EFRAG
European Financial Reporting Advisory Group

129. DSR-Sitzung
10.02.2009

08b_DP_ FSP_DCL_EFRAG

xx April 2009

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 9 April 2009

Dear Sir/Madam

Re: Discussion Paper *Preliminary Views on Financial Statement Presentation*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB/FASB Phase B financial statement presentation project discussion paper *Preliminary Views on Financial Statement Presentation*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The discussion paper (DP) deals mainly with the following issues:

- implementation of the cohesiveness principle,
- classification of items into operating, investing, and financing categories, which starts with the classification of assets and liabilities and is then applied to related income, expense and cash flow items,
- the adoption of the direct method in the statement of cash flows, and
- the introduction of a new reconciliation schedule, which would reconcile cash flows to comprehensive income. This reconciliation schedule disaggregates income into its cash, accrual, and disaggregates the remeasurement components (for example, fair value changes).

Financial Statement Presentation is an issue of fundamental importance, and we are pleased that the IASB has decided to address some of the key issues involved and to give the work a high priority. We also support the decision to do the work as a convergence project with the FASB.

Furthermore, we think the DP contains many good ideas and we support much of what it says. Our detailed comments are set out in the appendix 1 to this letter, and a summary of those comments is set out in appendix 2. Below we highlight our main concerns with the proposals:

- Although we think that cohesiveness is a good principle, we do not think the only way—or indeed best way—to achieve it is to apply an 'everything in the same order and disaggregated to the same extent' rule. Yet we think that is largely what the DP proposes. In our view, it is very important that the implementation of the cohesiveness principle is done in a way that is thoughtful and pragmatic if it is to provide useful, meaningful information. The debate should therefore be primarily about where the balance should be struck.

- From our discussions with others, it would appear that there is a divergence of view as to how much flexibility the DP is proposing to allow preparers when it proposes that a management approach to classification should be adopted. We would not support an approach allowing considerable flexibility on as important an issue as financial statements presentation; however, we do not think that is what is being proposed. We think the DP is proposing that the standard should require the principle set out in paragraph 2.27 of the DP to be applied. (Paragraph 2.27 states that the objective is that the classification of the various assets and liabilities should reflect how each of those assets and liabilities are used in the business). That would mean that, although management will usually have substantial—perhaps even total—discretion as to how the assets and liabilities are used in the business, having exercised that discretion management will have little if any flexibility as to how the assets and liabilities are classified in the statement of financial position. We support such an approach.

- We do not support the proposal that the new standard should require use of the direct method of presenting operating cash flows. We are not persuaded by the DP that such an approach provides information that is more decision-useful than an indirect method and therefore justifies the additional cost that would usually be involved. We prefer the indirect method of presenting operating cash flows in the statement of cash flows.

- We think that, although the proposed reconciliation schedule is a very interesting idea, too many of the numbers that would be disclosed will be of little informational value to justify the cost of preparing the schedule in the form proposed. Our suggestion is that the schedule should be scaled down and should focus instead on remeasurements and large non-cash items.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Aleš Novak or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1:
All EFRAG's responses to the questions asked in the discussion paper

GENERAL COMMENT

1 Financial Statement Presentation is an issue of fundamental importance, and we are pleased that the boards have decided to address some of the key issues involved and to give the work a high priority. It is good that the DP has looked afresh at age-old issues and contains new ideas and thinking.

2 We also support the decision to do the work as a convergence project with the FASB. A key aspect of the convergence process must be to converge presentation approaches.

3 Finally, although we have focused in our responses below to the issues that concern us most, there is also much in the DP that we agree with.

QUESTIONS CONCERNING OBJECTIVES AND PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

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.

4 EFRAG broadly supports the proposed objectives as long as they are not applied in an extreme way 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>

5 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 this cohesiveness principle 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?

6 EFRAG thinks that the 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 it is applied in the DP as an '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 that the implementation of the cohesiveness principle is done in a way that is thoughtful and pragmatic if it is to provide useful, meaningful

information.[1] 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.

7 Currently under IFRSs an entity is required to present its post-employment defined 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 always a financial asset or a financial liability). Following the cohesiveness principle, an entity should then 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 should allow (at least in this case) the flows deriving from a single statement of financial position item to be classified in different categories.

8 The DP also proposes that dividends payable on equity shares should be classified as a financing liability in the statement of financial position and the dividend payments on those shares should be classified in the financing liability category in the statement of cash flows, not the equity section. Such payments will not though be included in the financing section of the statement of comprehensive income, because under IFRSs distributions to owners are not depicted in comprehensive income. We think this is a bit confusing, particularly as some companies might not actually report dividends payable in their financial statements (because the liability does not arise until after year-end) and thus noting that there are limits to cohesiveness set also by other than the presentation principles. We think what is needed is a thoughtful, pragmatic approach that will result in as little confusion as possible and some classifications that will not make it difficult for users to understand the relationships between the numbers.

<u>Disaggregation objective</u>

9 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.

10 EFRAG agrees entities should disaggregate the information in their financial statements in a manner that is useful. However, we have two concerns: (a) the risk of disaggregation resulting in a lot of lines in the primary financial statements that might distract users' attention, obscure the messages, and thereby reduce the usefulness of the information provided, and (b) the proposal's focus on assessing future cash flows. These concerns are discussed further below.

---

[1] The boards do not strictly follow this principle themselves since, within the categories, the statement of financial position is not divided into functions: it is apparently only the flow statements that have to be cohesive at this level.

11 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."

12 EFRAG agrees that there is a delicate balance to strike, but is not convinced that the proposals in the paper always manage to get that balance right. 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 to be provided on the face of the financial statements, because that can lead to excessive detail that could obscure more than it communicates, which 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."

13 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 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 limited to information that is useful in assessing future cash flows.

(a) 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.

(b) In this context we note that paragraph 2.11 of the DP states that:

> "Although the disaggregation objective refers to assessing the amount, timing and uncertainty of future cash flows, the boards understand that users often base their expectations of future cash flows on an analysis of an entity's prospects for creating value in the future. Such analyses often involve forecasts of income, components of income, or cash flows generated from specific activities."

Although we agree with the paragraph—and would add that 'such analyses' often involve other things as well—we are not sure what the relevance is of its inclusion at this point in the DP. Is the intention to suggest that forward looking information such as forecasts should be included in the financial statements?

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

14 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).

15 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.

16 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 the 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) is too narrow; on the other hand, if the reference to 'to alter amounts and timing of cash flows' was omitted (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>

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

18 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.

19 One example of why this needs to be clarified is the perceived tension between comparability and the DP's 'management approach'. (This issue is discussed further in our response to question 5).

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?

20 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.

21 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.

22 EFRAG believes that the separation of business activities from financing activities, based on the management approach, would provide information that is decision-

useful to users. The approach seems to fit well with the way users work, and is also pretty well in line with the way most industrial entities look at their businesses and currently show their results. However, we note that those in the banking and similar sectors might have difficulties drawing a dividing line between business and financing items.

23 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?

24 The boards propose a separate equity section which would include items that meet the IFRSs definition of equity. For example, under current IFRSs 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.

25 EFRAG thinks that if the current distinction in the financial statements between equity and liabilities is to be retained, it is appropriate to present non-owner sources of finance separately from owner sources of finance and thus equity should be presented as a section separate from the financing section. We also note 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?

26 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 it is important that discontinued operations are clearly highlighted in the financial statements.

27 However, we think there are grounds for giving some further thought to alternatives to the principle underlying IFRS 5 *Discontinued Operations*, which is that discontinued operations should be presented separately and in a condensed form in the primary financial statements, as for example presentation in a memorandum column or simply in the notes. We would therefore encourage the boards to take another, longer, look at them as soon as possible, ideally in the next step, which is the development of the Phase B exposure draft (ED) of the financial statement presentation project.

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?

Some general comments

28 Before we comment on the specific issues, we want to make a few general comments about the approach to classification that the discussion paper refers to as 'the management approach' in order to try to provide clarity to a debate that is in danger of getting confused.

29 Our first point is that there seems to be some difference of view as to what exactly the management approach proposed in the DP involves.

(a) Some seem to view the approach as giving management substantial—perhaps even total—discretion as to how the assets and liabilities are classified in the statement of financial position. If this is indeed the intention behind the proposal, we would be very concerned; we do not think it would be appropriate to permit a 'free for all' in an area as important as financial statement presentation.

