

IASB staff draft of new presentation model for financial statements

What you need to know

- ▶ The IASB and FASB issued a staff draft ED that proposes fundamental changes in financial statement presentation
- ▶ The level of detail in financial statement disclosures will significantly increase due to disaggregation of financial information
- ▶ A direct method cash flow statement would no longer be optional, but is required
- ▶ Implementing the proposed changes is likely to require significant changes to processes and information systems
- ▶ The notes will include disclosures of remeasurements and a detailed analysis of changes in select asset and liability line items
- ▶ The proposals are consistent with US GAAP, except for the increased segment disclosures proposed by the FASB

Introduction

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB, and collectively, the Boards) have posted to their respective websites, a staff draft of an exposure draft (herein the draft ED) of a new financial statement presentation standard. The issuance of the draft ED is part of the work plan of the overall financial statement presentation project which is a joint project of the Boards.

The draft ED reflects the Boards' tentative decisions to date regarding their efforts in developing a new financial statement presentation standard. The Boards' proposals are fundamentally the same, although there are some minor differences around segment disclosures.

The Boards have decided to engage in additional public outreach activities before finalising and publishing the final exposure draft of the proposed standards. This is in order to consider the perceived benefits and costs of the proposals as well as the implications of the proposals on financial services entities. After completing these additional outreach activities, the Boards will consider whether to change any of their tentative decisions in response to the input received.¹ An exposure draft of the new standard is expected to be issued in early 2011.

Summary of proposals

If adopted as proposed in the draft ED, the standard will fundamentally redefine the way that companies present their performance, financial position and cash flows.

Cohesiveness and disaggregation are the key drivers to address concerns expressed by financial statement users about a lack of consistency and comparability in today's financial statements. The new presentation model would represent a fundamental change for all reporting entities and is likely to require significant changes to entities' information systems.

¹ The staff draft has been made available only for information as a basis for outreach activities. The Boards are not formally inviting comments on the staff draft, however, they welcome input from interested parties.

The primary financial statements would be organised consistently around an entity's business activities (the way it creates value) and separately from its financing activities (the way it funds those activities). Business activities would further distinguish operating activities separately from investing activities while financing activities would be separated into debt and equity categories based on today's definitions of liabilities and equity. An entity also would present separate sections for discontinued operations, income taxes and multi-category transactions.

One of the more significant changes to current practice is the requirement for a direct method operating cash flow presentation in addition to a reconciliation of operating income to operating cash flows. The proposed guidance would also require a significant increase in the amount of information that entities disclose, due to increased disaggregation by function, nature and measurement basis in the financial statements. An entity would also disclose information on remeasurements, as defined in the proposals, recognised in the financial statements and an analysis (i.e., a roll-forward) of the changes in select balance sheet line items.

Core principles

The proposed standard is based on two core principles – cohesiveness and disaggregation. The Boards believe that, together, these principles enhance the understandability of a reporting entity's financial information.

Cohesiveness

Cohesiveness focuses on the relationship between items in the financial statements. It links transactions consistently across the financial statements.

To illustrate the cohesiveness principle, consider the presentation of interest in financial statements today. While accrued interest might be a current liability in the balance sheet, interest expense is usually classified as finance cost in the income statement, and interest paid is classified as operating cash flow in the statement of cash flows. In the proposed presentation model, interest would be presented in the debt category of the financing section in a consistent manner across the financial statements.

Disaggregation

The objective of disaggregation is to provide sufficient detail within the financial statements so that the activities and cash flows of the entity are clear and the relationships between assets or liabilities, and the effects of changes in those assets or liabilities, are consistently reflected in the financial statements. Transactions without similar economic characteristics are required to be presented as separate line items, based on their nature, function or measurement basis. For example, within cost of goods sold, labour and materials will likely have different economic characteristics, so an entity would consider presenting them on a disaggregated basis.

Financial statement classification model

The guidance in the proposals would establish common sections and categories in which a reporting entity classifies financial information in its statements of financial position, comprehensive income, and cash flows. Each of those statements would have the sections and categories (with subtotals) described in Box 1.

An entity will classify items in its financial statements into the appropriate sections and categories based on how those items relate to its activities in a cohesive manner across the financial statements. Thus, the classification of items could differ based on

the industry in which the reporting entity operates (e.g., financial service entities). Entities with more than one reportable segment would classify items in a way that reflects the function of the items at segment level.

An entity would be required to disclose the basis for classification of line items in the sections and categories and subcategory in the financial statements.

Changes to the statement of financial position

The structure and appearance of the statement of financial position would change significantly, classified according to the sections and categories discussed

above, rather than presenting assets, liabilities, and equity as it does today. However, in addition to the subtotals required for each new section and category, certain required subtotals in the statement of financial position, such as total assets and liabilities, total short- and long-term assets and liabilities, would continue to be presented.

