discussion Paper address the alignment of the 'operating section'?

a) Address the degree of alignment

18. If the Discussion Paper develops a framework for entities to determine and present an operating profit metric in the statement(s) of financial performance, then it would make sense to align this metric with the subtotal of operating activities in the statement of cash flows. Making this alignment would help users to improve their understanding of and insight into an entity's cash conversion cycle (ie the extent to which operating profit is converted to cash).

19. The degree of alignment between the statement(s) of financial performance and the statement of cash flows is an aspect that should be carefully considered because:

    (a) a high degree of alignment at line-item level might enable users to better forecast future cash flows. However, such an approach could be impractical or too costly for some entities; likewise,

    (b) a lower degree alignment between the two statements could imply less costs of preparation, but might not assist users in improving their ability to link the operating section in both statements.

b) Develop or describe what is operating from a cash flows perspective

20. Aligning the operating section in the statement(s) of financial performance with the operating section of the statement of cash flows would entail developing a definition or description of 'operating' that could be used across both statements.

21. The Discussion Paper could explore either having a broad definition of operating activities that permits management to decide which activities would be considered as

[4] Refer to paragraph 31 of Agenda Paper 21D of November 2016.

[5] Refer to slide 7 in Agenda Paper 21C of November 2016.

‘operating’; or the project could define operating activities more narrowly. However, as we have referred to in paragraph 6(c) of Agenda Paper 21A defining or describing ‘operating’ is quite challenging because there are different views on what should be considered an operating activity. In addition, aligning the operating section across the two statements could result in some drastic changes to the definition of ‘operating cash flows’ in IAS 7. For instance:

(a) the operating cash flows section could stop being a residual category because, for example, some activities that are currently classified as ‘operating’ by default would have to be classified as investing or financing activities; and

(b) capital expenditures may no longer be considered part of ‘investing’ activities. Classifying capital expenditures as operating cash flows is arguably consistent with the classification of depreciation and amortisation in the operating section of the statement(s) of financial performance.

Questions for the Board (Section 1.2)
1.2.1 Does the Board support our recommendation to explore aligning the operating section of the statement of cash flows with operating profit in the statement(s) of financial performance?

1.3 Having a consistent starting point for the indirect reconciliation of cash flows

What did we learn?

22. We learned that:

(a) many entities (in the sample of financial statements that we reviewed) use profit or loss as a starting point for the reconciliation to cash flows from operating activities, however, some entities used other starting points such as ‘profit attributable to shareholders’, ‘profit from continuing operations’, ‘profit before tax’, ‘operating profit and ‘cash generated from operations’;[6]

[6] Refer to paragraphs 52–58 of Agenda Paper 21A of November 2016.

(b) one of the studies also identified different starting points for the indirect method of operating cash flows; and[7]

(c) some users noted that the starting point for the indirect reconciliation of cash flows varies which they think hinders comparisons and analysis.[8]

How could the Discussion Paper address the starting point for the indirect reconciliation of cash flows?

23. We observe that paragraph 20 of IAS 7 states that, under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss.[9] However, our research and outreach activities showed that entities use different starting points for the indirect reconciliation of cash flows.

24. We think that the focus of the Discussion Paper should be on having a consistent starting point for an indirect reconciliation of cash flows. If the starting point were to be a subtotal other than profit or loss, then the Board would need to prescribe and define subtotals such as earnings before interest and tax (EBIT) or operating profit.

25. If the Discussion Paper explores starting the indirect reconciliation of cash flows with for example, 'operating profit' this could bring some benefits, not only in terms of easing the alignment of the statement(s) of financial performance and the statement of cash flows, but also because it would remove the need to reconcile changes in items associated with investing or financing cash flows which would:

(a) simplify the indirect reconciliation of cash flows; and

(b) make it easier for users to understand the link between operating profit and operating income across the statement(s) of financial performance and the statement of cash flows.

26. We observe that the UK Financial Reporting Council's (FRC) Discussion Paper discusses a proposal to start the indirect reconciliation of cash flows with operating profit (refer to paragraphs 4.4-4.6) but only if 'operating' profit is defined with enough precision.

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[7] Refer to slide 10 of Agenda Paper 21C of November 2016.

[8] Refer to paragraph 51 of Agenda Paper 21D of November 2016.

[9] The Illustrative examples accompanying IAS 7 use 'profit before tax' as the starting point for determining net cash flow from operating activities.

Question for the Board (Section 1.3)
1.3.1 Does the Board support our recommendation to explore having a consistent starting point in the indirect reconciliation of cash flows and that this could be the subtotal 'operating profit'?