(b) However, we had not read the DP's proposals in that way. Paragraph 2.27 of the DP states that the objective is that the classification of the various assets and liabilities should reflect how each of those assets and liabilities are used in the business. We had assumed that the proposal is that this should be a key requirement in the final standard. We think that, under such a requirement, although management will usually have substantial—perhaps even total—discretion as to how the assets and liabilities are used in the business, having exercised that discretion management will have little if any flexibility as to how the assets and liabilities are classified in the statement of financial position.

30 Our second point concerns the tension that is sometimes perceived to exist between the adoption of the so-called management approach and comparability. (The wording of the question in (b) is an example of this perceived tension.) If the approach involved management in having considerable discretion to classify items as they wished regardless of other factors, we agree that such tension would exist. However, as already explained that is in our opinion not what the DP intends. In fact, under the approach proposed (with paragraph 2.27 of the DP as a requirement), management will have little if any discretion as to how items are classified. Two businesses that appear the same at first glance might classify items differently, but that will in most cases be because they do not use their assets and liabilities in the same way. In other words, they look different because they are different. (As with most accounting issues, some judgement will be involved and as a result entities that are the same might classify some items

differently, but this will not be the main reason why assets and liabilities will be classified differently.)

31 Our third point is that, although comparability is a very desirable attribute, it is important to be realistic about its limitations. For example, it is in our view probably realistic to expect just limited comparability between entities in different industries. On the other hand, comparability between entities within the same industry is a realistic objective.

<u>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?</u>

32 For the reasons we have just explained, we do not accept the premise (implicit in the question) that the management approach described in the DP will reduce the comparability of the financial statements—because we think the proposal is that the principle in paragraph 2.27 should be a requirement. In our view it is just as likely to enhance their comparability by highlighting differences between businesses.

<u>Would a management approach provide the most useful view of an entity to users of its financial statements?</u>

33 This is a complex issue. EFRAG is aware that in practice there is always a trade-off between different objectives and characteristics in order to maximise the usefulness of the information provided overall.

34 On balance, EFRAG thinks an approach based around how the reporting entity organises its activities and uses its assets and liabilities (such as the approach proposed in the discussion paper) will probably provide the most useful information for users. That is because we think that such an approach helps users to understand an entity's business model, which users tell us is essential to enable them to use the financial statements effectively. (EFRAG made reference to this in its comment letter on the ED *An Improved Conceptual Framework for Financial Reporting—Chapter 1 and Chapter 2*.)

35 EFRAG's biggest theoretical concerns about the management approach to classification relate to consistency from period-to-period; the risk that entities might continually adjust their classifications, with the effect that it is 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. However:

(a) the management approach proposed in the DP does not involve the sort of flexibility or discretion that the management approach in the IFRS 8 *Operating Segments* does, so in many ways it is not a fair comparison; and

(b) the DP proposes that the classification of assets and liabilities in the operating, investing, financing asset, and financing liability categories would be an accounting policy, and that an entity should explain its basis for classification of items into categories in its accounting policy note disclosure (see paragraphs 4.2–4.4 of the DP). In our opinion this explanation should be a justification for the classification and not just a description. 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?

36 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.

37 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 could in the beginning present some difficulties for users, because they are used to the classification on the basis of elements (assets, liabilities and equity) with few (sub)totals. However, having discussed the proposed approach with users, we have reached the conclusion that overall the approach will benefit 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, especially as the proposed presentational model has the potential to facilitate the calculation of some key financial ratios.

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.

38 The issue here is at what level the classification exercise should 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.

39 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 reportable segments usually include operations that are 'through the eyes of the management' similar in nature and economic behaviour.

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

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.

41 The requirements of 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.[2] 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?

42 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, IFRSs 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.

43 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.

44 So, turning to the first question, if it is deemed sufficient under the current presentation system for entities to disclose only total assets for each segment (rather than say fixed assets, current assets etc.)—when assets are disclosed at all— will it also be sufficient under the proposal just to disclose only the total assets? We are not convinced it will be; or rather 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.

---

[2] 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.

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?

45 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 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.

46 We note that these descriptions are not very precise. However, we see them as being in the nature of a high-level principle that helps preparers to understand the objectives of the exercise. This, coupled with the DP's clear message that the assets and liabilities should be classified in a way that best reflects the way they are used by the business, should in our view be sufficient to ensure that the discretion in practice is not significant. We are as a result broadly happy with how the business section is described.

47 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.

48 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.

49 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.

50 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', as for example expenditure for research activities. 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.

51 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.[3] 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?

52 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.

53 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)

[3] This is not the same as the case from paragraph 10 of the IAS 40 *Investment Property* which deals with properties where <u>a portion</u> is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held or use in the production or supply of goods or services or for administrative purposes.

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.

54 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 sources of finance and thus labelled 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 to classification is being adopted or it is not being adopted.

55 EFRAG does not believe that restricting the financing section just to financial assets and financial liabilities is consistent with the management approach to classification 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.

56 The 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.

QUESTIONS CONCERNING IMPLICATIONS OF THE OBJECTIVES AND PRINCIPLES 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 sub-categories 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?

<u>The short-term/long-term split</u>

57 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.

58 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.

59 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.

60 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.

<u>The option</u>

61 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 sub-categories. (This is further discussed under question 11(a).)

62 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.

63 EFRAG notes that, in the ED of proposed amendments to IFRS 7 *Financial Instruments: Disclosures*, 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 inappropriate—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.

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

64 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 sub-categories. As a result, for those entities, the proposed short-term and long-term sub-categories 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 based more around liquidity.

65 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,[4] 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.

66 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 the way this is dealt with in any eventual standard takes into account the IASB's latest thinking on the same issue in other projects (such as IFRS 7).

(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?

67 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?

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

69 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

---

[4] 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).

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.

70 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.

71 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?

72 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.

73 We think it would also be useful to clarify exactly what the boards mean here when they talk 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 to fair value 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 become impractical were it to be applied to more than two basic measurement bases, so we suggest it focuses on cost-based amounts and current value amounts.

Question 14

Should an entity present comprehensive income and its components in a single statement of comprehensive income as proposed (see paragraphs 3.24–3.33 of the DP)? Why or why not? If not, how should they be presented?

74 IAS 1 *Presentation of Financial Statements* (issued in September 2007) requires an entity to present all items of income and expense recognised in a period either in a single statement of comprehensive income or in two separate statements (a statement displaying profit or loss (an income statement) and a statement of comprehensive income that begins with profit or loss and displays items of other comprehensive income). The DP proposes that the option to present two separate statements should be deleted; all entities should henceforth present a single statement of comprehensive income.

75 The DP goes on to propose that, within that statement, comprehensive income would be divided into profit or loss and other comprehensive income, so the current disaggregation between profit or loss/net income and other comprehensive income is maintained. In the DP the boards acknowledge that "one of the key issues related to presentation of information in the statement of comprehensive income is whether items of other comprehensive income should continue to be presented in a manner different from all other income or expense items." The boards discussed a range of views on how income or expense items that are currently presented outside profit or loss could be presented in a single statement of comprehensive income, but concluded that anything other than the approach proposed in the DP would involve a need to address recognition and measurement issues that are beyond the scope of the project.

76 Despite this, the boards believe that presenting a single statement of comprehensive income will improve the comparability of financial statements because all entities will present the components of comprehensive income in a similar manner in the same financial statement. The boards also believe that including all income and expense items in a single statement of comprehensive income will make it easier for users to understand and use that information in their analyses because they will need to look to only one financial statement for information on all non-owner changes in an entity's net assets.

77 EFRAG agrees that it would not be appropriate to make piecemeal changes to the profit or loss/other comprehensive income division; what is needed is a comprehensive consideration of the, in some cases complex, issues involved. We agree though that there is not enough time to do that at this stage if the DP is to result in a standard by 2011.

78 In our comment letter on the ED of proposed amendments to IAS 1 *Presentation of Financial Statements: A Revised Presentation* (the Phase A ED) we argued that the issue of whether entities should present one or two performance statements is a matter that warrants extensive debate and that, until that debate takes place, entities should be permitted a choice. However, our main concern at that time (and still) is the point made in the previous paragraph—that changes should not be made to the profit or loss/other comprehensive income division without an extensive debate.

79 EFRAG members are split as to whether the standard that will be developed from this DP should eliminate the option to prepare two separate statements. Some members think it should and that it would result in an improvement in financial

reporting for all the reasons set out in the DP. However, some other members believe that, having ensured that:

(a) items of income and expense are presented in a statement or statements that is/are separate from owner changes in equity, and

(b) if two statements are presented, the second will be presented immediately after the first,

it is a matter of no importance where the page break is and it should be left to preparers to find the presentation that works best for them.

