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European Financial Reporting Advisory Group

IASB/FASB discussion paper *Preliminary Views on Financial Statement Presentation*

Draft Responses to the Questions 1-13

INTRODUCTION

1 The intention at the December 2008 EFRAG meeting is for EFRAG members to continue debating the IASB/FASB (the boards) discussion paper on financial statement presentation and to provide final input to staff for drafting EFRAG's draft comment letter.

2 The questions below, which are taken from the DP, are grouped as follows:

Paper 3.1

(a) questions concerning basic principles and classification of items (Q1-10)

(b) some of the questions concerning implications for each financial statement (Q11-13), and

Paper 3.2

(c) the remaining questions concerning implications for each financial statement (Q14-20), and

(d) questions concerning proposed additional notes to financial statements, including reconciliation schedule questions (Q21-25).

3 Questions 1-13 have already been discussed at the November 2008 EFRAG meeting, so the draft responses below to those questions are based on EFRAG's preliminary views. We would like to finalise those responses subject to drafting in the session on Wednesday evening.

4 EFRAG has not yet discussed Questions 14-25 in any detail, so the draft responses below to those questions are based on the initial EFRAG members' thoughts received at the October 2008 meeting together with some additional staff comments. We hope that it will be possible to spend most of the Thursday session on these responses.

QUESTIONS CONCERNING BASIC PRINCIPLES AND CLASSIFICATION OF ITEMS

Question 1 *Would the objectives of financial statement presentation proposed in paragraphs 2.5-2.13 (cohesiveness, disaggregation, helping users to assess an entity's liquidity and financial flexibility) improve the usefulness of the information provided in an entity's financial statements and help users make better decisions in their capacity as capital providers? Why or why not? Should the boards consider any other objectives of financial statement presentation in this discussion paper? If so, please describe and explain.*

5 EFRAG broadly supports the proposed objectives as long as they are not taken to extreme because that might not result in useful information for users. However, we believe that the above question is best addressed by considering each of the proposed objectives in turn.

<u>Cohesiveness objective</u>

6 As explained in paragraphs 2.5 and 2.6, the DP proposes that an entity should present information in its financial statements in a manner that portrays a cohesive financial picture of its activities. A 'cohesive financial picture' is described as meaning the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible. Financial statements that are consistent with the cohesiveness objective would display data in a way that clearly associates related information across the statements so that the information is understandable. Is this cohesiveness objective appropriate and complete?

7 EFRAG thinks that cohesiveness principle is a good objective in the way that it is described in the opening two sentences of paragraph 2.6 (see above). However, it quickly becomes apparent that the DP views the cohesiveness principle as requiring an almost slavish adherence to a 'everything in the same order and disaggregated to the same extent' rule; we do not think that is what the cohesiveness principle demands, nor do we think it is appropriate. In our view, it is very important the implementation of the cohesiveness principle is done in a way that is thoughtful and pragmatic. The debate should therefore be primarily about where the balance should be struck. The paragraphs that follow give some examples of the issues that we think show there is a need for a thoughtful and pragmatic application of the cohesiveness principle.

8 Currently under IFRSs an entity is required to present its postemployment benefit plan assets and obligations as a net asset or net liability. That net asset or net liability would be classified, in the proposed presentational model, in the operating category rather than the financing section (because the net post-employment asset or liability relates to employee remuneration or compensation and because it is not a financial asset or a financial liability). Following the cohesiveness principle, an entity should than classify the related post-employment benefit expenses, including items such as service cost, interest cost and return on plan assets, and cash flows in the same category as its net post-employment benefit asset or liability—in other words, operating. Yet the extent to which an entity chooses to fund its post-retirement benefit obligations is clearly a financing decision, and the interest cost and return on plan assets would appear to be more in the nature of investing or financing items rather than operating items. The problem here, EFRAG thinks, is that the DP is wrong to insist that all the flows from a single contract should be classified in the same way.

