

Comment on IASB Discussion Paper: *Preliminary Views on Financial Statement Presentation*

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?

Comment on Question 5

Firstly, it should be noted the approach adopted in the IASB Discussion paper is not a pure management approach, because management discretion in classifying assets and liabilities into operating, investing, and financing categories is limited by the definitions and guidance provided regarding which assets and liabilities should be classified into each category.

The more relevant question to consider is: how tightly should the three categories be defined.

If the definitions of the three categories are framed too tightly, some entities will be compelled to classify assets and liabilities into categories, which are inappropriate, given the nature of their business operations, with the result that the financial statements do not appropriately reflect the performance and/or financial position of the entity. The definitions need to be framed with sufficient flexibility to enable entities with very different business operations to classify assets and liabilities into different categories, to appropriately reflect the nature of each entity's business operations. An example provided in the discussion paper, (paragraphs 2.34, and 2.79), illustrates this required flexibility: Financial instruments used to finance a manufacturing entity's operating and investing activities should be classified in the finance category, whereas a financial services entity, which uses the same type of financial instruments to conduct its financial services business operations, should classify the financial instruments in its operating classification.

Therefore preparers and auditors of financial reports must exercise professional judgement in the context of the definitions of the three categories, and the nature of the entity's activities, to determine the appropriate classification of assets and liabilities.

Alternatively, if the definitions of the three categories are framed too loosely, it is extremely likely that entities with similar business operations will classify similar assets and liabilities into different categories, which would undermine the consistency and comparability of financial reports across different entities. The definitions need to be framed sufficiently tightly such that in similar situations assets and liabilities are classified consistently by different entities. For example, all entities that invest surplus funds, which are not presently required to conduct their core operating activities, into financial instruments, should classify those financial instruments as investing activities. The comparability and consistency of financial reports would be undermined if some entities classified such financial instruments in the financing category, while other entities classified such financial instruments in the investing category.

The discussion paper, (paragraph 2.66), provides an example which indicates that an entity may classify some activities as either operating or investing activities. Such possibilities undermine the comparability and consistency of financial reports.

Question 9

Are the **business section** and the **operating and investing categories** within that section defined appropriately (see paragraphs 2.31–2.33 and 2.63–2.67)? Why or why not?

It appears unnecessary to independently define the business section, given that business activities are sub-classified into operating and investing activities. The accounting standard should require all assets and liabilities to be classified into one of three categories/ sections: operating, investing, and financing. The accounting standard should require the sub-totals of net assets for the operating and investing categories to be added to arrive at a total of net assets for the business section.

The operating category is appropriately defined and described in paragraph 2.32. The definition/ description refers to the fundamental principle, which is used to distinguish operating assets and liabilities from investing and financing assets and liabilities. This definition of operating category needs to be supported by explanations and examples of assets and liabilities which should be included in the operating category, in order to promote consistency of classification of assets and liabilities by different entities.

To demonstrate how broad the definition of operating category is, and to distinguish the new definitions, from the old definitions presently in IAS7/AASB107: Statement of Cash Flows, the accounting standard should explain, (more definitely than expressed in paragraph 2.65), that property, plant, and equipment, and intangible assets used directly or indirectly to conduct primary revenue and expense generating activities should be included in the operating category. As suggested by paragraph 2.45, liabilities directly related to primary revenue and expense generating activities, such as accounts payable provisions for employee benefits, and warranties, should be included in the operating category.

If the definition of business section is removed as proposed above, the investing category needs to be redefined. The investing category should include assets and liabilities relating to activities conducted with the intention of creating value, which are unrelated to the central purposes for which the entity is in business, (i.e. other than primary revenue and expense generating activities). The definition on investing category should not include a reference to “continuing activities”, (see paragraph 2.31), because an entity may invest surplus funds temporarily, until those funds are required for operating activities.