Question 15

Paragraph 3.25 proposes that an entity should indicate the category to which items of other comprehensive income relate (except some foreign currency translation adjustments) (paragraphs 3.37–3.41, see also pages 107 and 129). Would that information be decision-useful? Why or why not?

80 It seems to us that indicating whether an item of other comprehensive income relates to (or will relate to) an operating activity, investing activity, financing asset or financing liability should help users to understand better the relationship between the statement of comprehensive income and the statement of financial position and is therefore necessary if the cohesiveness objective that we support is to be met. We think it would also help users to understand better the section or category of profit or loss in which potential future reclassification adjustments will be presented in the future statements of comprehensive income, so we think it will result in decision-useful information.

81 We also believe that, for most items of other comprehensive income, making that identification should be straightforward.

82 The only item of other comprehensive income that the DP proposes an entity should not be required to identify with a section or category in the statement of financial position is a foreign currency translation adjustment on a consolidated subsidiary (and a proportionately consolidated joint venture)[5]. We agree with the proposal.

Question 16

Paragraphs 3.42–3.48 propose that an entity should further disaggregate within each section and category in the statement of comprehensive income its revenues, expenses, gains and losses by their function, by their nature, or both if doing so will enhance the usefulness of the information in predicting the entity's future cash flows. Would this level of disaggregation provide information that is decision-useful to users in their capacity as capital providers? Why or why not?

83 IAS 1 (issued in September 2007) requires an entity to "present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant" (paragraph 99). IAS 1 also requires an entity that classifies expenses by function to disclose additional information on the nature of expenses, including depreciation, amortisation and employee benefits expense.

---

5 This is because the translation adjustment may relate to more than one category of assets and liabilities in the statement of financial position.

84 In paragraphs 3.42 and 3.44, the DP proposes that, to the extent that it will enhance the usefulness of the information in predicting the entity's future cash flows:

(a) an entity should disaggregate income and expense items within each category by function;

(b) an entity should disaggregate the items in that disaggregation-by-function further by nature.

However, paragraph 3.48 proposes that those entities that do not provide a disaggregation by function ("because such disaggregation would not enhance the usefulness of the information in predicting the entity's future cash flows'") should disaggregate those items by their nature to the extent that this will enhance the usefulness of the information in predicting the entity's future cash flows.

85 It could be argued therefore that there is no major change being proposed to the existing requirements: (a) a disaggregation by function should be provided unless it is not very useful, in which case a disaggregation by nature should be provided, and (b) if a disaggregation by function is provided, some disaggregation by nature should be provided as well. As under current IAS 1, there is no requirement that an entity that disaggregates items by nature would have to disclose additional information based on a by function disaggregation of those disaggregated-by-nature numbers.

86 However, the fact that an entity must disaggregate first by function unless that would not enhance the usefulness of the information in predicting the entity's future cash flows is in our view significant, because our understanding is that users generally and increasingly prefer a disaggregation by nature to one by function. Thus, the effect of the requirement will normally be that an entity will be required to disaggregate by function and then provide some further disaggregation of those numbers by nature.

87 We are broadly comfortable with these proposals. We are not generally in favour of options in accounting standards, particularly in areas of fundamental importance, but this option has been structured to ensure that there is no option except when the especially alternative is to provide information that is of no use. We find this approach acceptable.

88 In addition, we understand that the proposed disaggregation might be quite difficult to apply for certain industrial companies, particularly the by nature analysis of cost of sales when the costs lose their by nature identity through the standard-cost process, variances and various inventory accounts.

89 A general concern we have about the proposals in the DP is that they might result in too much data, and not enough information; and that the primary financial statements will become excessively detailed. Nevertheless, the proposal that (a) the disaggregations by function and nature should be provided "to the extent that it will enhance the usefulness of the information in predicting the entity's future cash flows" and that (b) if management thinks the statement of comprehensive income is getting too lengthy and/or too detailed, the disaggregation by nature information can be presented in the notes (see paragraph 3.46) we think will help considerably.

90 One important indication of whether a particular disaggregation model is likely to enhance the usefulness of the information in predicting the entity's cash flows is

whether it is used internally. In other words, if the entity uses the by nature disaggregation for internal reporting purposes, than the disaggregation by function would in our opinion most likely "not enhance the usefulness of the information in predicting the entity's future cash flows" for external users and thus the by nature disaggregation should be used. We propose that a comment along these lines is also included in the ED that will be developed from this DP.

Question 17

Paragraph 3.55 proposes that an entity should allocate and present income taxes within the statement of comprehensive income in accordance with existing requirements (paragraphs 3.56–3.62). To which sections and categories, if any, should an entity allocate income taxes in order to provide information that is decision-useful to users? Please explain.

91 In the current IFRS literature income tax expenses/benefits must be split into the following components: (a) relating to items that are recognised directly in equity (b) relating to items recorded in other comprehensive income (OCI); (c) relating to items reported as discontinued operations; and (d) the remaining items in profit or loss/net income. Furthermore, each item of other comprehensive income is required to be shown on a net of tax basis, which means estimating the tax effect of each item.

92 The boards propose that an entity should continue to apply those existing requirements for allocating and presenting income taxes in the statement of comprehensive income. An entity would thus not allocate income taxes to the business or financing section or to categories within those sections. According to the DP, one of the main reasons for keeping the existing tax allocation approach was that it allows users to distinguish between the income tax implications associated with income from continuing operations and those associated with discontinued operations and other comprehensive income.

93 EFRAG believes that, in theory, presenting income tax information in the same category as the related transaction would help users to assess the effectiveness of management's decisions, as the decision of whether to enter into a transaction is often made after considering the income tax consequences. Under this view, income taxes would be allocated to the categories/sections in the statement of comprehensive income (operating, investing, financing assets and financing liabilities, discontinued operations, OCI). However, EFRAG would not be in favour of such an approach, because in practice the exercise would more often than not be little more than an arithmetical apportionment of the total charge between the individual items. Such apportionments provide little useful information.

94 Indeed, when the current IAS 1 was issued in September 2007, EFRAG's endorsement advice criticised the requirement that the entities disclose the income tax relating to each component of other comprehensive income on exactly those grounds:

> "Most EFRAG members question the relevance of the information in practice, because in their view estimating the tax effects would involve a significant amount of judgement, approximation and arbitrariness, at least partly because of the interdependence between the different items of other comprehensive income. This arbitrariness in particular could be a problem for comparability, relevance and even reliability."

95 We continue to be strongly of that view, and would encourage the IASB to reconsider this part of existing IAS 1.

Question 18

Paragraph 3.63 proposes that an entity should present foreign currency transaction gains and losses, including the components of any net gain or loss arising on remeasurement into its functional currency, in the same section and category as the assets and liabilities that gave rise to the gains or losses (paragraphs 3.63–3.69).

(a) Would this provide decision-useful information to users in their capacity as capital providers? Please explain why or why not and discuss any alternative methods of presenting this information.

(b) What costs should the boards consider related to presenting the components of net foreign currency transaction gains or losses for presentation in different sections and categories?

96 An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies[6] or it may have foreign operations.[7] IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to include in profit or loss the gain or loss resulting from translating either foreign currency transactions or foreign currency financial statements into the entity's functional currency, except that in certain cases a gain or loss is required to be recognised in other comprehensive income.

97 Although disclosure is required of the amount of exchange differences recognised in profit or loss for the period, the IAS 21 does not specify where in the statement of comprehensive income such differences should be presented. Very common practice today is that all exchange differences are included in the statement of comprehensive income as part of finance costs, although it is also acceptable to allocate the exchange differences to the various line items. For example, an entity might classify exchange differences on trade receivable arising from the purchase of inventory as part of cost of sale, and exchange differences arising from loans as parts of finance costs.

98 The DP proposes that a gain or loss on a transaction denominated in a foreign currency, such as debt denominated in euro for an entity with US dollar functional currency,[8] should be presented in the same section and category as the asset or

---

[6] A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity [IAS 21.20]:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

(c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

[7] Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity [IAS 21.1].

[8] In this case all transactions that are not denominated in US dollars (hereinafter USD) are foreign currency transactions, which first have to be translated into USD, i.e. into the entity's functional currency. Each foreign currency (non-USD denominated) transaction shall thus be recorded on initial recognition in the functional currency (USD) at the transaction rate (the spot exchange rate at the date of the transaction) between the entity's functional currency (USD) and the foreign currency. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use

liability that gave rise to it. In this case the entity would include such a gain or loss in the financing liability category of the statement of comprehensive income, assuming that the debt is classified in the financing liabilities category in the statement of financial position.