9 With a finance lease, the lessee recognises on its statement of financial position the whole asset and a matching liability to the lessor. Following the proposed presentational model, the asset and liability would have to be classified according to the entity's classification policy, based on the management approach. In contrast to the postemployment benefit case, both the asset and the liability could be classified either in the same category (most likely operating, as illustrated in the Appendix A of the DP on page 108) or in separate categories, as for example the asset in the operating category and the liability in the financing section (see paragraph 2.58 of the DP). Consequently, all the flows from finance lease could be found in one category (as illustrated in the Appendix A of the DP on pages 106 and 110) or in different categories.

10 Other examples of potentially controversial applications of cohesiveness principle would be the costs of the treasury department, where it is not clear whether the costs of the team that manages the entity's financing should (following the cohesiveness objective) be treated as a financing cost or be classified to another category, or dividends, where the boards propose that the classification of dividends payable and the related cash flows should be based on the existing classification of dividends payable as a liability. Therefore, dividend payments on ordinary (common) shares should be classified as a financing liability in the statement of financial position and in the financing liability category in the statement of cash flows, not the equity section.

Disaggregation objective

11 The DP proposes that an entity should disaggregate information in its financial statements in a manner that makes it useful in assessing the amount, timing and uncertainty of its future cash flows (paragraphs 2.7-2.11). Classification in financial statements facilitates analysis by grouping items with essentially similar economic characteristics, providing meaningful totals and subtotals for them, and disaggregating items with essentially different economic characteristics.

12 EFRAG agrees entities should disaggregate the information in their financial statements in a manner that is useful. However, we have two concerns: the risk of disaggregation causing clutter, and the proposal's focus on assessing future cash flows. These concerns are discussed further below.

13 Paragraph 2.10 of the DP states that 'in applying the disaggregation objective, an entity should include, as appropriate, additional line items in its financial statements to explain the components of its financial position, performance and cash flows. The boards acknowledge that there is a delicate balance between having too much information and having too little information. Thus, it is important that application of the disaggregation objective should lead to sufficient but not excessive disaggregation.' EFRAG agrees that there is a delicate balance to strike, but is not convinced that the proposals in the paper always manage to strike that balance. We think the problem is often about whether the information should be provided on the face of the financial statements or in the notes. In our view, the disaggregation objective should not always require the information should be provided on the face of the financial statements, because that can cause clutter that would create conflict with the more general objectives of understandability and clarity. As paragraph 45 of the existing IASB Framework states 'in practice a balancing, or trade-off, between qualitative characteristics is often necessary.'

14 When EFRAG responded to the ED *An Improved Conceptual Framework for Financial Reporting—Chapter 1 and Chapter 2*, it expressed concern about the ED's unsupported assertion that the main focus of financial reporting should be on an entity´s ability to generate future net cash flows. In our view, the proposed objective

of financial reporting proposed in that ED requires a broader focus than merely future cash flows. For that reason, we are also not comfortable with the proposal that the focus of the disaggregation objective should be on information that is useful is assessing future cash flows.

As a separate but related point, we also expressed concern in responding to that ED that, although the ED states that users need information that helps them make an assessment about future cash flows, it does not go on to explain what sort of information is most useful for that purpose. That makes it difficult to operationalise the disaggregation objective now being proposed.

<u>The liquidity and financial flexibility objective</u>

15 The DP proposes that an entity should present information in its financial statements in a manner that helps users to assess the entity's ability to meet its financial commitments as they become due and to invest in business opportunities (paragraphs 2.12 and 2.13).

16 The DP explains that 'liquidity' here is about the entity having the resources (including its ability to raise capital and to use existing assets to generate future cash flows) to fulfil its financial commitments. 'Financial flexibility' is a broader notion than liquidity, relating to an entity's ability (a) to earn returns on investments and to fund future growth and (b) to take effective action to alter amounts and timing of cash flows so that it can respond to unexpected needs and opportunities.

17 EFRAG believes that this liquidity and financial flexibility objective has merit, but believes there are also some potential problems with it. In particular:

(a) we note that there is no reference to financial flexibility in the existing or proposed revised IASB Framework; perhaps there should be. We note that there is a reference to it in the FASB's and ASB's Frameworks; and

(b) we have already mentioned our concern that disaggregation objective focuses too much on future cash flows, and we think that is also true of the financial flexibility part of the objective. For example, we think the description of the notion in paragraph 2.13(b) too narrow; on the other hand, if the reference to 'to alter amounts and timing of cash flows' was removed (so that the paragraph refers to financial flexibility as involving an ability to take effective action to respond to unexpected needs and opportunities) we would strongly support it.