The statement of financial position contains all of the defined sections and categories, except for the multi-category transactions section. A separate presentation of discontinued operations as well as income taxes continues to apply.

Box 1: What's included in the sections and categories?

Business section	
▶ Operating category	Items and transactions that generate revenue through a process that requires the interrelated use of the net resources of the reporting entity. Examples: Revenue, accounts receivable, cash from customers, inventory, property, plant and equipment.
▶ Operating finance sub-category	Liabilities that have a primary operating function and a secondary financing function that are closely related. Examples: Pension expense, pension obligations, and cash payments to retirees, leases and asset retirement obligations.
▶ Investing category	Items and transactions that generally yield a return in the form of interest, royalties and dividends for the reporting entity. No significant synergies are created for the reporting entity by combining investing assets. Examples: Share of profits of associates, interest and dividends received, investments in debt or equity securities.
Financing section	
▶ Debt category	Borrowing arrangements that are entered into for the purpose of obtaining (or repaying) capital, including assets and liabilities that arise from transactions involving a reporting entity's own equity. Examples: Interest expense, loans, principal and interest payments.
▶ Equity category	Items defined as equity in IFRSs.
Income tax section	Current and deferred tax items and transactions.
Discontinued operation section	Assets and liabilities related to a discontinued operation as determined in accordance with IFRSs, changes therein and related cash flows.
Multi-category transaction section	The effects of an acquisition or disposal transaction that affects more than one section or category on the statement of comprehensive income and statement of cash flows. Example: Acquisition or disposition of a business.

Note that cash would always be classified in the operating category of the business section. The proposal removes the concept of cash equivalents, so items currently considered as cash equivalents would be included in the investing category for most commercial entities.

The draft ED requires, within the sections and categories, disaggregation of similar assets and liabilities when disaggregation is relevant for an understanding of an entity's financial position. The entity considers the function of assets and liabilities, the nature and liquidity of assets, the nature and timing of liabilities and measurement bases of assets and liabilities in making that determination. For example, an entity would disaggregate investments in affiliates accounted for under the equity method from those accounted for under the fair value option.

Assets and liabilities will continue to be classified as short and long-term within each section and category.

However, the proposal no longer permits an entity to consider an operating cycle longer than 12 months in that classification. Rather, an asset or liability would be classified as short-term if the shorter of its contractual maturity or its expected date of realisation or settlement is within one year of the reporting date. Otherwise, an asset or liability is classified as long-term.

Entities may present the statement of financial position in order of liquidity within each section and category, rather than classified as short- and long-term, if that presentation provides more useful information (e.g., financial institutions).

Changes to the statement of comprehensive income

The Boards have separately proposed to eliminate the option to present the statement of comprehensive income in two statements and require a single, continuous statement of comprehensive income with two distinct sections for profit or loss and other comprehensive income.² That proposal, referred to herein as the 'OCI ED' is also reflected in the draft ED. Entities would continue to present profit or loss separately from total comprehensive income and profit or loss will continue to be the basis for the EPS calculation.

Entities will generally disaggregate income and expense by function (e.g., product revenue, service revenue, related costs of revenue, sales and marketing, etc.) on the face of the statement of comprehensive income. The proposals require entities to further disaggregate income and expense by nature within the related functional grouping to the extent that such disaggregation provides meaningful information, either on the face or in the notes to the financial statements (e.g., disaggregating costs of sales into materials, labour, energy and transport costs). Note that when an entity does not consider a disaggregation by function to be useful to users, the entity may disaggregate its income and expense items by nature in the statement of comprehensive income only.

How we see it

The significant increase in the information to be presented, as well as changes to the presentation model itself, may require substantial changes in the systems and processes that reporting entities use to prepare their financial statements.

² Exposure Draft *Presentation of Items in Other Comprehensive Income – Proposed Amendments to IAS 1* (issued in May 2010), see our publication *Supplement to IFRS outlook* Issue 74.

Line items presented as part of other comprehensive income would indicate whether they relate to operating, investing or financing activities, or to discontinued operations. This presentation is intended to identify the category of profit or loss that would be affected by any subsequent reclassification adjustments.

There are other changes proposed by the OCI ED related to the presentation of other comprehensive income that have been included in the draft ED. Other comprehensive income would be required to be grouped into items which would subsequently be reclassified to profit or loss and items which would never be reclassified. In addition, reclassification adjustments would be presented separately for each item of other comprehensive income.

Changes to the statement of cash flows

One of the most significant changes from current practice that is being proposed is the requirement for a direct method statement of cash flows. The direct method requires the presentation of gross cash receipts and cash payments classified in the same section and category as the related asset, liability, or equity item in the statement of financial position and the related income or expense item in the statement of comprehensive income. The Boards believe that a direct method cash flow statement provides more useful information for the users of financial statements to assess the amount, timing and uncertainty of future cash flows.

