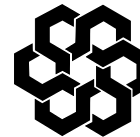

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International Accounting Standards Board

This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **November 2006, London**

Project: **Views on the Strategic Direction of Financial Reporting**
Recap on the discussions at the last SAC Meeting, June 2006
(Agenda Paper 2)

"A COMPREHENSIVE BUSINESS REPORTING MODEL: Financial Reporting for Investors" issued by the CFA Centre for Financial Market Integrity dated 24 October 2005 (the "CFA-Paper")

In the last SAC Meeting in June 2006 the SAC commenced to discuss the CFA business reporting model as outlined in the Minutes of this SAC Meeting (see Agenda Paper 1 for the SAC November 2006 meeting). For convenience purposes the relevant sections of the Minutes have been extracted and attached as **Appendix I**.

For the same reason the "CFA-Paper - Considerations on the main theses" used to support and to focus the discussion of the SAC in June 2006 has been attached as **Appendix II**.

In order to recap and to continue the discussions on this topic it is helpful to repeat herein the 12 principles that serve as a basis for the proposed business reporting model as follows:

Principle 1	The company must be viewed from the perspective of a current investor in the company's common equity. *)
Principle 2	Fair value information is the only information relevant for financial decision making. *)
Principle 3	Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone.
Principle 4	All economic transactions and events should be completely and accurately

	recognized as they occur in the financial statements. *)
Principle 5	Investors' wealth assessments must determine the materiality threshold.
Principle 6	Financial reporting must be neutral.
Principle 7	All changes in net assets must be recorded in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners. *)
Principle 8	The Statement of Changes in Net Assets Available to Common Shareholders should include timely recognition of all changes in *fair values* of assets and liabilities. *)
Principle 9	The Cash Flow Statement provides information essential to the analysis of a company and should be prepared using the direct method only. *)
Principle 10	Changes affecting each of the financial statements must be reported and explained on a disaggregated basis.
Principle 11	Individual line items should be reported based upon the *nature* of the items rather than the *function* for which they are used. *)
Principle 12	Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures.

Those principles which, according to the Minutes, were discussed during the last SAC meeting in June 2006 are marked above *). It seems fair to say that some of the discussions were quite controversial and several SAC members did challenge the CFA views. In addition the discussions on the above principles might not be seen as all-inclusive or complete.

At first glance it seems that principle 3 "Relevance vs. Reliability" was not covered in the discussion. However, there were some linkages based on the issues raised in the "CFA-Paper - Considerations on the main theses" and in my view this principle was discussed as part of the discussion about Fair Value (principle 2). If the SAC follows this view, the discussions on principles 5, 6, 10 and12 are outstanding.

Accordingly, my **proposal to the SAC** is

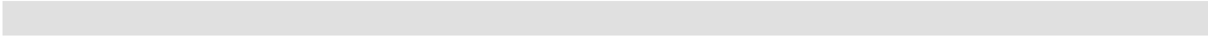
- to start in a first step with the outstanding discussion of these principles in the forthcoming SAC Meeting in November, and
- to complete the SAC's discussion on the topic by means of a final general discussion on the CFA business reporting model as a whole.

To support the discussion of the principles not yet covered, it is expected that a representative of the CFA will introduce these principles followed by questions or comments by the signee to stimulate the debate of the SAC.

Principles 5 "Materiality" and 6 "Neutrality" are related to the IASB's work on the Conceptual Framework. Without disgracing the importance of these qualitative characteristics I recommend to emphasise the discussions on Principles 10 and 12 and the proposals made by CFA in this regard.

In the “CFA-Paper - Considerations on the main theses” – see Appendix II - issues 5. and 6. deal with these two Principles 10 and 12. For convenience only and to facilitate the preparation of the SAC members, these issues are inserted below to avoid referring back each time to Appendix II.

Jochen Pape
28. October 2006



5. Issue: Reconciliation statement

a) Thesis

An additional statement should reconcile every balance sheet item in detail. (Principle 10)

b) CFA Centre's views

Every balance sheet item should be reconciled from the beginning of the period to the end of the period by showing

- cash effects (divided into current period transactions and accruals),
- accruals and
- valuation adjustments (divided into estimates and fair value)

for every single type of transaction within a balance sheet item, building a bridge between balance sheet, cash flow statement and income statement. This is central to reaching transparent and understandable financial statements. [p. 35-37]

