Financial Accounting Standards Board

Board Meeting Handout

Financial Statement Presentation

May 16, 2007

PURPOSE

The purpose of this Board Meeting is to discuss (a) the presentation of liquidity information and (b) classification issues related to diversified entities.

MEMORANDUM 51A AND 51C: PRESENTATION OF LIQUIDITY INFORMATION

In October 2006, the Boards tentatively agreed that entities that are not financial institutions should be required to classify the assets and liabilities in each of the categories on the statement of financial position into short- and long-term subcategories. In December 2006, the Boards tentatively agreed that financial institutions should not be required to present short- and long-term subcategories for each category on the statement of financial position and asked the staff to develop a principle for presenting liquidity information that would apply to all entities, including "hybrids."

Issue 1: Changes to the Liquidity Working Principle

In February, the staff distributed a Board paper that addressed including solvency in the "liquidity" working principle and the application of that revised working principle. The FASB discussed that paper at an education session, but not at a Board meeting. Board members were of the view that solvency should be included in the working principle at the same level as liquidity and asked the staff to consider adding the concepts of (a) capital adequacy and (b) financial flexibility. The staff recommends that the working principle be revised as follows (marked changes are to the original working principle):

> Financial statements should present information in a manner that helps a user assess ~~the liquidity of the~~ an entity's ~~assets and liabilities (nearness to cash or time to conversion to cash)~~ ability to meet its financial commitments as they come due and to invest in business opportunities. An entity's ability to meet its financial commitments includes, but is not limited to, its ability to use existing assets and to raise capital. An entity's financial commitments include those related to operations, financing, and the payment of dividends.

Question for the Board:

1. *Do Board members want to change the working principle to incorporate the concept of:*
   a. *An entity's ability to meet financial commitments as they come due?*
   b. *Continuing to raise capital for operations?*
   c. *Raising capital to take advantage of future business opportunities?*

   If so, do Board members agree with the wording of the revised working principle?

Issue 2: Application of the Revised Working Principle

Issue 2a: Quantitative Disclosures

The staff suggests that the initial discussion document set out the Boards' preliminary views as expressed to date and seek feedback on how to operationalize those views. That is, the document would use the term *financial institutions* to differentiate who presents what information but not define that term (except by example). If the Boards are supportive of that approach, the staff recommends the document include the following preliminary views:

a. **Entities that are not financial institutions** should present a classified statement of financial position. That is, they should present short and long-term subcategories for operating, investing, and financing assets and liabilities.
   i. An asset or liability would be classified as short-term if the shorter of (a) the contractual maturity or (b) the expected realization or settlement of the asset or liability is within one year.

b. **Entities that are financial institutions** (such as banks, investment banks, and insurance companies) should present a detailed maturity schedule for short-term contractual assets and liabilities.
   i. Contractual maturity dates should be used in the schedule. If the expected realization/settlement date for any asset or liability is significantly different from the contractual maturity date, the entity should explain that difference.
   ii. An entity should use its judgment to determine the amount of detail provided. For example, an entity might determine that the following time bands are appropriate: on demand, less than one month; more than one month and not more than three months; and more than three months and not more than one year.

c. **All entities** should present a maturity schedule for long-term contractual assets and liabilities. Much of this is already required to be disclosed (leases, pensions, long-term debt).

   i. Amounts presented should be undiscounted and the schedule should reconcile to the statement of financial position.

   ii. Contractual maturity dates should be used in the schedule. If the expected realization/settlement date for any asset or liability is significantly different from the contractual maturity date, the entity should explain that difference.

   iii. If short-term/long-term "placement" in the schedule differs from what is on the statement of financial position (if short and long-term categories are presented), the entity needs to explain that difference.

In keeping with the Boards preference for a principles-based requirement, the underlying principle would be that all entities should present information about the maturities of all their contractual assets and liabilities. Some entities will present more information about **short-term** contractual assets and liabilities and some entities will present more information about **non-contractual** assets and liabilities.

Questions for the Board:

2. *Should entities that are not financial institutions be required to present a classified statement of financial position as described above?*
3. *Should entities that are financial institutions be required to present a detailed maturity schedule for short-term contractual assets and liabilities as described above?*
4. *Should all entities be required to present a maturity schedule for contractual long-term assets and liabilities as described above?*

Issue 2b: Qualitative Disclosures

The staff recommends that an entity disclose capital management information as described below. The following requirements are the same as those recently added to IAS 1, *Presentation of Financial Statements*.

1. Qualitative information about an entity's objectives, policies, and processes for managing capital, including (but not limited to):
   a. A description of what it manages as capital
   b. When an entity is subject to externally imposed capital requirements, the nature of those requirements, and how those requirements are incorporated into the management of capital
   c. How it is meeting its objectives for managing capital.
2. Summary quantitative data about what an entity manages as capital. Some entities regard some financial liabilities (for example, some forms of subordinated debt) as

part of capital. Other entities regard capital as excluding some components of equity (for example, components arising from cash flow hedges).