99 EFRAG notes that this approach is consistent with the cohesiveness objective, seems sensible and would not be difficult or costly to do for an individual asset or liability denominated in a foreign currency. On the other hand, we can also imagine circumstances where inter-company (or other) accounts that include both operating (transfers of products, royalties) and financing transactions (interest on loans) would have to be (probably largely arbitrarily) split between operating and financing transactions for the proposed purpose. We can also see practical difficulties in allocating foreign exchange hedges that cover exposures in more than one category.

Net foreign currency transaction gain or loss on remeasuring an entity's local currency financial statements into its functional currency

100 When a reporting entity prepares financial statements, IAS 21 requires each individual entity included in the reporting entity—whether it is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)—to determine its functional currency and measure its results and financial position in that currency [IAS 21.IN7].

101 The boards considered whether to require the components of the net foreign currency transaction gain or loss on <u>remeasuring</u> an entity's local currency financial statements into its functional currency to be classified in the same sections and categories as the assets and liabilities that gave rise to the net adjustment.

102 'Remeasurement' is the restatement of the foreign entity's financial statements from local currency that the entity used to into the foreign entity's functional currency. Remeasurement is required only when the functional currency is different from the currency used to maintain the books and records of the foreign entity. It is worth noting that the term remeasurement cannot be found in the IFRSs but only in the U.S. GAAP, i.e. in the SFAS No. 52 *Foreign Currency Translation,*[9] while within the IAS 21 for the same thing a more general term translation is used.[10]

For example, an entity located in euro area, might have a subsidiary that operates in Russia whose functional currency is the euro (hereinafter EUR), but maintain its books and

---

of the average rate for a period is inappropriate [IAS 21.21 and 22]. At the end of each reporting period items denominated in a currency other than functional currency should be translated as follows: monetary items are translated at the exchange rate at the reporting date, non-monetary items measured at historical cost are not retranslated – they remain at the exchange rate at the date of transaction; and non-monetary items measured at fair value are translated at the exchange rate when the fair value was determined [IAS 21.23].

9 If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency [SFAS 52.10].

10 When an entity keeps its books and records in a currency other than its functional currency, at the time the entity prepares its financial statements all amounts are <u>translated</u> into the functional currency in accordance with paragraphs 20–26. This produces the same amounts in the functional currency as would have occurred had the items been recorded initially in the functional currency. For example, monetary items are translated into the functional currency using the closing rate, and non-monetary items that are measured on a historical cost basis are translated using the exchange rate at the date of the transaction that resulted in their recognition [IAS 21.34].

records in local currency, i.e. in rubles (to provide required reports to the Russian government). Because EUR is the functional currency, the subsidiary's (trial) financial statements will be remeasured into EUR. The remeasurement process should produce the same end result as if the subsidiary's transactions had been initially recorded in EUR and thus (similar to foreign currency transactions) divides the statement of financial position items into monetary and non-monetary items.

The Russian entity's monetary assets and liabilities (which are maintained in its books and records in rubels) would thus be remeasured into the EUR using the rubel-to-euro exchange rate at the end of the reporting period, while the related income and expense items would be remeasured using a weighted-average exchange rate to approximate the amounts that would result if each individual item was remeasured using the rate on the date it occurred.[11] That remeasurement process would result in a net foreign currency transaction exchange gain or loss, which should be included in profit or loss.

103 The boards observed that the amount of foreign currency transaction gain or loss to present in a particular section or category, for example, the financing liability category, can often be determined directly by applying the amount of the rate change during the period to the net liabilities or assets in that section or category and the related income or expense amounts. However, doing so could be difficult for a complex entity with many acquisitions (incurrences) and disposals (settlements) of assets (liabilities) during a reporting period. In addition, determining the effects of exchange rate changes on items of income and expense could be complex, although the effects might be closely approximated by using a weighted-average exchange rate.

104 Thus, in some circumstances, determining the components of the net foreign currency transaction gain or loss on remeasurement of foreign currency financial statements to facilitate classification in the appropriate sections or categories in the statement of comprehensive income may be more difficult than simply including the gain or loss on an individual item denominated in a foreign currency in the same category as the asset or liability that gave rise to it.

105 For that reason, the boards considered either including the net foreign currency transaction gain or loss in a single category, probably the operating category (practical expedient), or presenting that amount in a separate section. However, the boards observed that IFRSs and US GAAP make no conceptual distinction between the foreign currency transaction gain or loss on an individual item denominated in a foreign currency (such as the euro-denominated debt when USD is functional currency), and the net gain or loss on remeasuring foreign currency financial statements (case of Russian subsidiary) into the functional currency. In addition, the boards reasoned that classifying the entire gain or loss in a single category would result in information that is not a faithful representation if part of the amount resulted from items classified in other categories. For those reasons, the DP proposed that entities should present foreign currency transaction gains and losses, including the components of any net gain or loss arising on remeasurement into its functional currency, in the same section and category as the assets and liabilities that gave rise to the gains or losses.

106 EFRAG does not support this proposal, because it thinks that it would often be difficult to apply (for similar reasons to those given in paragraph 99 above), and would in many cases require a lot of arbitrary assumptions and allocations. EFRAG thus believes that the net foreign currency transaction gain or loss should be included in a single category, but is at this point in time not sure in which

---

[11] The appropriate historical exchange rate is used to remeasure non-monetary statement of financial position items and related revenues, expenses, gains, and losses.

category. In addition, we just do not know all the costs which would arise in relation to presenting the components of net foreign currency transaction gains or losses in different sections and categories.

Question 19

Paragraph 3.75 proposes that an entity should use a direct method of presenting cash flows in the statement of cash flows.

<u>Explanation of the presentation methods discussed in the DP</u>

107 In theory, there are a number of different ways of presenting the statement of cash flows, although nowadays the debate usually focuses on how the operating cash flows are presented.

108 Under the direct method of presenting cash flows from operating activities, major classes of gross operating cash receipts and payments are presented. This information about major classes of gross cash receipts and gross cash payments may be obtained either [IAS 7.19]:

(a) from the accounting records of the entity (essentially based on an analysis of the cash book); or

(b) by adjusting sales, costs of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of comprehensive income (so called the 'indirect direct method') for:

(i) changes during the period in inventories and operating receivables and payables;

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

109 Under the indirect method, the entity presents no operating cash receipts or payments in its statement of cash flows. Instead, the operating category of the statement of cash flows begins with profit or loss/net income and adjusts for items that did not result in operating cash flows during the period [IAS 7.20]:

(a) changes during the period in inventories and operating receivables and payables;

(b) other non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates, and non-controlling interests; and

(c) all other items for which the cash effects are investing and financing cash flows[12].

[12] Alternatively, the net cash flow from operating activities may be presented under indirect method by showing the revenues and expenses disclosed in the statement of comprehensive income and the changes during the period in inventories and operating receivables and payables [IAS 7.20]. An example of this rarely used alternative is given at the end of Appendix A to IAS 7.

110 Thus, the details presented in the statement of cash flows when an indirect method is used consist of non-cash operating items included in profit or loss/net income rather than operating cash receipts and payments.

111 IAS 7 *Statement of Cash Flows* encourages entities to report cash flows from operating activities using the direct method (on the grounds that it provides information which may be useful in estimating future cash flows and which is not available under indirect method), although the indirect method of presenting operating cash flows is also permitted. We understand most entities use the indirect method.

112 There seems to be no dispute that investing and financing cash flows should be presented gross (i.e. using the direct method of presentation).

<u>EFRAG's current position on the direct vs. indirect method debate</u>

113 In the paragraphs below we have responded to the questions the DP has asked about the respective merits of the direct and indirect methods of presenting operating cash flows. However, because those are very specific questions about a broader subject, we thought it would be helpful to start by explaining that, having considered the arguments in the DP, our preference is for the indirect method. In particular, we are not persuaded that the direct method provides information that is more decision-useful than an indirect method and therefore justifies the additional cost that would usually be involved.

(a) Would a direct method of presenting operating cash flows provide information that is decision-useful?

114 The DP argues that a major deficiency of the indirect method is that it derives the net cash flow from operating activities without separately presenting any of the operating cash receipts and payments. As such, "potentially useful information for forecasting cash flows would be lost".

115 The boards also state in the DP that many users have said they attempt to construct a direct method cash flow statement from other information available in the financial statements, although they also complain that to do this even approximately from the available data is difficult and time consuming because most companies provide insufficient information to permit them to decompose the entries affecting accounts receivable and to determine the amounts of cash collected from customers, which is perhaps the single most important direct operating cash flow number and a primary indicator of the company's cash-generating ability. Gross estimates must thus be made, greatly reducing the reliability and usefulness of the information generated by the exercise. The same is true to a greater or lesser extent for all of the other numbers which are otherwise produced by a direct method of presenting operating cash flows.