"For investors to be able to understand the changes that have occurred in financial statements and, consequently, to their wealth, it is essential that they be able to analyze the individual forces at work that affect the company's performance. Accounting standards currently permit assets and related liabilities, revenues, and expenses, as well as investing and financing cash inflows and outflows, to be reported on a highly aggregated or netted basis, causing much important information to be obscured or lost altogether. The information loss can result in misleading analyses, distorted conclusions, and suboptimal investment decisions. Such aggregation and netting should not be permitted." [p. 17]

"Similarly, we do not believe that netting should be permitted for individual line items. For example, changes in the property, plant, and equipment account can arise as a result of (1) purchases and exchanges, (2) sales and abandonment, (3) self-construction, (4) mergers and divestitures, (5) leases, (6) foreign currency changes, (7) depreciation, and (8) impairment write-downs. Clearly, information as to the precise source of the change is essential if investors and other users are to evaluate managers' investments in productive capital, the effectiveness of managers' decisions to invest scarce capital, and the value of the company's capital." [p. 17]

The reconciliation-disclosures for property, plant and equipment in IAS 16 are explicitly mentioned as a good example, but they should to be applicable for all items.

With regard to the obviously expected counter-argument of the resulting additional costs the paper outlines on page 35 the following: "Arguments about costs of preparation are not relevant to this presentation. The cost is in the data production, all of which is currently available to managers, not the data display. Investor should not be forced to expend additional costs to put the puzzle back together. See Figures 4A and 4B."

c) Own considerations

The proposed reconciliation statement certainly improves transparency. On the other hand we are not convinced whether all the data is truly available, in particular taking into account the consolidation procedures necessary to present such a reconciliation on a consolidated basis. The paper does not refer to any evidence for the above statement made.

We are also not certain whether the very much detailed information contained in the reconciliation would actually be used by all investors or financial Analysts for each company.

d) Question to the SAC members

Q 5.1: "Do you agree with the usefulness of presenting an additional reconciliation statement?"

Q 5.2: "Do you believe that all data needed are already available or does it cause significant additional requirements and costs?"

6. Issue: Disclosures

a) Thesis

More relevant disclosures have to be made. (Principle 12)

b) CFA Centre's views

The CFA Centre is of the opinion that more respectively other disclosures have to be made: it is assumed that currently there is an overload of *useless* information. Instead, *useful* information is never overloaded. [p. 46]

"Investors require sufficient disclosure to be able to understand and properly evaluate changes in the wealth of the company, the quality of reported earnings and other financial statement metrics, and to make forecasts about the future prospects of the company. In this chapter, we will discuss the types of disclosures investors need and will propose new disclosures that will help us to better meet these needs." [p. 46]

With regard to the obviously expected counter-argument of an information overload the paper outlines the following: "A protest that is frequently launched, either when additional disclosures are sought by investors or when standard setters propose to require them, is that investors are already overloaded with disclosures and cannot suffer the burden of any more. We would hasten to assure standard setters that useful information is never overload, Indeed, investors cannot properly conduct their analyses and make their financial investment decisions without it." [p. 46]

The CFA Centre therefore provides a concept of 11 disclosure objectives and following up several criteria for a development of effective and useful disclosures. [p. 47-62]

Disclosure objectives:

1. Managers' accounting policy choices;
2. The methods and valuation models (including assumptions, inputs, and other judgments) managers have used to implement the policy choices;
3. How these decisions have affected the recognition and measurement of individual financial statement items;
4. How they have affected the amounts and timing of items recognized in the financial statements;
5. What degree of uncertainty is associated with individual measurements;
6. How to disaggregate the reported financial statement information into components that:

a. Exhibit different economic characteristics and trends; and that

b. Have differential and sometimes offsetting effects on the financial statements;
7. How the company's risk exposures, including market, price, currency, and event risk, might affect the company's operations and financial position;
8. How economic assets and liabilities that are not reported in the financial statements may affect the company's operations;
9. How the nonfinancial drivers influence financial statement results;
10. The implications of the economics for the investor's forecasts of future events; and
11. How the investor's event forecasts will affect forecasts of financial statement components.

Criteria for a development of effective and useful disclosures:

1. Disclosure Is Not a Substitute for Recognition and Measurement, and Recognition and Measurement Do Not Remove the Need for Disclosure.
2. Standards for Recognition and Measurement of Financial Statement Items and Their Related Disclosures Must Be Developed Concurrently.
3. Policy Choices, Assumptions, Judgments, and Methods Must Be Fully and Clearly Disclosed.
4. Disclosures Should Provide Sufficient Disaggregated Information for Investors to Be Able to Fully Understand and Interpret the Summary Information in the Financial Statements.
5. Risk Disclosures.
6. Investors Must Have Clear and Complete Disclosure of All Off-Balance-Sheet Assets, Liabilities, and Other Financial Arrangements and Commitments.
7. Investors Require Clear and Complete Information about Intangible Assets Held By a Company.
8. Investors Require Clear and Complete Information about a Company's Contingencies and Other Risk Exposures.

c) Own considerations

More disclosures certainly improve the ability to understand information presented and to derive forecasts about the future.

