Organismo Italiano di Contabilità – OIC
(The Italian Standard Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

EFRAG
35 Square de Meeûs
B-1000 Brussels
BELGIUM
e-mail: commentletter@efrag.org

14 March 2011

Re: ***EFRAG PAPER on IASB Staff Draft of ED Financial Statement Presentation – Replacement of IAS 1 and IAS 7 (1 July 2010)***

Dear Sir/Madam,

We are pleased to have the opportunity to comment on EFRAG - *Paper* on IASB *Staff Draft of ED Financial Statement Presentation – Replacement of IAS 1 and IAS 7* (the Draft ED).

We broadly support the joint efforts of the IASB and the FASB to achieve a wider convergence between IFRSs and US GAAPs in the presentation of financial statements, to improve comparability among entities and cohesiveness among the primary financial statements. However we have some concerns on how the IASB intends to achieve these objectives.

About the EFRAG Paper, we generally agree with most of the technical issues raised by EFRAG on the tentative decisions included in the Draft ED.

As a general remark, we share EFRAG's view on the opportunity that the IASB should give a higher priority to some fundamental issues underlying performance reporting, which would affect also financial statement presentation. As indicated in the OIC comment letters on various projects, we do believe that the IASB should try to resolve the fundamental issue of the definition of the concept of performance within the current project on Conceptual Framework and then in the projects on financial statement presentation. However, we note that at the moment no current IASB project is dealing with the definition of the concept of performance.

Our comments on the issues raised by the EFRAG Paper and our major concerns on the Draft ED are the following.

A) Relationship between Business section and Financing section

We would suggest that EFRAG could better support its view on the content of the Financing section by giving more prominence to the lack of rationale and to the undesirable effects of IASB tentative decisions rather than by using the net debt position concept (difficult to define).

a) Operating finance sub-category and Financing section

We question the usefulness of the *Operating finance subcategory* in the Statement of financial position and in the Statement of comprehensive income. It includes both items not having a financing cause (e.g.: a decommissioning liability, a deferred bonus that is to be paid to employees at a later date) and items having a financing cause (financial leases, long-term borrowing arrangements with suppliers).

The Draft ED defines the Debt items of the Financing section as '*Liabilities that are borrowing arrangements entered into for the purpose of obtaining (or repaying) capital* (par. 86).

If a liability has a financial cause or, in other words, if a liability has been entered into for the purpose of obtaining capital for the entity's activity, the natural consequence should be to classify it within the Debt category of the Financing section.

Its classification in the *Operating category* breaches the <u>substance over form principle</u>: the form of having a liability as a consequence of an exchange of services or goods prevails over the substance of having entered into a financial arrangements in order to buy services or goods.

Furthermore, <u>comparability</u> among financial statements of different entities would be compromised as a result of the classification of financial liabilities in the Operating finance sub-category, i.e. the operating profit (loss) and the total financial Debts would be different between two entities since they are influenced by the form of the contract instead of its economic substance (e.g. a financial lease instead of a mortgage obtained to buy a property).

As a consequence, the first benefit for users listed in the Basis for Conclusions of the Draft ED is contradicted. BC18.a affirms: '*Users of financial statements would be better able to analyse an entity's performance independently of its capital structure because every reporting entity would segregate the effects of its financing decisions and related activities from all other activities*'. However, the decision of financing the purchase of a good through a bank loan instead of a financial lease or a long-term vendor borrowing would change the operating profit and the total Debts.

For these reasons, we would prefer to classify all financing liabilities, including financial leases and long-term vendor borrowings, in the Financing section while eliminating the Operating finance subcategory, since it would no longer be useful. In this case, the other liabilities that the Draft ED proposes to classify in the Operating finance sub-category (decommissioning liabilities, deferred bonus to be paid to employees at a later date, defined benefit plans liabilities) could be classified in the Operating category and highlighted separately inside the Operating long-term liabilities. In this way, the user of the financial statement would have all the relevant information to consider the peculiarity of these items.

b) Operating Investing category of the Business section and Financing section

According to the Draft ED, the short-term investments of the entity in fixed-income securities and equity securities and other financial assets (that are not part of the business in which the entity is engaged) are classified within the Investing category of the Business section.

We argue that these items, since they do not belong to the ordinary business, should be classified inside the Financing section, for the reason that they are pertinent to the way in which the entity manage its cash and financing debts in the short term rather than to its business/operating activity.

c) Classification of cash

Having said that the classification of cash among the Operating category or the Investing category or the Financing section could be totally arbitrary or, anyway, should be based on the not demonstrable management views, we do not agree with the Draft ED proposal of classifying cash within the assets of the Operating category.

For the same reasons given above for the short term investments, we would prefer to classify cash as an asset in the Financing section, since cash seems to be relevant to the way in which the entity manage its liquidity and financing debts in the short term rather than to its business/operating activity.

This classification seems to be more consistent with the classification of overdrafts within the Debt category of the Financing section (instead of Operating category): according to the IASB's choice, if the bank balance is positive it should be classified in the Operating category, while if the bank balance is negative (overdraft) in the Financing section.

d) Consistency between primary financial statements and net-debt position

As a further consequence of the proposals explained above, there would be a substantial consistency between the presentation of items in the primary financial statements and the disclosure about the analysis of changes in the net debt position required by par. 255 of the Draft ED ('*An entity shall provide an analysis of changes for the following line items in a single note and include a total for these items: (a) cash; (b) short-term investments; (c) finance leases; and (d) each line item in the debt category*').