116 To start by answering the question that has been asked, EFRAG believes that a direct method of presenting operating cash flows <u>does</u> provide information that is decision-useful, largely for the reasons given in the DP. However, to answer a question that has not been asked, our discussions with users suggest to us that the indirect method also provides information that is decision-useful. Indeed, the majority of the users we have spoken to have said they actually prefer the indirect method, mainly due to the fact that it is linked to profit or loss. Indeed, in contrast to the comment in the DP about how users struggle to obtain the information they need from the indirect method, most of the users we have spoken believe they can

get from the indirect method of presenting operating cash flows the same information they need and can get from the direct method.

(b) Is a direct method more consistent with the proposed cohesiveness and disaggregation objectives (see paragraphs 3.75–3.80) than an indirect method? Why or why not?

117 As we have said several times already, although we believe the cohesiveness principle—that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible—is important, we believe that it should not be applied as an 'everything in the same order and disaggregated to the same degree' rule to meet that objective. For that reason, we do not see why the direct method should necessarily be viewed as being more consistent with the proposed cohesiveness objective than the indirect method.

118 The question also asks about the disaggregation objective, which is 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. We have discussed the boards' proposed adoption of the direct method of presenting operating cash flows with a number of users and our impression is that, while views vary and some users do find the direct method more useful than the indirect method, many more seem not to. We would have thought it follows from that that the direct method is not more consistent with the disaggregation objective than the indirect method.

(c) Would the information currently provided using an indirect method to present operating cash flows be provided in the proposed reconciliation schedule (see paragraphs 4.19 and 4.45 of the DP)? Why or why not?

119 As already stated above, when using indirect method, the cash flow from operations is the only cash flow amount in the operating category of the statement of cash flows. The first necessary condition to provide exactly the same information currently provided using an indirect method would be application of the by nature disaggregation of income and expense items in the statement of comprehensive income. We note that the DP proposes that ideally the by function disaggregation should be applied with the by nature disaggregation within those functions only to the extent that this will enhance the usefulness of the information in predicting the entity's future cash flows.

120 We believe that there are some substantive similarities between the indirect method and the proposed reconciliation schedule, but just the example of 'changes in accounts receivable'—which would be aggregated in the 'accruals, allocations and other' column somewhere between 'cash received from customers' and 'sales'—shows that it would not be identical.

Other issues relating to the proposals in this paper and a summary of our views

121 To conclude on the technical merits of the proposal, EFRAG believes that the DP has not made a sufficiently persuasive case that the direct method of presenting operating cash flows provides information that is more decision-useful than an indirect method. In addition, we do not think that the direct method is necessarily more consistent with the proposed financial statement presentation objectives than the indirect method. As we explain in our response to question 20, it is also clear that there are concerns about the relative cost of implementing the direct method.

But, perhaps most important of all, the users we have spoken to tell us that they prefer the indirect method.

122 EFRAG's view, having considered all the factors involved (including cost), is that the indirect method of presenting operating cash flows in the statement of cash flows is the preferable approach. We are therefore against the proposed mandatory use of the direct method for this purpose.

Question 20

What costs should the boards consider related to using a direct method to present operating cash flows (see paragraphs 3.81–3.83 of the DP)? Please distinguish between one-off or one-time implementation costs and ongoing application costs. How might those costs be reduced without reducing the benefits of presenting operating cash receipts and payments?

123 The DP explains that the boards understand that preparers are concerned about the costs of applying the direct method of presenting operating cash flows; in other words, about the costs of obtaining information about operating cash receipts and payments. Preparers are as a result questioning whether the costs of implementing the approach will be justified by the benefits of presenting those amounts.

124 The DP goes on to explain that the boards believe that much of the cost of moving to a direct method of presenting operating cash flows will be the one-off or one-time costs of making the systems changes needed either to collect the information directly or to derive the information indirectly.

125 EFRAG thinks that the one-off implementation costs would differ depending on whether the necessary information would be collected directly or derived indirectly using the so called 'indirect direct method'.

(a) The one off costs to collect the information directly would probably involve setting up systems to analyse flows on cash/bank accounts. It is probably fair to say here that the more detailed these systems are (e.g. for a line-by-line analysis cohesive with the statement of comprehensive income), the more costly they will be. That would also probably apply to the ongoing costs of such a system; collecting information this way in a complex modern industrial environment would be quite difficult, especially in the current framework of the accrual-basis information in the other statements.

(b) As a result, many entities would collect the direct cash flow information using the less costly 'indirect direct method'. When using 'indirect direct method' preparers actually do not need to go all the way back to original transactions to trace the individual cash flows, but can indirectly obtain them by adjusting individual profit or loss items for the noncash changes in underlying individual assets and liabilities (in other words, by 'backing out' the direct cash flows from the accruals-based information in the other statements). Nevertheless, we have been told that for complex entities even such a collection of information would often not be practically achievable at a reasonable cost. It has also been suggested to us that, whatever the costs, they would be purely compliance costs without any benefit for internal planning and control purposes.

Question 21

On the basis of the discussion in paragraphs 3.88-3.95, should the effects of basket transactions be allocated to the related sections and categories in the statement of comprehensive income and the statement of cash flows to achieve cohesiveness? If not, in which section or category should those effects be presented?

126 A basket transaction is a single transaction that involves the acquisition or disposal of a number of assets and/or liabilities. A basket transaction is interesting for the purpose of the DP when it involves the acquisition or disposal of assets and/or liabilities that could be classified in more than one section or category. A typical example of this is a business combination in which the acquirer acquires 100 percent of the equity instruments of the acquiree for cash; the acquiree's assets and liabilities are then consolidated with the existing assets and liabilities of the acquirer. These transactions may also result in income or expense items and cash receipts or payments (effects of basket transactions).

127 In present practice, the effects of basket transactions are often presented in a single line item in the statement of comprehensive income and in the statement of cash flows. For example, IAS 7 *Statement of Cash Flows* requires specific disclosures relating to obtaining and losing control of subsidiaries or other businesses during the period; some of the transactions covered by those requirements would meet the definition of a basket transaction. Similarly, IFRS 5 requires the separate presentation in the statement of comprehensive income of discontinued operations.

128 The DP explains that, although the boards believe that it is appropriate to classify and present the assets and liabilities acquired in a basket transaction in the appropriate sections and categories in the statement of financial position, it is not obvious how the effects of basket transactions should be classified in the statements of comprehensive income and cash flows. The effects of basket transactions could be classified:

(a) in more than one section or category, thereby requiring an allocation of the total effect; or

(b) in a single section or category, what would not require allocation of the total effects.[13] The DP discusses three possible approaches that could be adopted if the total effects are not to be allocated:

   (i) Alternative A: Present in the operating category (practical expedient).

   (ii) Alternative B: Present in the category that reflects the activity that was the predominant source of those effects (similar basis already applied in the proposed classification of items).

   (iii) Alternative C: Present in a separate section (the most prominent exception to cohesiveness principle).

129 The DP reaches no conclusions on this issue and therefore makes no proposal.

---

[13] Not allocating these amounts to the related categories would thus result in amounts (such as operating income) that are not representationally faithful.

130 EFRAG thinks that this is another area where cohesiveness needs to be tempered with pragmatism. Users need information that enables them to understand the effect of the basket transaction on the entity's financial information, and ideally this information is needed at the disaggregated level. This would probably mean, we think, not allocating basket transactions on the face of the financial statements. Our preference would be to apply Alternative C (i.e. present in a separate section)—because it is the easiest for users to understand—but require the effects of each basket transaction to be disclosed in the notes on a disaggregated basis.

131 However, with regard to acquisitions for example, acquired businesses are very often integrated as rapidly as possible into existing businesses so that, by the end of the financial year, their assets and liabilities are no longer distinguishable and their separate results for the period since acquisition would have been most likely subject to a significant degree of estimation.

132 Less crucially, the boards should in our opinion consider a change of terminology. We suggest the term 'acquisitions and divestments of a bundle of assets and/or liabilities' as one possible alternative for the kind of things the boards appear to have in mind. We recognise the term is not as short as 'basket transaction', but it is far more descriptive and if we wish to keep accounting as simple as possible we need to use more terms that are descriptive.

QUESTIONS CONCERNING THE PROPOSED ADDITIONAL NOTES TO THE FINANCIAL STATEMENTS

Question 22

Should an entity that presents assets and liabilities in order of liquidity in its statement of financial position disclose information about the maturities of its short-term contractual assets and liabilities in the notes to financial statements as proposed in paragraph 4.7? Should all entities present this information? Why or why not?