Section 2. Improvements to the statement of financial position

What did we learn?

27. We learned that:

    (a) users did not express major concerns on, and did not suggest major revisions to, the structure or content of the statement of financial position; however, some thought that having more disaggregation in this statement would be helpful.[10]

    (b) the academic studies that we reviewed did not report issues on the presentation of the statement of financial position; and

    (c) there were no major inconsistencies in the presentation of the statement of financial position in the sample entities that we reviewed.[11][12]

Should the Discussion Paper address the statement of financial position?

28. On the basis of the feedback received and the results of our review of financial statements and academic research, we suggest that the Discussion Paper should not explore targeted improvements to the presentation of the statement of financial position.

29. However, to address the concerns about the lack of disaggregation in the statement of financial position, it would be useful if the Discussion Paper considers developing disaggregation concepts or a disaggregation principle that would apply equally to all the primary financial statements. We explore this issue in **Section 5** of this paper.

[10] Refer to paragraphs 14(a) and 17(c) of Agenda Paper 21D of November 2016.

[11] Refer to paragraphs 63–66 of Agenda Paper 21A of November 2016.

[12] This could be due to the fact that paragraph 54 of IAS 1 requires the presentation of more line items making it a more standardised financial statement.

Questions the Board (Section 2)
2.1. Does the Board agree that the Discussion Paper should not address the presentation of the statement of financial position?

Section 3. Improvements to segment reporting (including the presentation of discontinued operations as part of the segment note)

What did we learn?

30. We learned that:

(a) users hold the view that the reporting of line items and subtotals by segment is often very limited or highly aggregated, with the consequence that they find it difficult to perform their analyses.[13]

(b) the entities in our sample of financial statements provide different levels of disaggregation of the line items by segment.[14]

(c) users need more detail in the segment note according to some studies.[15]

(d) a few users hold the view that the single line item for discontinued operations in the statement(s) of financial performance is too aggregated and suggest that it should be replaced with more detailed line items in the segment note. These users thought this change would lead to more information about the discontinued operations.[16]

What can we do in respect of the concerns raised about segment reporting and discontinued operations?

31. We acknowledge that some users would like the Board to reconsider the IFRS Standards dealing with segments and the presentation of discontinued operations. However, we are of the view that addressing these topics would significantly delay the project and would distract the Board from more significant areas of needed improvement in presentation.

[13] Refer to paragraph 34 of Agenda Paper 21D of November 2016.

[14] Refer to paragraphs 67–74 of Agenda Paper 21A of November 2016.

[15] Refer to slide 11 in Agenda Paper 21C of November 2016.

[16] Refer to paragraph 35 of Agenda Paper 21D of November 2016.

32. In addition, we observe that the Board has already discussed the number of line items reported in segment reporting at its October 2016 meeting, when it discussed the feedback received on the post-implementation review of IFRS 8 *Operating Segments*. At that meeting the Board tentatively decided not to mandate the number of line items reported within the segment note because this would not be in line with the 'management approach' which is the underlying principle in IFRS 8.[17] The Report and Feedback Statement *Post-implementation Review: IFRS 8 Operating Segments* that was issued in July 2013 stated that although investors' views on IFRS 8 were mixed, the Board's conclusion was that the Standard was functioning as expected and no revision of its principles was necessary.[18]

Questions for the Board (Section 3)
3.1. Does the Board agree that the Discussion Paper should not address segment reporting?
3.2. Does the Board agree that the Discussion Paper should not address discontinued operations?

Section 4. Developing templates for the primary financial statements for particular industries

What did we learn?

33. We learned that:

(a) users were of the view that the Board should develop illustrative examples of the primary financial statements tailored to a limited number of specific industries (eg banks, insurance, property, financials) that users could analyse and compare more easily. Several of these users said that these examples should be a required, rather than an optional format to promote comparability within the same industry.[19]

[17] Refer to IASB Update of October 2016.

[18] For example, refer to page 6 of this report in http://www.ifrs.org/Current-Projects/IASB-Projects/PIR/IFRS-8/Documents/PIR-IFRS-8-Operating-Segments-July-2013.pdf

[19] Refer to paragraph 33 of Agenda Paper 21D of November 2016.

(b) most participants at the Board's IFRS Taxonomy Consultative Group (ITCG) mentioned that having a format or a structure for the primary financial statements could increase comparability and data quality.[20]

Should the Discussion Paper develop templates of the primary financial statements?

34. We agree that developing templates for the primary financial statement for particular industries could provide more standardised financial statements that users could analyse and compare more easily. Such templates would also help the development of the IFRS Taxonomy.