<u>Are other financial statement presentation objectives needed?</u>

18 We think that there are other important objectives for financial statement presentation. However, they apply to financial statements in general and are thus already stated in the IASB's Framework.

19 Having said that, we think it might be useful to explain briefly how the financial statement presentation objectives relate to (and interrelate with) the objectives and qualitative characteristics in the Framework. We assume, for example, that they are thought to flow from those characteristics and therefore do not overrule them in any way, but if that is the case it would be helpful to make that clear.

20 One example of why this needs to be clarified is because of the tension between comparability and the management approach. Despite the fact that some could argue that the proposed management approach to financial statement presentation would generally impair comparability, EFRAG thinks that in practice there is always a trade-off between different objectives and characteristics and that it is worth

sacrificing some formal comparability for getting more meaningful information. EFRAG believes that it is probably unrealistic to expect comparability between industries; while on the other hand, it is reasonable to expect comparability within an industry and industry-specific harmonisation efforts seem quite likely.

Question 2 *Would the separation of business activities from financing activities provide information that is more decision-useful than that provided in the financial statement formats used today (see paragraph 2.19 of the DP)? Why or why not?*

21 The proposed presentation model requires an entity to present information about the way it creates value (its business activities) separately from information about the way it funds or finances those business activities (its financing activities). The business category should be further divided between operating and investing.

22 The DP proposes that the classification should be determined by first classifying the assets and liabilities, and then applying that same classification to related income, expense and cash flow items. If an entity cannot clearly identify an asset or liability as relating to operating, investing or financing activities, the entity should presume that the asset or liability relates to its operating activities.

23 EFRAG believes that the separation of business activities from financing activities, based on the management approach, would provide information that is more decision-useful to the users. The approach seems to fit well with the way users work, and is also pretty well in line with the way most industrial/commercial entities look at their businesses and currently show their results.

24 We have some concerns about the separation of operating items from investing items, but that is discussed further in our response to question 9 below.

Question 3 *Should equity be presented as a section separate from the financing section or should it be included as a category in the financing section (see paragraphs 2.19(b), 2.36 and 2.52–2.55)? Why or why not?*

25 The boards propose a separate equity section which would include items that meet the IFRS definition of equity. For example, under current IFRS the equity section of the statement of financial position would include items such as ordinary or common shares, treasury shares and retained earnings. All cash flows related to equity should be presented in the equity section in the statement of cash flows. All owner changes in equity should be presented in the statement of changes in equity, and all non-owner changes in equity should be presented in the statement of comprehensive income.

26 EFRAG thinks that, if there is to continue to be a distinction made in the financial statements between equity and liabilities, it is appropriate to present non-owner sources of finance separately from owner sources of finance. We note also that this is the approach that is applied in the IFRSs today and is hence familiar to users.

Question 4 *In the proposed presentation model, an entity would present its discontinued operations in a separate section (paragraphs 2.20, 2.37 and 2.71–2.73). Does this presentation provide decision-useful information? Instead of presenting this information in a separate section, should an entity present information about its discontinued operations in the relevant categories (operating, investing, financing assets and financing liabilities)? Why or why not?*

27 Information about the results of discontinued operations such as the related earnings and cash flows are usually treated differently from the results of continuing

operations because they have different implications for future cash flows, so EFRAG believes that discontinued operations should be presented in a separate section.

Question 5 *The proposed presentation model relies on a management approach to classification of assets and liabilities and the related changes in those items in the sections and categories in order to reflect the way an item is used within the entity or its reportable segment (see paragraphs 2.27, 2.34 and 2.39–2.41).*

(a) Would a management approach provide the most useful view of an entity to users of its financial statements?

(b) Would the potential for reduced comparability of financial statements resulting from a management approach to classification outweigh the benefits of that approach? Why or why not?