3. Any changes in the above qualitative and quantitative data from the previous period.
4. Whether during the period an entity complied with any externally imposed capital requirements to which it is subject.
5. When the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

IAS 1 states that "when an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity should disclose separate information for each capital requirement to which the entity is subject." The staff recommends that the financial statement presentation document include a similar requirement.

The memo for discussion at this meeting suggested that the Boards could require an entity to disclose information about its liquidity risk management as described below. Those disclosures are similar to what is in IFRS 7, *Financial Instruments: Disclosures,* except that they would cover financial assets as well as financial liabilities (words not in IFRS 7 are underlined).

6. Qualitative information about an entity's objectives, policies, and processes for managing liquidity risk inherent in financial assets and liabilities, including a description of an entity's ability to meet its expected future cash outflows over the near term. The factors that an entity might consider in providing this disclosure include, but are not limited to, whether the entity:

   a. Expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank)
   b. Expects some of its undrawn loan commitments not to be drawn
   c. Holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs
   d. Has committed borrowing facilities (for example, commercial paper facilities) or other lines of credit (for example, stand-by credit facilities) that it can access to meet liquidity needs
   e. Holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities
   f. Holds deposits at central banks to meet liquidity needs
   g. Has very diverse funding sources or
   h. Has significant concentrations of liquidity risk in either its assets or its funding sources.

The staff recommends that the Boards **not** add this disclosure requirement because, while it would be useful information, there is probably more that should be considered to fully address the issue (such as risk related to nonfinancial instruments; for example, leases and pension obligations) and doing so is beyond the scope of this project.

Questions for the Board:

5. *Do FASB Board members agree to include disclosures 1-5 above in the financial statement presentation document?*
6. *Do Board members want to require disclosure of information about liquidity risk management? If so, should that requirement in this document be limited to financial assets and financial liabilities as described in item 6 above or be broadened (which would require more staff work)?*

MEMORANDUM 51B: CLASSIFICATION BY DIVERSIFIED ENTITIES

The Boards' preliminary view is that an entity should classify its assets and liabilities as business or financing based on how it manages its activities or functions. In January, the Boards decided to include in the initial discussion document its preliminary view on how a consolidated reporting entity consisting of significantly different businesses (a diversified entity) should apply the classification guidance.

Issue 1: Application of Classification Guidance

The staff proposes three possible alternatives for determining how a diversified entity should classify its assets and liabilities:

> **Alternative A**—The classification criteria would be set at the **consolidated reporting level**, thus all segments of the reporting entity would classify their assets and liabilities in the same manner.
>
> **Alternative B**—The classification criteria would be set at the **reportable segment level**, and, thus at the consolidated level, similar assets and liabilities could be classified differently.
>
> **Alternative C**—The classification criteria would be set at some **other lower level**, such as a reporting unit or an operating segment that is not a reportable segment.

The staff believes that the most useful financial information will be generated from asset and liability classifications that reflect the individual business models of a diversified entity. This is consistent with one of the key aspects of the Board's preliminary views to date—that classification should be consistent with how the asset or liability is viewed by management (how it is utilized). Therefore, the staff recommends that an entity classify its assets and liabilities at the reportable segment level (Alternative B). Classification at this level will provide the most useful information regarding the role of assets and liabilities within the business (reportable segment) and reflect how they are managed.

Question for the Board:

8. *Should a diversified entity classify its assets and liabilities at the consolidation or reportable segment level?*

Issue 2: Presentation Format and Segment Reporting

If the Boards agree that a diversified entity should classify its assets and liabilities at the reportable segment level, a related question is how the financial information should be presented on the face of the primary statements and in the segment note disclosures, if there are differences in classification between one or more reportable segments. The staff has identified the following alternatives for how information could be presented in the primary financial statements if classification at the reportable segment level results in one or more reportable segments classifying similar assets and liabilities in different categories. Presentation is not an issue if there are no classification differences.

Alternative A—Only consolidated information would be presented, as it is today, on the face of the financial statements. The segment disclosure requirements would be modified to include summary financial information for the operating category of each primary financial statement. This summary information would be limited to the operating category, as financing activities are often centralized. The summary information would tie into the consolidated amounts.

Alternative B—Each primary financial statement would include segment information on the face of the financial statements for all categories of the working format (operating, investing, financing, discontinued operations, income taxes, and equity).

Alternative C—Only consolidated information would be presented, as it is today, on the face of the financial statements. A new primary statement would be introduced that would present operating category information by segment for the statements of financial position, comprehensive income, and cash flows.

