



LETTER OF COMMENT NO. 130



12 March 2009

Submitted to the "open for comments" web page.

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Dear Sir or Madam

## **Preliminary Views on Financial Statement Presentation**

The Audit Commission welcomes the opportunity to comment on the discussion paper, "Preliminary Views on Financial Statement Presentation"

The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services in England to deliver better outcomes for everyone. Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies. As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.

### **The Commission's Response**

We have some general reservations about the proposals in the discussion paper.

1. The DP specifically scopes out not-for-profit entities. Whilst we understand that not-for-profit entities' financial statements often diverge from those of commercial entities, we do not believe such an approach is helpful in the long run as, certainly in the UK, not-for-profit entities adopt any resultant standards. The proposals would require not-for-profit sectors to make significant departures from the resulting accounting standard in order to prepare their financial statements.
2. We have fundamental concerns about the increased prevalence of the "management approach" to determining the relevant categories of classification. We feel that such an approach is inherently subjective, hard to verify and consequently will lead to lack of comparability and increased subjectivity in entities' accounts. The approach will also likely result in additional work audit work to obtain comfort on the classifications and potential disputes with management.
3. The proposals introduce numerous areas which could increase the volume of the primary statements. We are firmly of the view that the primary statements should be as concise as possible to increase the "user friendliness" and understandability of the statements. Any expanded presentation should be contained in thoroughly referenced and clearly presented notes to the various statements. This enables users with specific information requirements to drill down further into the notes as required.

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*Our detailed comments on each of the Preliminary Views are included in the attached Annex.*

Yours faithfully

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## Annex

### Chapter 2: Objectives and principles of financial statement presentation

**1. Would the objectives of financial statement presentation proposed in paragraphs 2.5–2.13 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 addition to or instead of the objectives proposed in this discussion paper? If so, please describe and explain.**

#### Response

As we discussed in our response to the exposure draft on the IASB Conceptual Framework, in preparing our response we are, in the context of not-for-profit entities, mindful of a wider class of users rather than just capital providers. Mindful of the needs of those users, we have concerns about the proposals:

- (a) Cohesiveness: By splitting the primary statements into objective categories (business, financing, discontinued ops and taxes) the users may lose an element of understandability present in a more subjective traditional format.
- (b) Disaggregation: Excessive disaggregation could increase the bulk of the primary statements, lead to a decrease in understandability and reduce the ability of users to navigate through the financial statements. There is a need to strike a balance between the level of detail contained in the notes to the accounts and the primary statements themselves. This is referred to in a number of our further responses below.
- (c) Liquidity: We believe this objective should be at the conceptual framework level and indeed is referred to in the Phase A conceptual framework exposure draft. As such it does not require re-iteration at the accounting standard level.

**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)? Why or why not?**

#### Response

We fundamentally disagree with the concept of splitting the statement of financial position (SOFP) into the proposed categories. Such a split is likely to be arbitrary to a large extent. Even if such a split could be achieved on a meaningful basis, splitting readily understood sub categories, such as current assets, will lead to a reduction in understandability.

We are more comfortable with the splitting of the statement of comprehensive income (SOI) and cash flows into business and financing activities as entities will tend to report internally along such lines already. We believe this could enhance decision usefulness of the financial statements.

**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?**

**Response**

As discussed above, we do not agree with the concept of splitting the SOFP in the proposed format but, as long as equity is clearly identifiable in the statement, its location in the statement is of little importance. However, that being the case, we struggle to see why it should be removed from its familiar location at the foot of the statement.

**4. In the proposed presentation model, an entity would present its discontinued operations in a separate section (see 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?**

**Response**

If discontinued operations are to be included in the primary statements we would prefer that activities relating to that operation be grouped together rather than as sub categories throughout the various sections of the statements. The latter option would result in unnecessary and potentially complicated additional analysis by users to understand the effects of the decision to discontinue the operation. If the latter proposal is adopted, we believe a columnar format is preferable, splitting the statements into continuing and discontinued operations.

**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?**

**Response**

As discussed in our response to Q2, we do not agree with splitting the traditional SOFP categories into the proposed sections. Our principle objection is the very fact that such presentation relies heavily on a management approach. Such an approach is inherently hard to verify. This will inevitably lead to a divergence in the comparability between entities' accounts and therefore a reduction in the decision usefulness of the information.

**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 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?**

**Response**

Please see our objections to this proposal in our responses to questions 2 and 5, above.

**7. Paragraphs 2.27, 2.76 and 2.77 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.**

**Response**

For reasons expressed above we do not believe all entities will be able accurately to split assets and liabilities across reportable segments. This inherently introduces excessive subjectivity into the preparation of accounts and will result in reduced comparability of financial statements. We have concerns about the current requirements of IFRS 8 to split assets and liabilities by segment and believe that requiring a further split of segmental assets and liabilities into the proposed classifications only compounds this problem.

**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.**

**Response**

We would draw your attention to our concerns about the segmental reporting requirements detailed in question 8, above. We do not believe the SOFP should be split as proposed and certainly believe that it should not be split even further to align with segmental reporting requirements.