28 The advantage of the management approach to classification is, as paragraph 2.39 of the DP explains, that it allows an entity's management to communicate the unique aspects of its business to users of its financial statements. On the other hand, the approach could cause problems for users, at least some of whom quite reasonably would ideally like a largely standardised classification approach in which they know which items will be classified where to be adopted. There are a number of other possible approaches between these two extremes.

29 This is a difficult issue. As already mentioned, EFRAG is aware that in practice there is always a trade-off between different objectives and characteristics, so the issue is whether it is worth sacrificing some comparability for getting information that is more relevant. It is in any case probably unrealistic to expect comparability between industries; but comparability between entities within the same industry is a realistic objective, though not one made any more achievable by the adoption of the management approach. Having said that, industry-specific harmonisation efforts seem quite likely.

30 On balance, EFRAG thinks the approach proposed in the paper is the one that will probably provide the most useful information for users, especially as it could provide additional information about the entity's business model. (EFRAG noted in its comment letter on the ED *An Improved Conceptual Framework for Financial Reporting—Chapter 1 and Chapter 2* that our discussions with users suggest that understanding the reporting entity's business model is essential to enable them to use the financial statements effectively.)

31 EFRAG's biggest concerns with the management approach relate to consistency; the risk that entities might continually adjust their classifications, making it difficult to compare an entity's financial statements over time. These concerns are based mainly on the experience EFRAG members have had with the use of the management approach to determine the segments to be used for segment reporting purposes, where there are apparently frequent changes and restatements in segment reporting because of internal reorganisations that have no impact on the activities themselves and other factors. For that reason we support the DP's proposal that the classification of assets and liabilities in the operating, investing, financing asset, and financing liability categories would be an accounting policy, which would be described in its accounting policy note disclosure (see paragraphs 4.2–4.4 of the DP); and that a change in an entity's classification policy would have to be implemented through retrospective application of the new classification policy to prior periods, as required by the IFRSs.

Question 6 *Paragraph 2.27 proposes that both assets and liabilities should be presented in the business section and in the financing section of the statement of financial position. Would this change in presentation coupled with the separation of business and financing activities in the statements of comprehensive income and cash flows will make it easier for users to calculate some key financial ratios for an entity's business activities or its financing activities? Why or why not?*

32 The approach proposed would result in the separate presentation of net assets for each section in the statement of financial position—and therefore a more fragmented statement of financial position than at present. The DP also proposes that entities should be required to disclose, either on the face of the statement of financial position or in the notes, the totals of all assets and of all liabilities.

33 This proposal will have a significant effect on the statement of financial position, because assets of one type will no longer be shown together and the statement will have many more lines than at present. We think this will present some difficulties for users. However, having discussed the proposed approach with users, we have reached the conclusion that overall the approach will make things easier for users—as long as the totals of all assets and of all liabilities are also shown on the face of the statement of financial position.

Question 7 *Paragraphs 2.27, 2.76 and 2.77 of the DP discuss classification of assets and liabilities by entities that have more than one reportable segment for segment reporting purposes. Should those entities classify assets and liabilities (and related changes) at the reportable segment level as proposed instead of at the entity level? Please explain.*

34 The issue here is at what level should the classification exercise be carried out. If an entity classified its assets and liabilities at the entity level, it would mean that the classification of the assets and liabilities of each reportable segment of an entity would be the same. So for example, regardless of whether a particular type of financial instrument is used in the entity's banking activities or manufacturing activities, it would be classified in the same category. On the other hand, if an entity classified its assets and liabilities at the reporting segment level, that particular type of financial instrument would be classified differently for each segment if its use in each segment is different. It would also mean that, in the entity level financial statements, there would be very different types of assets and liabilities aggregated together within each classification.

35 Although it is simpler to apply an entity level approach—in that only one classification decision needs to be taken for each asset- or liability-type—the boards have concluded that applying the classification guidelines at the reportable segment level should better represent the way an asset or liability is used within an entity because, by definition, reportable segments include operations that are similar in nature and economic behaviour.

36 EFRAG agrees with this conclusion. In our view, any other approach would not be consistent with the adoption of the management approach.