133 As already mentioned, the DP proposes that the assets and liabilities that are recognised in the various categories on the statement of financial position should be sub-classified into short- and long-term, unless "a presentation based on liquidity provides information that is more relevant". The DP also proposes that, if a presentation based on liquidity is presented, note disclosures should be provided about the maturities of the entity's <u>short-term</u> contractual assets and liabilities.

134 The DP goes on to explain that:

(a) 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.

(b) contractual maturity dates should be used to prepare the maturity schedule. If the expected realisation (cash conversion) or settlement date for any asset or liability is significantly different from its contractual maturity date, the expected realisation or settlement date should also be indicated and the difference explained.

(c) the disclosure is being proposed because a statement of financial position presented in order of liquidity will provide little, if any, information about the maturity dates of an entity's assets and liabilities. The disclosure proposed will therefore ensure that users have information about the maturities of the entity's short-term contractual assets and liabilities that will be helpful in assessing the entity's liquidity.

135 The DP is also proposing to require all entities to present note disclosures about its contractual <u>long-term</u> assets and liabilities.

136 It is worth noting here that the current version of IFRS 7 *Financial Instruments: Disclosures* requires the disclosure of a maturity analysis of financial liabilities based on the remaining contractual maturities. An ED of proposed amendments to IFRS 7 has been issued and it proposes that entities should provide, in place of the existing IFRS 7 disclosures, of (a) non-derivative liabilities analysed by both contractual and—if the entity manages liquidity on the basis of expected maturities, which would certainly be the case for banks and insurance companies—expected maturity dates and (b) a maturity analysis for derivative financial liabilities that is based on how the entity manages the liquidity risk associated with such instruments.

137 We agree that note information about maturity should be provided if a presentation based on liquidity has been used, and that that information should cover both short- and long-term contractual assets and liabilities. This disclosure would affect mainly banks and insurance companies, where the information should be readily available. However:

(a) in responding to the IFRS 7 ED we have queried the usefulness of maturity analyses based on contractual maturity dates where the liquidity risk involved is measured on some other basis; in our view expected maturity date is generally more useful, although some indication of the implications of any significant changes in those expectations would be useful;

(b) we would be particularly concerned were the IFRS 7 analysis to be done on one basis (say expected maturity date) whilst the statement of presentation order and related note disclosure to be done on a different basis (the shorter of the contractual maturity and expected realisation or settlement); and

(c) we think the note disclosure is also useful if a short-term/long-term presentation is used, because it will highlight liquidity issues within the short-term 'bucket' and within the long-term 'bucket'. We note that paragraph 4.11 proposes that the entities should present disclosures about its contractual <u>long-term</u> assets and liabilities, but there appears to be no equivalent proposal for short-term assets and liabilities.

138 Last, but not the least, EFRAG notes that the terms 'contractual asset' and 'contractual liability' are not defined in the current IFRSs, so we are not sure what was meant by these terms. We are also unsure what the benefits are of focusing just on the contractual items.

Question 23

Paragraph 4.19 proposes that an entity should present a schedule in the notes to financial statements that reconciles cash flows to comprehensive income and disaggregates comprehensive income into four components: (a) cash received or paid other than in transactions with owners, (b) accruals other than remeasurements, (c) remeasurements that are recurring fair value changes or valuation adjustments, and (d) remeasurements that are not recurring fair value changes or valuation adjustments.

(a) Would the proposed reconciliation schedule increase users' understanding of the amount, timing and uncertainty of an entity's future cash flows? Why or why not? Please include a discussion of the costs and benefits of providing the reconciliation schedule!

139 The proposal in the DP is that an entity should be required to present a schedule in the notes that reconciles the line items in the statement of cash flows to the line items in the statement of comprehensive income and, in doing so, categorises the reconciling items under the headings set out in (a) to (d) of the question.

140 The boards' rationale for proposing this reconciliation schedule is broadly as follows:

(a) The disaggregation objective described in the DP suggests that users can better assess an entity's ability to create value in the future and assess the amount, timing and uncertainty of its future cash flows when items that have different implications for the future are disaggregated within comprehensive income. The proposed reconciliation schedule is one of the proposed changes that are designed to ensure that users have that information.

(b) Users have asked the boards for information to help them understand how components of accrual accounting, such as changes in accruals (for example, accounts payable and receivable) and fair value remeasurements, affect an entity's comprehensive income and future cash flows. The boards have relied on users' feedback and academic research to identify components of comprehensive income that exhibit systematic differences in persistence, measurement subjectivity or both.

(c) Academic research shows that the implications of a given amount of accrual income often differ from the implications of the same amount of cash income. Also, accruals resulting from transactions with third parties (for example, accruing wages payable as an employee provides services) often do not have the same implications for future cash flows as accruals resulting from remeasurements (such as a change in the fair value of an entity's derivative instruments holdings or changes in its pension obligation resulting from a change in interest [discount] rates). The existing presentation of information in the statement of comprehensive income often frustrates users who in their analyses want to distinguish remeasurement gains and losses from other accruals and from cash flows.

(d) The boards observed that the reconciliation schedule should also provide more transparency about the use of fair value. Specifically, users are concerned that commingling gains or losses from fair value remeasurements and other components of comprehensive income results in measures of financial performance that are difficult to analyse. The separate presentation of those income components in the reconciliation schedule should enable a more effective analysis.

141 We think that the proposed reconciliation schedule is a very interesting idea. We understand that financial statements are prepared to meet the reasonable information needs of users and that, as financial reporting gets more sophisticated and increasingly reflects non-cash items and other events, including remeasurement, it will not be sufficient to provide merely a vertical disaggregation of broad categories of income and expense into narrower income and expense categories; a horizontal disaggregation into the different types of element making

up an item of income or expense (i.e. cash flows, accruals and remeasurements) might be needed.

142 However, we are not currently convinced by the proposal, for several reasons:

(a) We will be very interested to see what the field testing the boards are currently carrying out will reveal, but our instinct is that the reconciliation schedule will result in a lot of numbers being disclosed, only some of which will be useful enough to justify the resources spent on providing them.

(i) If that is the case, it might be better to develop a disclosure that requires reconciliation of just some most important items. Such a requirement would probably meet the majority of users' information needs without imposing too much burden on the preparers. For example, a number of users have told us that they attach a high priority to a reconciliation of net debt, while the DP is silent on this issue.

(ii) We suspect the concerns will be with the accruals column. For example, is it really so important and beneficial to see, for example, the difference between 'cash paid for marketing personnel expenses' and 'marketing personnel expenses' explained? We are aware of some of the academic research referred to in the DP but nevertheless wonder whether this is an aspect of the proposal that could be simplified. Another concern could be a strict line-by-line reconciliation of the 'by nature within the by function' disaggregated operating expenses with the cash outflows might prove costly and thus hinder the practical implementation of the proposed schedule.

(b) We note that the proposed reconciliation schedule is closely connected with the proposed mandatory use of the direct method of presenting operating cash flows in the statement of cash flows and that all the 'pros' and 'cons' of the whole 'package' have to be carefully weighed. However, we think that the benefits of line-by-line cohesiveness between the statement of comprehensive income and statement of cash flows and line-by-line reconciliation of the two statements need to be clearer and more persuasive if this close connection is to be a significant factor. Feedback that we have got from the users indicates that a properly presented indirect-method cash flow statement reconciling operating profit with operating cash flow provides them with enough information to satisfy their information needs.

143 Therefore in our view, rather than proceed with the reconciliation schedule propose, we suggest the disclosure should be scaled down and should focus on the numbers that would have been disclosed in such a schedule that are considered the most useful.

(b) Should changes in assets and liabilities be disaggregated into the four components described in paragraph 4.19 of the DP? Please explain your rationale for any component you would either add or omit.

144 As we have already said, we think the proposed reconciliation schedule will involve a lot of numbers being disclosed, only some of which will useful enough to justify providing them. This concern probably relates most to the 'accruals other than remeasurements' column; we think most of the numbers in that column will usually be of relatively little information value. We realise that it is a necessary condition

for the complete reconciliation between both flows statements, but wonder whether this kind of line-by-line reconciliation is really necessary and useful.

145 We recognise that research suggests that it can make a difference to users whether a number in the statement of comprehensive income is based on a cash transaction or an accrual, but our discussions with users suggest to us that it will generally be only the bigger and more long-term accruals that will be of interest to them.

146 The DP also reports that users want the additional information on remeasurement that Columns D and E of the schedule would give them. We support this aspect of the proposal and think that the proposal should probably be amended to concentrate on that aspect.