35. We therefore recommend that the Discussion Paper should explore the development of templates for the primary financial statements for a small number of industries (for example, banks, non-financial institutions, insurance companies and investment property companies). The Discussion Paper would include some high-level illustrative primary financial statements similar to the ones we included in the materials that we distributed to stakeholders during our outreach activities (refer to the illustrations in pages 7–8 of Agenda Paper 21E of November 2016).

36. Such high-level illustrative primary financial statements would also help to illustrate the Board's preliminary views on possible improvements to the primary financial statements.

37. Depending on the feedback we receive on the Discussion Paper, the Board could consider developing more detailed templates in coordination with the Taxonomy team and with the assistance of specialists from different industries (for example, experts on the banking sector, insurance or real estate).

Question for the Board (Section 4)
4.1. Does the Board agree that the Discussion Paper could explore the development of templates for the primary financial statements for a small number of industries?

[20] Refer to paragraph 44 of Agenda Paper 21D of November 2016.

Section 5. Developing a principle for aggregating and disaggregating information in the primary financial statements

What did we learn?

38. We learned that:

(a) in the statement(s) of financial performance, of the entities that we analysed, a few did not present expenses by nature or by function (eg they present operating expenses as a single line item). Some also included a large 'other' category in primary financial statements that made it difficult to compare items presented by different entities.[21]

(b) members from the ASAF and many users expressed dissatisfaction with the current level of disaggregation and transparency about individual line items or subtotals and suggested the Board to develop more guidance on aggregation and disaggregation.[22]

(c) a few members from the CMAC and GPF and a few investors from Japan thought that the level of disaggregation of the statement of financial position was not sufficient and that more disaggregation would be helpful[23].

Should the Discussion Paper consider further developing the aggregation and disaggregation requirements for the primary financial statements?

39. IAS 1 *Presentation of Financial Statements* has requirements on the aggregation and disaggregation of line items in the financial statements. The aggregation process and the placement of the information (whether on the statement or the notes) is based on an entity determining if an item is material.

40. However, the requirements in IAS 1 are principle-based and give preparers flexibility in deciding how much detail is necessary in order to provide enough information to meet the needs of its primary users, which has led to a lack of comparability and understandability in the information presented.

[21] Refer to paragraphs 21 and 65 of Agenda Paper 21A of November 2016.

[22] Refer to paragraphs 18(c) and 52 of Agenda Paper 21D of November 2016.

[23] Refer to paragraph 17(c) and 52 of Agenda Paper 21D of November 2016.

41. We are of the view that the Discussion Paper could explore the requirements on aggregation or disaggregation in IAS 1 and determine whether these requirements could be enhanced to help users to access the information that they need and to make financial statements more comparable and more understandable.

42. We observe that the Discussion Paper could potentially explore the following aspects:

    (a) the characteristics that could be used for aggregating homogenous items or disaggregating dissimilar items. For example, one of these characteristics could be a similar or a different measurement basis.

    (b) determine how to distinguish a ‘functional’ line from a ‘natural’ line and when to require disaggregation both by function and by nature (or by nature or by function only).

    (c) require more minimum line items in the primary financial statements.

43. We note that the Financial Statements Presentation Staff Draft contains some general guidance for disaggregating items in the financial statements that could be examined as part of the Discussion Paper.

44. We also note that the Principles of Disclosure project has developed some guidance on materiality and aggregation for the notes to the financial statements but has not developed general principles for disaggregation and aggregation in the primary financial statements.

45. We think that the Discussion Paper could also explore some specific areas where disaggregation is needed. For example, during our outreach activities we heard that users want to understand how the changes in working capital amounts (and other changes in non-current assets or liabilities) in an indirect reconciliation of cash flows relate to the corresponding beginning and ending balance amounts in the statement of financial position.[24]

46. We think that to address the concerns raised the Discussion Paper could explore requiring or encouraging greater disaggregation of the changes in working capital (and other changes in other non-current assets or liabilities) in an indirect reconciliation of cash flows. For example, the *change in receivables and other assets*

[24] Refer to paragraph 53 of Agenda Paper 21D of November 2016.

in an indirect reconciliation of cash flows could be required to be further disaggregated into its different components (ie change in accounts receivable, current assets, non-current assets, and tax refunds) to give users a better view into the cash and non-cash changes of some of the line items in the statement of financial position.

Question for the Board (Section 5)
5.1 Does the Board agree that the Discussion Paper should explore ways to enhance the requirements on aggregation or disaggregation for the financial statements?