37 Having said that, some guidance might be needed to explain how to apply the classification at the reporting segment level in the case where there are wide divergences in cost structure between segments: would a segment that has only an immaterial amount of one type of expense be compelled to collect and report that amount if for another segment it is more significant, just so that they can be 'added across'?

***Question 8** The proposed presentation model introduces sections and categories in the statements of financial position, comprehensive income and cash flows. As discussed in paragraph 1.21(c), the boards will need to consider making consequential amendments to existing segment disclosure requirements as a result of the proposed classification scheme. For example, the boards may need to clarify which assets should be disclosed by segment: only total assets as required today or assets for each section or category within a section. What, if any, changes in segment disclosures should the boards consider to make segment information more useful in light of the proposed presentation model? Please explain.*

38 The requirements of the IFRS 8 *Operating Segments* are based on the way that management regards an entity, focusing on information about the components of the business that management uses to make decisions about operating matters. Thus, if a piece of information is not provided to the Chief Operating Decision Maker (CODM) as part of the internal segmental information, it is not required to be disclosed under IFRS 8.[1] This raises two questions. Firstly, assuming whether the information is provided to the CODM is not an issue, what information about assets and liabilities should be provided at the segment level? And, secondly, should some or all of that information be required even if it is not provided to the CODM?

39 We think the second question is relatively straight-forward to answer. For as long as we have a segment reporting standard that is based on the 'through the eyes of management' approach, IFRS should not require segment information that is not provided to the CODM. EFRAG believes that it would be inconsistent with the 'through the eyes of management' approach adopted in IFRS 8 to push the classification down to the segment level and thus to require disclosure of certain items that are not reported to the chief operating decision maker.

40 Having said that, we would encourage the IASB to carry out an early post-implementation review of IFRS 8 in order to consider whether it is working effectively and in the way intended, and is likely to continue to do that under the proposals set out in this paper.

41 It is could perhaps be argued that, if under the current presentation system, it is deemed sufficient for entities to disclose only total assets for each segment (rather than say fixed assets, current assets etc.)—when assets are disclosed at all—then it should also be sufficient to disclose only total assets under the proposal. However, we think that if the new classification system's usefulness is to be maximised, it probably will be necessary to require assets and liabilities to be disclosed by category at the segment reporting level—if such information is provided to the CODM. Although this information might sometimes not be provided to the CODM at present, we suspect that in many cases practice will change if a standard along the lines of the DP issued.

***Question 9** Are the business section and the operating and investing categories within that section defined appropriately (see paragraphs 2.31-2.22 and 2.63-2.67 of the DP)? Why or why not?*

42 The DP explains that:

(a) The business section should include assets and liabilities that management views as part of its continuing business activities and changes in those assets and liabilities. Business activities are those conducted with the intention of

[1] To clarify the example of total assets used in the question, it should be noted that the IASB has recently issued an ED that proposes to amend IFRS 8 and require total assets to be disclosed at the segment level only if it is information that is provided to the Chief Operating Decision Maker.

creating value, such as producing goods or providing services. The business section would normally include assets and liabilities that are related to transactions with customers, suppliers and employees (in their capacities as such) because such transactions usually relate directly to an entity's value-creating activities.

(b) The operating category within the business section should include assets and liabilities that management views as related to the central purpose(s) for which the entity is in business. An entity uses its operating assets and liabilities in its primary revenue—and expense-generating activities.

(c) The investing category within the business section should include business assets and business liabilities, if any, that management views as unrelated to the central purpose for which the entity is in business. An entity may use its investing assets and liabilities to generate a return in the form of interest, dividends or increased market prices but does not use them in its primary revenue- and expense-generating activities.

43 We note that these descriptions are rather vague and therefore allow considerable flexibility. However, we do not think that matters because the proposed management approach means there will be considerable flexibility anyway.

44 That point apart, we are broadly happy with how the business section is described.

45 The references in the descriptions to 'related to the central purpose(s) for which the entity is in business' and 'unrelated to the central purpose' suggest to us that the DP's operating and investing categories are based on a notion of 'core' and 'noncore' activities. As the DP explains, this approach is proposed because the boards' preliminary view is that the classification of assets and liabilities based on what management views as related to the central purpose for which the entity is in business will provide more useful information than a narrower or more prescriptive definition of operating and investing.