(c) Is the guidance provided in paragraphs 4.31, 4.41 and 4.44–4.46 of the DP clear and sufficient to prepare the reconciliation schedule? If not, please explain how the guidance should be modified.

147 We have not so far identified any issues on respect of which additional guidance would be necessary, bearing in mind that IFRSs represent a principles-based set of standards.

Question 24

Should the boards address further disaggregation of changes in fair value in a future project (see paragraphs 4.42 and 4.43 of the DP or paragraphs below)? Why or why not?

148 The DP notes that IFRSs currently provide limited guidance on whether and how an entity should disaggregate and present changes in the fair value of a financial instrument in the statement of comprehensive income. For example, an entity might disaggregate a change in the fair value of an interest-bearing instrument into changes attributable to current period interest accrual, other interest rate changes, credit risk changes, foreign currency changes and other changes and present those changes separately in its statement of comprehensive income. Because there is only limited guidance on this issue, in some cases a change in fair value may appear *as a single line item* in the statement of comprehensive income, and in other cases different components of a change in fair value may appear in separate line items. Some users have stated that the loss of information from not disaggregating the changes in fair values of financial instruments could be significant and that the statement of comprehensive income would have greater analytical value if the sources of the changes were identified and presented.

149 Another consequence of the limited guidance on this issue is that an entity may present changes in the fair value of a financial instrument in line items that include amounts relating to a similar instrument measured on a cost basis,[14] which raises concerns that the presentation is not consistent with the method of accounting. For example, presenting a gain or loss arising from a change in the fair value of a financial instrument in three line items—contractual interest, 'incurred' credit losses (comparable to what is required by IAS 39 *Financial Instruments: Recognition and Measurement*), and 'other'—does not appear consistent with a fair value measurement basis. This DP does not address disaggregation of the changes in

[14] This would be largely solved with the DP's proposal 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, what would also separate different measurement basis gains and losses.

fair values of financial instruments beyond the limited guidance that is currently in IFRSs. Doing so would require the boards to address recognition and measurement issues, which are beyond the scope of this project.

150 EFRAG's comment letter on the IASB Discussion Paper *Reducing Complexity in Financial Reporting* (issued 30 September 2008) pointed out that there is a widely held view that, in order to enhance user understanding of reported fair values, gains and losses reported in earnings need to be disaggregated into various categories and that this disaggregation needs to go far beyond what is contemplated currently in the (phase B) financial statement presentation project. We would therefore support the IASB carrying out further work on the subject, perhaps in the form of a future project on fair value disclosures.

Question 25

Should the boards consider other alternative reconciliation formats for disaggregating information in the financial statements, such as the statement of financial position reconciliation and the statement of comprehensive income matrix described in Appendix B, paragraphs B10–B22? For example, should entities that primarily manage assets and liabilities rather than cash flows (for example, entities in the financial services industries) be required to use the statement of financial position reconciliation format rather than the proposed format that reconciles cash flows to comprehensive income? Why or why not?

151 One of the alternative reconciliation formats proposed by the boards is a statement of financial position reconciliation, which would start with the amount in a statement of financial position line item (that is, an asset, liability, or equity item) at the beginning of the period. The change in the amount of that line item then would be disaggregated into a cash component (column B) and the three accrual components in the reconciliation schedule (columns C, D and E). The statement of financial position reconciliation includes captions from the statement of cash flows and the statement of comprehensive income that link the statement of financial position line items to those two statements. However, the statement of financial position reconciliation does not reconcile the statements of comprehensive income and cash flows in the same manner as is done in the reconciliation schedule.

152 The second alternative multicolumn format for presenting disaggregated information is called the statement of comprehensive income matrix. It disaggregates the statement of comprehensive income into components similar to those on the reconciliation schedule. It does not reconcile to either the statement of financial position or the statement of cash flows and thus the matrix does not include line item/captions from either the statement of cash flows or the statement of financial position.

153 EFRAG notes that all the various alternatives appear to be substantial items of disclosure that would involve a substantial amount of work. It seems to us that the first thing to do therefore is to identify what the objective is, because if that objective can be properly defined (and is deemed worthy of being met), that should tell us a lot about the form the disclosure should take. Our concern about the discussion in the DP is that there still appears to be considerable difference of opinion as to what the objective is, hence the very different reconciliations being proposed—each of which appears to provide a different (but overlapping) set of additional information.

154 We note, for example, that the CFA Institute[15] has previously argued for an approach that is very similar to the DP's statement of financial position reconciliation on the grounds that it is essential to its goal of increasing the transparency and understandability of companies' financial reporting and disclosures. Other users seem to have other objectives in mind. For example, a number of users have told us that they attach a high priority to a reconciliation of net debt (something which the DP is silent about). And the boards seem to be focusing on a different objective again.

155 **Questions for constituents:**

The DP is suggesting that, even with the changes to the presentation of the primary financial statements being proposed, something is missing and that, as a result, some sort of reconciliation (of either statement of cash flows to statement of comprehensive income or opening statement of financial position to closing statement of financial position) or breakdown (of the statement of comprehensive income) is needed to provide more information about the transactions, accruals and remeasurements that have taken place.

Do you agree that there is a need for such information that should be met in the financial statements?

If you do, what exactly is that need and in your opinion which of the proposals in the paper best meets that need? Does some other form of disclosure meet the need even better?

Does the type of disclosure needed vary depending on the type of entity involved? For example, should entities that primarily manage assets and liabilities rather than cash flows be required to use the statement of financial position reconciliation format rather than the proposed format that reconciles cash flows to comprehensive income?

Question 26

The FASB's preliminary view is that a memo column in the reconciliation schedule could provide a way for management to draw users' attention to unusual or infrequent events or transactions that are often presented as special items in earnings reports (paragraphs 4.48–4.52). As noted in paragraph 4.53, the IASB is not supportive of including information in the reconciliation schedule about unusual or infrequent events or transactions.

(a) Would this information be decision-useful to users in their capacity as capital providers? Why or why not?

156 The DP explains that the boards considered whether the reconciliation schedule might provide a way for management to highlight unusual or infrequent events or transactions in their financial statements—items that are often presented as special items in earnings reports (for example, the effect of amendments to a pension plan, an unusually large payment related to hiring a chief executive, or an unusually large sales order for a one-off event). In addition, the measurement of some of those less persistent events or transactions might also be more subjective.

---

15 See CFA Institute (2007): A Comprehensive Business Reporting Model: Financial Reporting for Investors, July 2007, pp. 29-35.

157 For that reason, the FASB supports adding a 'memo' column to the reconciliation schedule so that managers can inform users about components within a line item in the reconciliation schedule that are less persistent and more subjective than the rest of the components in that line item. That memo column would be included as the last column in the schedule because it is not part of the reconciliation of cash flows to comprehensive income. In addition, an entity should explain in the notes its rationale for including items in the memo column. We note that a similar view was expressed in a UBS research paper issued in 2007 (*Financial Reporting for Investors – Performance Measurement for Equity Analysis and Valuation*, 16 April 2007), where it was suggested that such items should be dealt with in a column next to the income statement.

158 However, the IASB does not support including this information in the reconciliation schedule because, the DP explains, there is no notion of unusual or infrequent events or transactions in IFRSs. It is also worth noting that, when the IASB revised IAS 1 in 2003, it prescribed that "no items may be presented on the face of the statement of income or in the notes as 'extraordinary items'." [IAS 1.85].

159 Our understanding is that users would like to have information about events and transactions that are genuinely unusual or infrequent, because it enables them to identify the recurring/sustainable numbers and use those to make assessments about the future. This seems to us to be a reasonable information need that should be met if possible.

160 To our minds therefore, one issue is whether it can be done in a way that is sufficiently objective to be useful. Much will therefore depend on how the terms are defined or explained.

161 A second issue is how best to bring these unusual items to users' attention. We would not support the reintroduction of extraordinary items by another name, so it is also important to us that the presentation approach does not feel like the 'extraordinary item notion'. On the other hand, we are not very keen on the proposal that it be presented in a memo column in a reconciliation schedule. Partly this is because we have concerns about the reconciliation schedule itself (see above our responses to questions 23-25). However, it would also involve including, in a disclosure intended to provide information about the types of event that have effected individual lines in the statement of comprehensive income, information prepared for a different purpose. Including both in a single disclosure would make the reconciliation schedule even more what we want to avoid it becoming: a rag bag of data that users search through to try to find information of use to them. We think the information provided in financial statements should be of a higher order than that.