Many of the proposed disclosures are already mandatory under current IFRS. The main differences between current disclosure requirements and proposed disclosures concern the following issues:

- estimates should be better explained (e.g. disclosure of all relevant assumptions), even sensitivity analyses of point estimates should be presented,
- information regarding the revenue recognition process and more details of the figures are required – see page 52.

Similarly to our concerns raised under Issue 5 we are not certain whether the additional detailed disclosure information requested would actually be used by all investors or financial analysts for each company.

d) Question to the SAC members

Q 6.1: "Do you agree that notes currently presented are often overloaded with useless information?

Q 6.2: "Do you agree with the disclosure objectives and criteria?"

Q 6.3: "Do you agree that especially the two issues mentioned above need significant improvement?"

APPENDIX I

EXTRACT FROM THE MINUTES OF THE MEETING OF THE STANDARDS ADVISORY COUNCIL HELD IN LONDON ON 26 AND 27 JUNE 2006

3 Views on the Strategic Direction of Financial Reporting

3.1 …

3.2 Patricia McConnell, SAC member and Chair of the Comprehensive Business Reporting Model Subcommittee of the CFA Centre for Financial Market Integrity (part of the CFA Institute), provided members with a background of the CFA Institute and the development of the paper, "A Comprehensive Business Reporting Model: Financial Reporting for Investors". The paper includes twelve principles that serve as a basis for a proposed comprehensive business reporting model.

3.3 To facilitate discussion of the principles, Ms. McConnell introduced a principle or group of principles and then Jochen Pape, SAC member, raised discussion questions for members to consider in relation to the principle(s). The following paragraphs summarise members' comments on the eight principles that were discussed at the meeting. Ms. McConnell was invited to lead a discussion of the remaining four principles at the November 2006 SAC meeting.

<u>Principle 1: The company must be viewed from the perspective of a current investor in the company's common equity.</u>

3.4 Several members disagreed with focusing on the perspective on the common shareholder. Those members stated that other parties (for example, debtholders) need financial reporting information. Ms. McConnell responded that the authors of the CFA Institute paper believe that the needs of all other users of financial statements would be satisfied by focusing on the existing common shareholder because entities will have to identify and explain all cash flows to arrive at the residual interest.

<u>Principle 2: Fair value information is the only information relevant for financial decision making.</u>

3.5 Several members disagreed with the principle for the following reasons:

(a) Several members suggested that since financial decisions are based on long term future cash flows, to the extent that fair value diverges from future cash flows, fair value might not be the most relevant measurement attribute.

(b) One member suggested that fair value is a useful disclosure, but creates a misleading view of the balance sheet because it does not represent future cash flows in many situations.

(c) Some members stated that since it is the combination of assets put together in a unique manner that generates cash flows, the fair value of individual assets and liabilities might not provide the most relevant information.

(d) Several members expressed concern about the reliability of fair value measurements when active markets do not exist.

3.6 Other members supported the principle. One member noted that volatility is not a valid argument against fair value measurements because volatility is a reality for businesses and consequently it should be reflected in financial reporting.

Principle 4: All economic transactions and events should be completely and accurately recognized as they occur in the financial statements.

Principle 7: All changes in net assets must be recorded in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners.

Principle 8: The Statement of Changes in Net Assets Available to Common Shareholders should include timely recognition of all changes in *fair values* of assets and liabilities.

3.7 Mr. Pape asked members for their views on whether net income is a valuable performance indicator. Several members expressed support for a net income figure, noting that net income is an established performance indicator. One member noted that analysts adjust earnings per share figures to provide more useful information for decision making.

Principle 9: The Cash Flow Statement provides information essential to the analysis of a company and should be prepared using the direct method only.

3.8 Mr. Pape agreed that the direct method is more informative than the indirect method, but expressed concern about the costs required to prepare direct method statements.

3.9 One member from a user background stated that he does not believe that the direct cash flow statement is more informative for predicting future cash flows. Another member suggested that entities would have to collect information in a completely different manner than they do now to prepare consolidated cash flows statements using the direct method.

Principle 11: Individual line items should be reported based upon the *nature* of the items rather than the *function* for which they are used.