46 However, we thought that some of the references to the investing category in the second sentence of paragraph 2.33 ('an entity may use its investing assets and liabilities to generate a return in the form of interest, dividends or increased market prices') and elsewhere in the DP suggest a rather different notion to a core/non-core split. We are not sure whether this is a simple labelling issue (i.e. the label 'investing' is misdirecting our thinking, because that word has a common-usage meaning that is different from the meaning it is given in the DP) or whether the issue is more substantial.

47 EFRAG also points out that in some countries (for example Poland) some entities have activities that they have inherited and are not allowed to get rid of. Such activities are not core activities (in that they are not related to the entity's central purpose), but they are also not investing because they are revenue- and expense-generating. Perhaps this example illustrates the point made in the previous paragraph about the confusion the 'investing' label will cause.

48 We do not know whether it is within the scope of this project, but thought nevertheless we should mention that users would welcome some sort of information about expenditure that the entity has incurred and expensed that it views as being 'an investment in the future'. We recognise that this would be difficult to scope precisely, but think that if a management approach is acceptable for classification purposes it probably ought to be acceptable for the purposes of determining whether expenditure is an investment in the future.

49 An entity might use an asset or liability in its business activities for more than one function. For example, an entity's headquarters building might be used in its operations and also be viewed by management as a real estate investment. The boards have yet to discuss how management should classify an item in those circumstances. One possibility would be to classify the asset or liability on the basis of its predominant purpose (operating or investing). This treatment would be consistent with the guidance in the IFRSs for classifying cash receipts and payments that relate to more than one type of activity in the statement of cash flows (DP, paragraph 2.43).

Question 10 *Are the financing section and the financing assets and financing liabilities categories within that section defined appropriately (see paragraphs 2.34 and 2.56-2.62)? Should the financing section be restricted to financial assets and financial liabilities as defined in IFRSs and US GAAP as proposed)? Why or why not?*

50 The boards propose that financing section should include categories for financing assets and financing liabilities and that financing assets and financing liabilities are financial assets and financial liabilities (as defined in IFRSs) that management views as part of the financing of the entity's business and other activities. Thus, not all financial assets and financial liabilities need to be included in financing, but no items that are not financial assets or financial liabilities shall be classified as financing.

51 The boards reasoned that liabilities that relate to a specific operating activity (for example, working capital) are different from liabilities that are generated to fund (finance) an entity's business(es) more generally and thus the financing section would normally include financial liabilities that originated from an entity's capital-raising activities (for example, a bank loan or bonds). In determining whether a financial liability is part of an entity's financing activities, management should consider whether the item is interchangeable with other general (non-owner) sources used to fund its business activities. Financing assets would include mainly treasury assets, in other words assets managed by the treasury function within an entity. However, because of the management approach to classification used in the proposed presentation model, items classified in the financing section by a manufacturing entity may differ from those classified in that section by a financial services entity.

52 EFRAG is not convinced that the DP is right to prohibit the inclusion of non-financial assets and liabilities in the financing category. Conceptually all liabilities could be viewed as financing liabilities. However, if the view is that liabilities that relate to a specific operating activity should be classified in the operating category, the remaining liabilities would indeed be composed mainly of financial liabilities—but we do not see why it should follow from that that the financing category should exclude non-financial items. The DP talks (in paragraph 2.62) about 'adding objectivity to the classification process' by restricting the financing category to financial assets and financial liabilities, but we find that argument wholly unconvincing. Objectivity is not added by arbitrarily excluding certain items from a category but allowing management the flexibility to exclude other items. Either a management approach is being adopted or it is not being adopted.

53 EFRAG does not believe that restricting financial section just to financial assets and financial liabilities is consistent with the management approach applied elsewhere, and therefore does not support the proposal. We think that non-contractual liabilities, including some postemployment benefit plan liabilities, should not be excluded from the financing liability category.

54 DP could in our opinion also be clearer as to whether the costs of the team that manages the entity's financing should (following the cohesiveness objective) be treated as a financing cost or be classified to another category.