(b) APB Opinion No. 30 Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, contains definitions of unusual and infrequent (repeated in paragraph 4.51). Are those definitions too restrictive? If so, what type of restrictions, if any, should be placed on information presented in this column?

162 APB 30 defines 'unusual nature' as involving an underlying event or transaction that possesses a high degree of abnormality and is of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

163 APB 30 defines 'infrequency of occurrence' as involving an underlying event or transaction that is of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

164 The DP notes (in paragraph 4.51) that an entity can include events or transactions that do not meet these definitions but "are similar to items that are unusual in nature or occur infrequently."

165 EFRAG is aware that producing a viable definition of terms such as 'unusual' and 'infrequent' events and transactions is always very difficult, especially if bearing in mind that IFRSs represent a principles-based set of standards. In addition, as we have already stated, we would not support the reintroduction of extraordinary items by another name.

(c) Should an entity have the option of presenting this information in narrative format only?

166 We are not against the adoption of a narrative format; however in our opinion the narrative format should also contain and explain numbers.

Other comments

<u>Unrecognised assets and liabilities</u>

167 The DP does not explicitly refer to the issue of classification of expenditures and expenses related to unrecognised assets. We note however that this issue has needed to be addressed twice by the IASB recently, in the 2007 Annual Improvements Standard and in the 2008 Annual Improvements ED.

168 For example, the recent ED addresses the concerns arising from the fact that some entities classify such expenditures as cash flows from operating activities and others classify them as investing activities. Examples of such expenditures are those for exploration and evaluation activities. The ED proposes to amend IAS 7 to state that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activities. We note that this would also apply to initial expenditures for development activities that do not meet the recognition criteria from IAS 38 *Intangible Assets*, which would be allocated to 'operating activities' under the proposed amendment even though it could be argued that these expenditures could also have been made as part of an entity's investing activities.

169 We are aware that this is a slightly different issue than the one in the DP, where the 'correct' classification is determined first by classifying the assets and liabilities, then applying that same classification to related income, expense and cash flow items. Our issue is whether the management approach would also be applied to the expenditures and expenses related to unrecognised assets. (So, if an entity views a particular type of unrecognised asset as an operating asset, it would classify the flows arising from that asset as operating too.) We think it would be useful if the boards' position on this issue could be clarified in the ED that will be developed from the DP.

Held-for-sale items

170 In our opinion it would also be helpful to have some indication how the boards foresee held-for-sale assets being categorised. (They relate, or at least did relate, to the 'core' activities but no longer have the same relationship with the operations.)

Appendix 2:
Summary of EFRAG's responses to the questions asked in the Discussion Paper

The purpose of this appendix is to briefly summarise the views expressed in appendix 1.

1 EFRAG supports much of what is proposed in the discussion paper (DP), but does have a number of concerns.

<u>The presentation objectives</u>

2 EFRAG is broadly in favour of the proposed financial statement presentation objectives. However, we would be concerned were they to be applied in a very rigid or mechanical way. For example:

(a) although we agree that it is very important that users should be able to understand the relationship between items across financial statements and that an entity's financial statements complement each other as much as possible, we do not think it follows that everything has to be shown in the same order and disaggregated to the same extent. Thoughtful and pragmatic application of the cohesiveness principle is needed.

(b) although we agree that an entity should provide disaggregated information that is as useful as possible to users, we do not think it follows that all that information should be provided on the face of the financial statements. Too many lines can obscure as much as enlighten.

<u>The management approach to the classification of items</u>

3 We are not in favour of an approach to classification that gives management substantial—perhaps even total—discretion as to how the assets and liabilities are classified in the statement of financial position. However, we do not think that is what the DP intends. Paragraph 2.27 of the paper states that the objective is that the classification of the various assets and liabilities should reflect how each of those assets and liabilities are used in the business. In our view this principle should be a key requirement of the eventual standard. It would mean that, although management would usually have substantial—perhaps even total—discretion as to how the assets and liabilities are used in the business, having exercised that discretion management would have little if any flexibility as to how the assets and liabilities are classified in the statement of financial position.

<u>Classification into business and financing and the sub-division of business into operating and investing</u>

4 We support the proposal to separate business activities from financing activities, and to show discontinued operations separately. We also support the sub-division of the business section into operating and investing categories, although we are not sure the DP is consistent in its explanations of what each of those categories should contain.

5 However, we do not support the proposal that only financial assets and financial liabilities should be included in the financing category; such an approach is in our view not consistent with the management approach to classification.

6 We agree that the classifications should be done at the reportable segment level. Any other approach would not be consistent with a management approach to classification.

<u>Disaggregation by function and/or by nature</u>

7 We are broadly comfortable with the DP's proposal that, to the extent that it will enhance the usefulness of the information in predicting the entity's future cash flows:

(a) an entity should disaggregate income and expense items within each category by function, and

(b) an entity should disaggregate the items in that disaggregation-by-function further by nature;

and that those entities that do not provide a disaggregation by function ("because such disaggregation would not enhance the usefulness of the information in predicting the entity's future cash flows") should disaggregate those items by their nature to the extent that this will enhance the usefulness of the information in predicting the entity's future cash flows.

<u>Allocation of tax amounts</u>

8 We are strongly against any further allocation of the tax expense/benefit to lines within the statement of comprehensive income, and are therefore, with one exception, pleased that the DP is proposing no changes to the existing requirements for allocating and presenting income taxes. (An entity would thus not allocate income taxes to the business or financing section or to categories within those sections.)

9 Our one concern is that we continue to believe strongly that it is not appropriate to require the allocation of the tax expense/benefit to each item of other comprehensive income and would encourage the IASB to reconsider this part of existing IAS 1.

<u>A single statement of comprehensive income</u>

10 EFRAG is divided on the proposal in the DP to eliminate the option in existing IFRS to present an income statement and a statement of other recognised income and expenses; in other words to require the presentation of a statement of comprehensive income. Some members think the proposal would be an improvement in financial reporting; and others believe that, having ensured that:

(a) items of income and expense are presented in a statement or statements that is/are separate from owner changes in equity, and

(b) if two statements are presented, the second will be presented immediately after the first,

it is a matter of no importance where the page break is and it should be left to preparers to find the presentation that works best for them.

11 The DP proposes that, within the statement of comprehensive income, comprehensive income would be divided into profit or loss and other comprehensive income, so the current disaggregation between profit or loss/net

income and other comprehensive income is maintained. EFRAG supports this proposal. Piecemeal changes to the profit or loss/other comprehensive income division should not be made; what is needed is a comprehensive consideration of the, in some cases complex, issues involved, and we agree that there is not enough time to do that at this stage if the DP is to result in a standard by 2011.

<u>The direct method of presenting operating cash flows</u>

12 We do not support the proposal that all entities should be required to use a direct method in presenting cash flows from operating activities in their statements of cash flows. We favour an indirect method.

13 In particular, we have not been convinced that the direct method of presenting operating cash flows provides information that is more decision-useful than the indirect method. We also do not think that the direct method is necessarily more consistent with the proposed financial statement presentation objectives than the indirect method. It is also clear that there are concerns about the relative cost of implementing the direct method.

<u>Reconciliation schedule</u>

14 We understand that financial statements are prepared to meet the reasonable information needs of users. We also recognise that, as financial reporting gets more sophisticated and increasingly reflects non-cash items and other events, including remeasurement, it will not be sufficient to provide merely a vertical disaggregation of broad categories of income and expense into narrower income and expense categories; a horizontal disaggregation into the different types of elements making up an item of income or expense (i.e. cash flows, accruals and remeasurements) might be needed. We are nevertheless not convinced by the DP's proposals that entities should be required to present a reconciliation schedule showing the accruals and remeasurements that reconcile each line of the statement of comprehensive income to the statement of cash flows.

15 This is primarily because we believe that the proposed reconciliation schedule will result in a lot of numbers being disclosed, only some of which will be useful enough to justify the resources spent on providing them. In our view it would probably be better to focus the schedule on the remeasurements and largest non-cash items or to provide a reconciliation of net debt.

<u>Memo column of unusual items</u>

16 Our understanding is that users would like to have information about events and transactions that are genuinely unusual or infrequent, because it enables them to identify the recurring/sustainable numbers and use those to make assessments about the future. This seems to us to be a reasonable information need that should be met if possible. The issues therefore are:

(a) can it be done in a way that is sufficiently objective to be useful? Much will depend here on how the terms are defined or explained.

(b) how best to bring these unusual items to users' attention? We do not like the suggestion that a memo column should be added to the reconciliation schedule, because we think it will make that schedule even more of a rag bag of data that users search through to try to find information of use to them.