3.10 Members' views were mixed on this principle. Some members supported reporting based upon the nature of items because it reflects how companies are managing operating expenses. Others suggested that the functional approach is more useful because it allows entities to compare their performance efficiencies with competitors. Still others suggested that a combination of natural and functional display is the most useful.

APPENDIX II

MEETING OF THE STANDARDS ADVISORY COUNCIL HELD IN LONDON ON 26 AND 27 JUNE 2006 – AGENDA PAPER 1

"CFA-Paper" - Considerations on the main theses

SAC contact: Jochen Pape

The following analysis are based on the document "A COMPREHENSIVE BUSINESS REPORTING MODEL: Financial Reporting for Investors", issued by the CFA Centre for Financial Market Integrity, on 24 October 2005[1]. The CFA Centre, being part of the CFA Institute based in the US, is one of the leading financial analysts' organisation worldwide. In this document they expressed their view on a desirable financial reporting model, covering about 60 pages and structured in 12 basic principles as well as details of the different financial statements. Patricia McConnell, SAC-member, took the chair of the Comprehensive Business Reporting Model Subcommittee within the CFA Centre.

The objective of our analysis is to summarise the main views of the above document as well as to raise questions for discussion purposes. Accordingly, it does not intend and is not able to capture all matters contained in the above document and can therefor not replace the careful reading of the paper.

The 12 basic principles are as follows:[2]

1 All assets and liabilities meeting the defined requirements have to be recognised.
2 All assets and liabilities have to be measured at fair value.
3 Relevance for decision usefulness is more important than measurement reliability.
4 All economic transactions and events should be completely recognised.
5 Materiality should not be assessed by quantitative threshold alone.
6 Neutrality requires cancellation of choices and unbiased estimates.
7 All changes in net assets have to reported in one single statement.
8 All changes in fair values have to be reported in the same category.
9 The cash flow statement should be prepared using the direct method only.
10 Financial statement items should be reported on a more disaggregated basis.
11 Expenses should be reported based on nature rather than function.
12 Disclosures should provide all relevant information to understand recognised items, measurement and risk exposure.

Trying to summarize the main aspects of the document according to our view the six most important issues (partly combining some principles) of the document are analysed as follows:

[1] This version is still the current version and named "draft" without saying when to finalise the document.
[2] Not identically with the headline of the principle, but reflecting the major content.

1. Issue: Comprehensive recognition of assets and liabilities

a) Thesis

All assets and liabilities meeting the defined requirements, including all relevant economic transactions and events, have to be completely and accurately recognised. (Principles 1 + 4)

b) CFA Centre's views

"For a common shareowner, the residual risk bearer in a company, all events and transactions that can affect assets, liabilities, and equities directly and that can affect the wealth of the shareowner are material and should be reported and explained." [p. 10]

"We recognise, however, that some accounting standards continue to permit some transactions, for example some financing vehicles, operating leases, pension liabilities, and executory contracts, to not be fully reflected in the balance sheet, or worse, to escape balance sheet recognition altogether. Such standards tend to rely on "bright line" rules, distinctions that we believe to be arbitrary and that fail to serve the best interests of investors." [p. 11, footnote 11]
The document thereby defines the term "assets" and "liabilities" as follows: [p. 19]

Asset:

- resource is a present right or other access to a future benefit that will flow to the company,
- right is controlled by the company,
- nonzero probability that the benefit will occur,
- right to the future benefit is separable from the company, i.e. transferable,
- result of a past event and
- the fair value of the right to the future benefit can be measured.

Liabilities:

- currently existing obligation,
- nonzero probability that the obligation will be settled by an outflow,
- Sufficient penalties to the enterprise from non-performance that the enterprise has no realistic alternative to settlement,
- it does not meet the definition of equity and
- the economic attributes and fair value of the obligation of the obligation can be measured.

"The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting." Hence, all off balance sheet transactions, including executory contracts, have to be recognised. [p. 5 + 14 re principle 4].

c) Own considerations

On the one hand the "nonzero-probability"-criterion would lead to a significant expansion of recognised assets and liabilities, currently already discussed for non-financial liabilities.

On the other hand the "fair value can be measured"-criterion would lead to non recognition of some assets currently being recognised:

- e.g. some financial equity instruments without quoted market price,
- e.g. purchased assets where costs can be defined but fair value may not be measurable in subsequent periods.