QUESTIONS CONCERNING IMPLICATIONS FOR EACH FINANCIAL STATEMENT

Question 11 *Paragraph 3.2 proposes that an entity should present a classified statement of financial position (short-term and long-term subcategories for assets and liabilities) except when a presentation of assets and liabilities in order of liquidity provides information that is more relevant (paragraph 3.2). Is this presentational option in order of liquidity really necessary?*

The short-term/long-term split

55 The DP explains that an asset or liability is short-term if either its contractual maturity or its expected date of realisation or settlement is within one year of the reporting date. In other words, the distinction is based on the shorter of (a) contractual maturity and (b) expected realisation or settlement. Otherwise, an asset or liability is long-term.

56 In practice today, an entity classifies its assets and liabilities as current or non-current (unless it provides a presentation based on liquidity) and the current/non-current distinction is based on the length of an entity's operating cycle (in other words, the typical time between an entity's acquisition of materials or services used in its production process and the final conversion of the outputs of that process to cash). That means that if an asset or liability is expected to be realised or settled within its operating cycle, it is classified as current even if it is not expected to be realised or settled for many years.

57 Paragraph 3.8 of the DP explains that the boards are proposing a one-year distinction rather than the length of an entity's operating cycle because (a) it is simpler and easier to understand, and (b) users with whom the boards discussed the issue generally preferred a one-year distinction because they thought it would be more objective and would increase comparability between entities in different industries.

58 EFRAG agrees with these arguments. It also notes that the current/non-current split is in practice also normally based on a one year notion and thus the current practice would not be significantly affected. We support the proposal.

The option

59 The DP proposes keeping the existing option to present assets and liabilities in order of liquidity, rather than on a current/non-current or short-/long-term basis. EFRAG supports this proposal because for some entities, for example deposit-taking or insurance companies, that typically have financial assets and financial liabilities with a wide range of maturity dates within a short time period, it would be arbitrary to specify any particular maturity date to distinguish two maturity subcategories (see more under Question 11.a).

60 On the other hand, recent events have reminded us that liquidity is a complex issue that is difficult to capture in a highly summarised way, so it is important that the messages coming from a liquidity presentation are treated with care by users.

61 EFRAG notes that in the ED of proposed amendments to IFRS 7, it is being proposed that analyses of non-derivative liabilities by both contractual and expected maturity dates should be given. Bearing this in mind, we wondered whether it would

be confusing—and perhaps even appropriate—for the analysis in the statement of financial position to be prepared by reference to the shorter of contractual or expected maturity, which is what is proposed in the DP.

Question 11(a) *What types of entities would you expect <u>not</u> to present a classified statement of financial position? Why?*

62 We think that for entities (such as deposit-taking or insurance companies) that typically have financial assets and financial liabilities with a wide range of maturity dates within a short time period, it would be arbitrary to specify any particular maturity date to distinguish two maturity subcategories. As a result, for those entities, the proposed short-term and long-term subcategories will generally be too broad to provide useful information to users. In addition, it often is not feasible to provide more granular short-term maturity information in the statement of financial position. Moreover, for those entities, liquidity information is often more important than an arbitrary split between short-term and long-term. For these reasons, the users might derive more benefit from a presentation of assets or liabilities that is based more around liquidity.

63 On the other hand, we know of a number of banks that, despite this, choose not to present their statement of financial position on the basis of liquidity because they consider such a presentation also does not show useful information (because liquidity is too complex an issue to be effectively communicated through such a presentation). In the context it is worth noting that entities are required by IFRS 7 to provide a maturity analysis of financial liabilities in the notes to the financial statements[2], and these disclosure requirements are in the process of being enhanced. We recognise that some would argue that this makes the option to present the statement of financial position on a liquidity basis unnecessary (see more about this issue under Question 22), but as already explained we still favour retention of the option.

64 We note that, if an entity adopts a presentation based on liquidity, the DP proposes (in paragraphs 3.6 and 4.7-4.10) that it should also disclose in the notes information about the maturities of its short-term contractual assets and liabilities. It will be important to ensure that what the ED says on this issue takes into account the IASB's latest thinking on the same issue in other projects (such as IFRS 7).