B) Risk of too much detail in the Statement of comprehensive income

According to the Draft ED '*An entity shall disaggregate and present its income and expense items by function within each section and category in the statement of comprehensive income so that the information is useful in understanding the activities of the entity and in assessing the amount, timing and uncertainty of future cash flows'. …(omissis)… . An entity shall disaggregate its income and expense items by their nature <u>within the related functional grouping</u> to the extent that the information is useful in assessing the amount, timing and uncertainty of future cash flows'.* In this latter case *'…(omissis)… income and expense items disaggregated by nature shall be presented in the statement of comprehensive income or disclosed in the notes. …(omissis)…An entity may choose not to disaggregate its income and expense items by function if that disaggregation is not useful to users of financial statements in understanding the entity's activities and the amount, timing and uncertainty of future cash flows. In those circumstances, an entity shall disaggregate its income and expense items by nature and present that information in the statement of comprehensive income*'.

While we do not believe that the Draft ED could cause too much detail in the Statement of financial position, we are concerned about the level of detail required in the face of the Statement of comprehensive income. We believe that these requirements may result in redundant detailed information, which could obscure key messages and the overall understandability of the financial statement rather than improve the information for users.

If an entity decides to disaggregate its income and expense items by their nature within the related functional grouping, too much detailed information would be presented in the face of the Statement of comprehensive income. We suggest that when the Statement of comprehensive income is classified by functions, the further classification by nature should be mandatorily disclosed only in the notes.

C) Statement of cash flows

a) Changes in cash and not in net debt position

We believe that cash flow statement should continue to provide information about changes in cash balance and not in the net figure of assets and liabilities included in the Financing section (i.e. “net debt” under EFRAG’s proposal in the EFRAG Paper), since the change in cash flow is widely considered by the majority of analysts, preparers and academics more predictive about the ‘*ability of an entity to generate cash and cash equivalents*’ and about ‘*the timing and certainty of their generation*’ (Cfr. Framework, par. 15).

b) Requirement of the direct method for presenting operating cash flows

We agree with EFRAG in disagreeing with the proposal to require the direct method for presenting operating cash flows (and not to allow the indirect method), accompanied with a mandatory indirect reconciliation of operating profit to operating cash flows.

We agree that the IASB has not provided compelling arguments explaining why the change is needed.

We believe that the direct method is more onerous than the indirect one.

Even if we could argue that the information provided by the direct method could be superior than by the indirect method (but the IASB has not demonstrated it), we feel sure that, on balance, the benefit for financial information does not justify the cost.

In our opinion, the current option of presenting cash flows using the indirect method should be retained. However, some improvements to it may be considered; for example, by defining the starting point for the statement to improve comparability between entities.

We further observe that many details (even if not all) on direct changes in cash flows are in any case provided in the notes within the analysis of changes of the most important assets and liabilities, and this could be considered sufficient.

D) Disclosure on remeasurements

We believe that currently there is a lack of clarity concerning the underlying criteria adopted by IASB to define remeasurements and their usefulness against the desired outcome to help users of financial statements in assessing the extent to which the various components of comprehensive income will recur in the future.

For example, It could be argued that the gains/losses realised on equipment disposals or on accounts receivable sales should not be part of the disclosure on remeasurements if the disposals or the sales are part of the recurrent activity of the entity.

The fact that, in theory, the definition of remeasurement would include the gross margin resulting from the sale of inventory is symptomatic of the lack of usefulness of the proposed disclosure: the Draft ED has to make an exception to avoid its inclusion among remeasurements (Cfr. par. 235).

We do not have specific solutions to improve this kind of disclosure at this stage, while we agree with EFRAG that most of the information about remeasurements is already required to be presented as part of the analysis of changes in assets and liabilities.

Since we do not support duplication of disclosures in financial statements, we believe that remeasurements can be usefully provided in the context of the analysis of changes in assets and liabilities, without summarizing them in a separate disclosure.

E) Reclassification of comparative figures when items are reclassified in the current period

According to par. 39 of the Draft ED '*If an entity changes the presentation or classification of items in its financial statements, it shall reclassify comparative amounts unless reclassification is impracticable*'.

It seems that the requirement should be applied in any situation, while we believe IASB should clarify, for the avoidance of any doubt, that the requirement should not apply when the different classification (different sections/categories) follows a change in the entity's activity or in the function of the items (i.e. the item was correctly classified in the previous years according to its function in that years). If the underlying principle is that financial statements reflect the functions in which assets and liabilities are used, and the function of a particular asset is different in different periods, then this should be reflected in the financial statements without any restatement of comparative information.

F) Cost/benefit analysis

At this stage, we are not able to provide a detailed analysis on costs and benefits deriving from implementation of the new rules on financial statement presentation. We believe that the analysis of implementing costs should be based on field tests performed by preparers.

In any case, we could affirm that the improved comparability among entities and the improved cohesiveness among the primary statements are the major and material benefits for users of financial statements.

On the other hand, we believe that the cost of implementing the new rules, especially if some requirements are retained (e.g. the mandatory direct method for the Statement of cash flows), could be material in the following areas: system costs (changes in the reporting and accounting systems); documentation of new procedures and controls; training of employees.

Yours sincerely,

Angelo Casò

(OIC Chairman)