Where an entity is engaged in a diversified range of activities/ operations, including some activities which constitute a minor part of its revenue and expense generating activities, there may be difficulties in classifying such minor activities in accordance with the definitions of operating and investing activities. For example, in 2008, Woolworth's consumer electronics and wholesale segments each contributed less than 5% of total segment revenue, less than 5% total segment results, and have less than 5% of total segment assets. [See Woolworths Ltd, 2008 Financial Report, Note 7: Segment Disclosures, accessed at <http://thomson.mobular.net/thomson/7/2805/3519/>]

Minor activities, such as Woolworth's consumer electronic and wholesale segments should be classified in the operating category, because the entity controls and manages such activities, and they are intended to be ongoing activities, (i.e. they are not discontinuing operations, as defined in IFRS5/AASB5). However, it could be argued that such minor activities are not “central”, nor “primary”, because they are not a major part of the entity's activities, and therefore should not be classified as operating activities, (see paragraph 2.32). Consequently such minor activities would be classified as an investing activity. Alternatively, it could be argued that such minor activities are “central”, and “primary”, because the entity controls and manages such activities, and they are part of the entity's ongoing activities. It follows from this argument that such minor activities should be classified as an operating activity. Paragraph 2.66 suggests that either interpretation is acceptable.

In contrast, minor investing activities, such as investing in property/real estate, equities, debentures/ bonds, derivatives, precious metals/stones, should be classified in the investing category, because such

minor investing activities are unrelated to the entity's "central" and "primary" activities. However, if such investing activities are a major part of the entity's activities, they should be classified in the operating category, because the investing activities are a "central" and "primary" part of the entity's activities.

The accounting standard should provide examples of classifying such minor activities. These examples should include minor activities such as Woolworth's consumer electronic and wholesale segments being classified in the operating category, and minor investment activities being classified in the investing category. Such examples are necessary to provide guidance on how the definitions of operating and investing activities should be interpreted and applied.

Paragraph 2.43 provides an example of an asset, head office building, that is used for more than one function. The building could be partly be used by the entity to manage its own operating activities, and partly rented to third parties, an investing activity. Where an asset is used for more than one function, the asset should be allocated to its predominant function. The alternative of allocating the asset, and its associated income and expenses, and cash flows between functions is likely to be arbitrary for many assets, and therefore result in unreliable measurements.

Question 10

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?

The financing section is appropriately defined in paragraph 2.34.

Paragraph 2.61 requires treasury assets should be included in the financing category. The rationale provided is those assets are included in the analysis of an entity's financing activities. An example is provided of an entity having cash in excess of its working capital needs. The entity considers whether it should use the excess cash to retire debt, or to engage in investing activities. The fact that investing and financing decisions are closely connected is not a justification for placing the activities into the one category for financial reporting purposes.

Operating and financing decisions are also closely connected. For example, when an entity is considering reinvesting internal funds into the entity's operating activities, the entity also needs to determine the best use of those funds: is it better to expand operations, or retire debt? Similarly when determining whether to raise additional debt or equity funds to expand the entity's operating activities, the entity needs to determine whether the returns generated by the expanded operations are likely to cover the cost of the additional funds. Following the logic of paragraph 2.61, operating assets should also be included in the financing category. The end result of this flawed logic is that all assets and liabilities should be included in the financing section.

It does not follow that there should be no assets in the financing category. Financial assets which are used to manage the risk associated with liabilities used to finance the entity's operating and investing activities should be included in financing category. For example a forward contract is used to manage the foreign exchange risk relating to a foreign currency loan. There may be a net asset position associated with the forward contract at reporting date.

Equity

Equity should be presented in the financing category, separate from debt/non-owner finance, as it is fundamentally a source of finance, along with debt, as noted in paragraph 2.53. The financing category in the Statement of Cash Flows could also be sub-divided into debt/non-owner and equity/owner sub-

sections, (which would be consistent with the presentation in the Statement of Financial Position).

Skilled users of financial reports will understand that:

the debt/non-owner sub-section of the financing category in the Statement of Financial Position, and the Statement of Cash Flows, will have a corresponding section in the Statement of Comprehensive Income; and

the equity/owner sub-section of the financing category in the Statement of Financial Position, and the Statement of Cash Flows, will have a corresponding items in the Statement of Changes in Equity

Furthermore, skilled users will also understand that the total of the equity section will equal the total of net assets.

The classification of equity as a separate section outside the financing category, (as proposed in the discussion paper), is driven by the desire for consistency in classification of items across three financial statements, (Statement of Financial Position, Statement of Cash Flows, and Statement of Comprehensive Income). [See paragraphs 2.54 and 2.55]. However, this consistency in classification of items is not achieved with regard to dividends payable, (which is directly associated with equity financing), but is classified in the financing category in the Statement of Financial Position, and in the Statement of Cash Flows. [See paragraph 2.48].

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