Question 11(b) *Should there be more guidance for distinguishing which entities should present a statement of financial position in order of liquidity? If so, what additional guidance is needed?*

65 EFRAG believes in principle-based standards, and therefore would prefer to see less guidance rather than more. We do suggest however that that standard should require entities to explain (a) why they have chosen the presentation they have, and (b) the basis used for the presentation in order of liquidity.

Question 12 *Paragraph 3.14 proposes that cash equivalents should be presented and classified in a manner similar to other short-term investments, not as part of cash. Do you agree? Why or why not?*

66 The focus of practice today in the statement of financial position and the statement of cash flows under IFRS is on the aggregate of cash and cash equivalents. Cash

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[2] Disclosures about liquidity risk include [IFRS 7.39]:

(a) a maturity analysis for financial liabilities that show the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and are so near their maturity that they present an insignificant risk of changes in value because of changes in interest rates. Cash equivalents have been lumped together with cash in this way because an entity's cash management activities generally include particular types of short-term investments considered to be essentially the same as cash. Therefore, whether cash is on hand, on deposit or invested in a short-term investment that is readily convertible to a known amount of cash is largely irrelevant to users' assessments of liquidity and future cash flows. Accordingly, in today's practice, the statement of cash flows focuses on the aggregate of cash and cash equivalents, and the statement of financial position presents either a line item or a subtotal that includes both cash and cash equivalents.

67 However, in developing the DP the boards concluded that excluding cash equivalents from the amount of cash presented in the statement of financial position would better help to achieve the liquidity and financial flexibility objective described in paragraph 2.12 of the DP. Refocusing the primary financial statements on cash (rather than cash and cash equivalents) is important for other reasons too. Investors, creditors and other capital providers who invest cash in an entity do so expecting to receive a return on, as well as a return of, the cash provided. An entity ordinarily distributes cash—not short-term investments considered to be the equivalent of cash—to its capital providers. The same is true for its other cash needs, such as paying employees and other suppliers. Although an entity would usually be able to convert cash equivalents to cash quickly to satisfy its needs for cash, no short-term investment can have all of the characteristics of currency on hand and on-demand deposits. For example, regardless of how near its maturity, a short-term investment is subject to some risk of price change attributable to, for example, sudden changes in the credit environment or the perceived credit quality of the issuer. Furthermore, if cash and cash equivalents were combined in the proposed presentation model, an entity would be required to present that combined amount as a single line item in the statement of financial position and would be precluded from presenting securities considered to be cash equivalents in a category different from the category in which cash is classified.

68 The boards therefore decided that allowing cash equivalents to be presented differently from cash would be more consistent with the management approach to classification, and it would also help users to assess an entity's liquidity and the amount, timing and uncertainty of its future cash flows.

69 EFRAG agrees with this reasoning and therefore supports the proposed treatment of cash equivalents.

Question 13 *Paragraph 3.19 proposes that an entity should present its similar assets and liabilities that are measured on different bases on separate lines in the statement of financial position (paragraph 3.19). Would this disaggregation provide information that is more decision-useful than a presentation that permits line items to include similar assets and liabilities measured on different bases? Why or why not?*

70 EFRAG agrees that presenting similar assets and liabilities that are measured on different bases separately would result in more decision-useful information. However, we are not convinced that it is essential that it should be done through disaggregation on the face of the statement of financial position; we think providing the information in the notes is sufficient. Using the notes would also reduce the number of lines and captions that would be required to be shown in the statement of financial position, which we think is important because otherwise there is a risk that

this proposal could make the statement of financial position long and less understandable.

71 We think it would also be useful to clarify exactly what the IASB means here when it talks about different measurement bases. For example, if an asset is carried at cost less an impairment provision, is that a different measurement bases to cost? Similarly, currently the various references in IFRS are not all interpreted to require exactly the same valuation approaches. Are they different measurement bases, or is the, measurement basis fair value? How should an asset that is measured at the lower of cost or market value be dealt with? For practical purposes, EFRAG thinks that the separate line requirement would have to be specifically applied only in the framework of the two basic measurement bases i.e. the cost-based amounts and fair value.