**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?**

**Response**

We do not agree with the splitting of the SOFP in the way proposed as discussed above. The further splitting of the business section into operating and investing categories only compounds our objections as it adds further subjectivity into the presentation of the SOFP. Such a split may also be difficult in practice as there will be, for example, instances where investing activities are to develop operational activities. This will lead to further inconsistencies between entities' financial statements.

**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?**

**Response**

We do not agree with the splitting of the SOFP in the way proposed as discussed above. The *management approach to designating financing assets and liabilities will be overly subjective and result in issues of verifiability and a lack of comparability between entities' accounts.*

**Chapter 3: Implications of the objectives and principles for each financial statement**

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

- (a) What types of entities would you expect not to present a classified statement of financial position? Why?**
- (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?**

**Response**

a) We would expect entities with material short term financial assets and liabilities to adopt the alternative liquidity presentation. However, we query whether the SOFP is the most appropriate place to provide such a liquidity analysis and whether this is not better included as a note to the account, leaving a statement of financial position in the traditional classified format.

b) We consider the guidance to be sufficient.

**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?**

**Response**

Recent economic developments would dictate that any instrument with any element of risk that it will not be convertible to cash at an expected value should be classified separately from cash. However, where an instrument is not subject to such risks, and is still analogous to cash, we believe a heading of "cash and cash equivalents" is still appropriate.

**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. 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?**

**Response**

We agree that assets and liabilities with differing measurement bases should be separately disclosed. However, we do not agree that the SOFP is the place to make this disclosure. This information can easily be included in notes and referenced to the primary statement for users that have an interest in such detail. The proposed restructure of the statement discussed earlier will already expand the statement to a potentially unmanageable size.

**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)? Why or why not? If not, how should they be presented?**

**Response**

We agree with the DP that a single statement of comprehensive income will lead to increased comparability of entities' statements.

**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) (see paragraphs 3.37–3.41). Would that information be decision-useful? Why or why not?**

**Response**

We believe that the proposed treatment of other comprehensive income will result in decision-useful information as long as the management approach to classification is sufficiently verifiable.

**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?**

**Response**

We believe such disaggregation is better situated in a note to the SOCI rather than in the statement itself. The volume of disclosure potentially required by a "by function" then "by nature" approach cannot possibly be contained in a meaningful primary statement. As with other proposals we have doubts over the requirement to split the SOCI using a management approach.

**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 (see 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.**

**Response**

We do not believe it will be practicable to split income taxes across the proposed sections and categories and agree with the proposals to leave such taxes together in the statements.

**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.**

- (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?**

**Response**

We have no comment on this view as foreign currency transactions are very rare in our sector.

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

- (a) Would a direct method of presenting operating cash flows provide information that is decision-useful?**
- (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?**
- (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)? Why or why not?**

**Response**

- (a) We agree that a cash flow statement prepared using the direct method would provide decision-useful information.**
- (b) The direct method does better align with the other primary statement formats proposed and is more consistent with the cohesiveness objective**

- (c) The information currently provided in the indirect method is directly reconcilable to the movements on the SOFP. The reconciliation schedule proposed in para 4.45 is not directly reconciled to the SOFP but would contain much of the same information as the indirect method of presenting cash flows.

**20. What costs should the boards consider related to using a direct method to present operating cash flows (see paragraphs 3.81–3.83)? 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?**

**Response**

We anticipate the main costs of requiring a direct method of cash flow presentation will be the one off costs in changing the way accounting data is captured and recorded in the majority of entities and the resulting system changes and training requirements. Ongoing costs will primarily arise from data quality review processes implemented to ensure transactions are being correctly input according to cash flow type.

**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?**

**Response**

We have no comment on this view as basket transactions are rare in sectors in which the Commission operates.

**Chapter 4: Notes to financial statements**

**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?**

**Response**

Please see our response to Question 11. We do not believe that the SOFP should be the location for any level of liquidity analysis other than short or long term. Where an entity has material short term financial assets or liabilities that have differing maturity dates a note is the appropriate place for a liquidity analysis.

**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.**
- (b) **Should changes in assets and liabilities be disaggregated into the components described in paragraph 4.19? Please explain your rationale for any component you would either add or omit.**
- (c) **Is the guidance provided in paragraphs 4.31, 4.41 and 4.44–4.46 clear and sufficient to prepare the reconciliation schedule? If not, please explain how the guidance should be modified.**

**Response**

- (a) Whilst the proposed reconciliation would be time-consuming to prepare, it should be possible for an entity that has properly coded its transactions in order to provide an accurate direct method cash flow statement.
- (b) We are unsure as to the merit of having a reference to "other" in category b) para 4.19 and para 4.45. This by default becomes a place to collect all transactions that the entity either cannot or does not want to explain further and consequently leads to reduced transparency in the accounts.
- (c) In the light of our response to (b) above, the guidance should include reference that significant or material "other" items should be separately explained.

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

**Response**

We have no comment on this view as such items are rare in the sectors in which the Commission operates.

**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?**

**Response**

A SOFP reconciliation may well be a better format for disaggregating information in the financial statements. For entities where managing and predicting cash flows is not a key objective the proposed reconciliation of cash flow to comprehensive income may not provide the most decision-useful method of disaggregating information in the accounts

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

**Response**

Our view on material unusual or infrequent items is that providing the impact on the entity of the item is adequately highlighted and explained within the statement of accounts, the location of this disclosure is rather irrelevant.