Appendix A

A1. The following is an extract from the Discussion Paper *Improving the Statement of Cash Flows* published by the UK Financial Reporting Council. It summarises the main suggestions made in that Discussion Paper[25].

The usefulness of information about cash flows (Section 1)

Requirements of current IAS 7	*Suggestions made in [the Discussion Paper]*
Investing and financing activities that do not require the use of cash shall be excluded from a statement of cash flows, but such transactions shall be disclosed elsewhere in the financial statements. (paragraphs 43 and 44)	Notional cash flows should not be reported in any section of the statement of cash flows. However, transparent disclosure of non-cash transactions should be required.

The classification of cash flows (Section 2)

Requirements of current IAS 7	*Suggestions made in [the Discussion Paper]*
Operating activities' include all activities that do not meet the definition of investing or financing activities. (paragraph 6)	Operating activities should be positively defined or described (perhaps as including transactions with customers, employees and suppliers) rather than being a residual or default classification. It should be clear that items should not be excluded from operating activities merely because they are unusual or non-recurring. However, these items should be separately disclosed. Items that do not relate to operating activities (or another defined section of the cash flow statement) should be reported in a separate section of the cash flow statement.
Cash payments to acquire property, plant and equipment, intangibles and other long term assets are reported within cash flows from investing activities. (paragraph 16(a)). Entities are encouraged to disclose the aggregate cash flows that represent increases in operating capacity separately from those that are required to maintain operating capacity. (paragraph 50(c))	Cash outflows to acquire property, plant and equipment should be reported as a cash outflow from operating activities. As such outflows are likely to be volatile, a sub-total of cash generated from operating activities before capital expenditure should be disclosed. Entities should be encouraged to disclose the extent to which expenditure on property, plant and equipment represents 'replacement' or 'expansion'.
Cash flows from interest and dividends received and paid shall be classified consistently as either operating, investing or financing activities. (paragraph 31)	Cash flows on financing liabilities (including the payment of interest) should be reported in the financing category of the cash flow statement. Cash received from customers (including any amount treated as interest income in the statement of profit or loss) should be reported within cash flow from operating activities.

[25] This extract can be found in pages 32 -34 of the FRC's Discussion Paper.

Cash flows arising from taxes on income shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. (paragraph 35)	Cash flows relating to tax should be reported in a separate section of the statement of cash flows.

Cash equivalents and the management of liquid resources (Section 3)

Requirements of current IAS 7	*Suggestions made in [the Discussion Paper]*
Cash flows are defined as inflows and outflows of cash and cash equivalents. (paragraph 6)	The statement of cash flows should report inflows and outflows of cash, rather than cash and cash equivalents. A separate section of the statement of cash flows should report cash flows relating to the management of liquid resources. Liquid resources should be limited to assets that are readily convertible into cash, but should otherwise not be restrictively defined. Entities should be required to disclose their policy for the management of liquid resources, and the classes of instruments that are treated as such.

Reconciliation of operating activities (Section 4)

Requirements of current IAS 7	*Suggestions made in [the Discussion Paper]*
No reconciliation is required where a direct method cash flow statement is presented. (paragraphs 18–20) It is implied that a reconciliation is required where an indirect method cash flow statement is presented.	A reconciliation of profit and cash flow should be presented in all cases (including where a direct method cash flow statement is presented). The reconciliation should be required to reconcile a sub-total in the statement of profit or loss that represents operating income (rather than, for example, net profit or loss) and reconcile that to cash flow from operating activities. Because the amounts reported in the reconciliation are not cash flows, the reconciliation should not be reported within the statement of cash flows itself, but as a supplementary note, perhaps immediately following the statement of cash flows.

Direct or indirect method (Section 5)

Requirements of current IAS 7	*Suggestions made in [the Discussion Paper]*
Use of the direct method for presenting cash flow from operating activities is encouraged but not required. (paragraphs 18–19). An indirect method of deriving net cash flow from operating activities may be derived either: (i) by adjusting profit or loss for: changes in inventories and operating receivables and payables; non-cash items; and items for which the cash effects are investing financing cash flows; or (ii) by adjusting the revenue and expenses disclosed in the statement of comprehensive income for changes in inventories and operating receivables and payables (paragraph 20).	It is not necessary for an accounting standard to require or permit a specific method for deriving 'cash flow from operations'. As a reconciliation of profit and cash flow from operating activities is to be required, the indirect method is likely to be widely used in practice: however the direct method should not be prohibited. However, an accounting standard should identify components of cash flow from operating activities that are particularly significant, and require disclosure either of the amount of such components or of changes in related working capital items.