Entities also would have to present a reconciliation of operating income and operating cash flows (i.e., based on the operating category as defined in the proposal) as an integral part of the cash flow statement.

How we see it

Presentation of a direct method cash flow statement will require significant changes to systems and processes for most entities. For example, an entity would need to distinguish accounts payable related to raw materials, direct labour and other items in order to derive cash paid for materials, wages and other business related cash flows.

The current requirement to present cash flows on a gross basis is carried forward in the proposal as well as the ability to present certain activity on a net basis. However, financial institutions will be required to present cash flows with their customers on a gross basis (e.g., a mortgage payment from the customer's account, deducting fees from a customer's account, or crediting interest to a customer's account).

Notes to the financial statements

Existing general disclosure requirements in the notes to the financial statements are unchanged by the proposal. However, significant new disclosures are proposed regarding remeasurements and the analysis of changes in assets and liabilities.

Remeasurements

The Boards have indicated that users have expressed a desire to have more information on the effect of changes in estimates in the financial statements. As a result, the Boards have included a requirement for disclosures about remeasurements in a single note to the financial statements.

A remeasurement is defined as an amount recognised in comprehensive income that reflects the effects of a change in the net carrying amount of an asset or liability, as a result of a change in (or realisation of):

- ▶ A current price or value
- ▶ An estimate of a current price or value, or
- ▶ Any estimate or method used to measure the carrying amount of an asset or liability

Examples of remeasurements include:

- ▶ Changes in fair value
- ▶ Asset impairments
- ▶ Realised gain/loss on sale of PP&E
- ▶ Changes in method of estimating an allowance

Items presented in the note must be presented using the same sections and categories described above. However, subtotals are not required. Entities must also include qualitative information to place remeasurement information in context. Information provided elsewhere in the financial statements need not be repeated.

How we see it

The remeasurements disclosure will illustrate how an entity's results were affected by management's estimates, whether those estimates relate to a change in a relatively objective measurement (e.g., a Level 1 fair value assessment), or more subjective estimates such as impairment of fixed assets or goodwill, or a change in the method of determining the allowance for doubtful accounts or sales returns.

Analysis of changes in assets and liabilities

The proposals include a requirement to disclose an analysis of changes in assets and liabilities that management consider as most important for understanding the reporting entity's financial position. In evaluating the relative importance of assets and liabilities for disclosure, entities would consider, among other criteria:

- ▶ Beginning or ending balance relative to total assets and liabilities
- ▶ Changes in the balance relative to revenues, expenses and cash flows
- ▶ Activity flowing through the line items relative to revenues, expenses and cash flows
- ▶ Whether assumptions or judgments are used in measuring the asset or liability and the level of uncertainty in the measurement
- ▶ Variability in the measurement resulting from exposure to risk and the nature of that exposure (e.g., credit risk, foreign currency risk, or interest rate risk)

The reconciliation requires a roll-forward of the beginning and ending balances of the asset or liability, separately presenting the effect of changes resulting from each of the following items:

- ▶ Cash inflows and cash outflows
- ▶ Non-cash transactions that are recurring and routine (e.g., credit sales, interest expense)
- ▶ Non-cash transactions that are neither recurring nor routine (e.g., business combination)
- ▶ Accounting allocations (e.g., depreciation expense)
- ▶ Write downs or impairment losses (e.g., bad debt allowance)
- ▶ Remeasurements (e.g., fair value changes or foreign currency translations)

How we see it

As a part of their financial statement close process today, reporting entities may prepare similar analyses for individual entities within a reporting group. However, the requirement to present this level of disaggregated information on a consolidated basis may present challenges to capture the necessary data and to consolidate it, taking into account any intercompany transactions and foreign exchange effects.

Management may present the analysis of changes for most accounts in the notes to the financial statements where the disclosure is most relevant (e.g., in the related footnote for that asset or liability). However, cash, short-term investments, finance leases and each line item of the debt category must be presented in a single note (the aggregate of these items is sometimes characterised as “net debt”).

Comparative information is required for all amounts disclosed as part of the analysis of changes in the current period.

Effective date and transition

A final IFRS is expected to be issued during the fourth quarter of 2011. No effective date has been proposed, however, it is not expected to be any earlier than 1 January 2013, thereby allowing preparers sufficient time to adequately implement the proposed changes. Furthermore, the Boards are expected to consider collectively the effective date and transition (including whether to permit early adoption) for the standards, including financial statement presentation, that they have targeted to issue in 2011 in order to consider the overall effect on constituents.

As proposed, entities will be required to adopt the requirements retrospectively. Accordingly, an entity would apply the requirements to previously issued financial statements, which would entail, for each prior period, reclassifications, new groupings and disaggregation of comparative information presented and disclosed as if the new presentation provisions had always been applied.

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