The staff recommends Alternative C. The inclusion of a new primary statement (including some segment information) would provide the information necessary to understand changes in the operating assets and liabilities of a diversified entity that, along with the consolidated statements, could be used to predict future cash flows. The prominence of the reporting segment information for the operating category in a primary statement reflects its importance in understanding the consolidated operations of a diversified entity. Further, this alternative provides a simplified and consistent mode of presentation that should enhance comparability across entities.

Questions for the Board:

9. *How should a diversified entity present information in its financial statements if classification at the reportable segment level results in one or more reportable segments classifying similar assets and liabilities in different categories?*
    a. *Should minor modifications be made to the segment disclosures, as in Alternative A?*
    b. *Should the consolidated financial statements include segment information on the face, as in Alternative B?*
    c. *Should a new primary financial statement be added, as in Alternative C?*

Issue 3: Other Possible Changes to Segment Reporting Requirements

Prior to issuing the initial discussion document, the staff would like the Boards to address other possible changes to segment disclosures to make those disclosures more consistent with the Boards' preliminary views on presentation in the primary financial statements. The staff recommends that the initial discussion document include the Board's preliminary views on the following two questions that would apply to all entities:

a. Should the amounts presented in segment disclosures be measured on a basis consistent with amounts presented in the consolidated financial statements? (The staff believes that they should; however, this is more than a presentation issue.)

b. Should the financial information reported by segment include more than what is currently required?[1] Possibilities include (this might be in addition to what is required already or instead of):

    i. For each reportable segment: the same line items as on each of the primary financial statements (this would be similar to Alternative B in Issue 2).

    ii. For each reportable segment: operating category line items as on each primary financial statement (this would be similar to Alternative C in Issue 2). (This would be the staff's leaning consistent with our recommendation on Issue 2.)

    iii. For each reportable segment: summary financial information (perhaps only subtotals for each category) from each of the primary financial statements.

[1] Current segment reporting guidance requires disclosure of the following for each reportable segment: a measure of profit or loss, total assets, revenues from external customers, revenues from transactions with other operating segments, interest revenue, interest expense, depreciation expense, depletion expense, amortization expense, unusual items, equity in net income of an equity method investee, income tax expense or benefit, extraordinary items, and significant non cash items (not already reported).

The staff believes that the initial discussion document does not need to include the Boards' preliminary view on whether any of the above segment information should be presented in the notes or as another primary financial statement.

Questions for the Board:

10. *Should the amounts presented in segment disclosures be measured on a basis consistent with amounts presented in the consolidated financial statements?*

11. *Should the reportable segment financial information presented in the financial statements include more information about assets, liabilities, cash flows, revenues, expenses, gains, and losses that would be presented consistent with the working format? If so, to what degree?*

Board Meeting Handout

STATEMENT 133 IMPLEMENTATION ISSUE – CLARIFICATION OF THE APPLICATION OF THE *SHORTCUT METHOD.*

May 16, 2007

PURPOSE

At today's meeting, the Board will discuss matters related to the Statement 133 Implementation Issue – Clarification of the Application of the *Shortcut Method*.

BACKGROUND

In February 2006, the Board added a project to its agenda to clarify certain criteria in paragraph 68 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

In January 2007, the Board voted to issue additional guidance in the form of a proposed Implementation Issue, "Clarification of the Application of the *Shortcut Method.*" Subsequently, the staff became aware of a potentially significant issue in practice involving the interaction between FASB Statement No. 157, *Fair Value Measurements*, and paragraph 68(b) of Statement 133. The staff believes this issue could be addressed in a timely fashion through the issuance of this Implementation Issue.

Paragraph 68(b) of Statement 133 requires the fair value of an interest rate swap at the inception of the hedging relationship to be zero in order to meet that requirement for the shortcut method. Prior to the issuance of Statement 157, the fair value of a derivative was generally considered to be the transaction price (an entry price). Upon adoption of Statement 157, the fair value of an interest-rate swap at initial recognition would be based on an exit price, which would likely be other than zero due to the existence of a bid-ask spread.

SUMMARY OF STAFF RECOMMENDATIONS

The staff believes that the Board did not intend for the provisions of Statement 157 to preclude the shortcut method for a company entering into an at-market interest rate swap with a transaction cost of zero in its principal market. The staff recommends that the following guidance be added to the proposed Implementation Issue:

> When a company enters into an interest rate swap with a transaction price of zero in its principal (or most advantageous) market, a difference between transaction price and fair value that is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction shall not preclude application of the shortcut method.

QUESTION TO THE BOARD

Does the Board agree with the staff recommendation to add additional guidance to the proposed Implementation Issue to address the issue described above?