This requirement seems to be in conflict with principle 3 “Relevance for decision usefulness is more important than measurement reliability” which makes clear that non reliability in measurement should be no excuse for non recognition. The overall impression of the paper permits the assumption that this criterion should not be taken too seriously within the recognition criteria, i.e. recognition should only fail in very rare circumstances.

d) Question to the SAC members

Q 1.1: “Do you agree, that all assets and liabilities meeting the above mentioned requirements should be completely recognised in the balance sheet?”

Q 1.2: “Do you explicitly agree that executory contracts should be recognised?”

2. Issue: Fair value measurement for all assets and liabilities – Relevance vs reliability

a) Thesis

Fair value information is the only information relevant for financial decision making. Hence, in a first step, fair value information should be given in the notes to all assets and liabilities, even if not carried at fair value in this phase. Finally, all assets and liabilities should be carried at fair value. (Principle 2)
Recognition and disclosure must be determined by the relevance of the information to Investment Decision making and not based upon measurement reliability alone. (Principle 3)

b) CFA Centre’s views

CFA Centre is of the opinion, that, “if asset exchanges and, indeed, all financial decisions are based upon fair values, then market efficiency requires that the information upon which such decisions are made should be reported at *current* fair value.” [p. 12]
“Information is relevant when it “influences the economic decisions of users by helping them evaluate past, present or future event or [when they are] confirming or correcting their past evaluations. Consequently, investors, who must rely on financial statement information, need to receive all relevant information”

“Opponents of fair value reporting argue that measuring and recognising assets and liabilities at fair value in the financial statements introduces volatility into the financial statements. We argue the contrary: If fair value measurement results in greater volatility, then the measurement has merely unmasked the true economic reality that was already there. Honesty and volatility should not be trade-offs. … One of the most important evaluations investors must make is to ascertain the degree of risk to which an investment is exposed: the greater the volatility, the greater the risk. The risk is then weighed against the investment’s expected returns. Reporting methods that mask true volatility do a great disservice to investors, impair their ability to make well-founded investment decisions, and can result in inefficient allocations of capital.” [p. 12]

According to the CFA Centre's view reliability has been much misunderstood and misused in the financial markets and it has been taken to mean certainty of occurrence and measurement. Rather it believes that reliable information is that which faithfully represents the events that it "purports to represent or could reasonably be expected to represent".

With regard to the consideration of changes in a company's own credit risk the CFA Centre takes the following view: "When viewed from the perspective of current shareowners, a downward change in the company's credit rating necessarily means that wealth is transferred from existing bondholders, who have already committed to an interest rate and thus bear the risk of changes in the interest rates, to shareowners. If bondholders had waited to purchase the obligations, they may well have received a higher interest rate. What is unsettling to many, however, is the fact that the fair value recognition of a negative credit change results in a gain to the company and an increase in shareowners' wealth. Such an occurrence is not a fluke of fair value reporting but rather is the inevitable result of the differential contractual claims of the bondholders and shareowners. We should note, however, that the increase in shareowners' wealth resulting from the credit downgrade may well be accompanied by a decline resulting from lowered expectations regarding the health of the company." [p. 20]

c) Own considerations

On the one hand many investors may see additional information value in <u>knowing</u> the fair value if significantly different from the carrying amount based upon a cost model. This information could be given in the notes.

The main questions, however, refer to the underlying concepts supporting any call for a full fair value model and to recognise the fair value/changes in fair value or in other words what is the measurement objective to support such a model?.

It is said that all financial decisions are based on fair values. But is it the fair value of the single assets which is of interest or is it the fair value of the whole company? If it is the fair value of the whole company it can be assumed that this is not equal to the sum of the fair values of the assets (deducting liabilities). Rather, the fair value of a company is valued by valuation models using discounted future cash flows, commonly derived from a sustainable profit of the current period.

Some analysts (e.g. DVFA, a German association of financial analysts with established reputation, not included in the CFA-Group) argue, that fair value changes have to be eliminated out of profit to get this starting point, the adjusted, sustainable profit of the current period. For assets (and liabilities) held for sale it is different, because they are not used to generate future cash flows through use, but through sale in the near future.

The Canadian discussion paper "Measurement Bases for Financial Accounting – Measurement on Initial Recognition" illustrates in detail, that the measurement basis is depending on the measurement objective (market versus entity-specific measurement objectives): The market value measurement objective reflects the price in an open and active competitive market. Entity-specific measurements reflect management assumptions and expectations, which may differ from those implicit in market prices. Finally the paper concludes that the market value measurement objective has important qualities that make it superior to entity-specific measurement objectives, at least on initial recognition. However, the debate has not yet been completed and in our view there are good

arguments for an entity-specific measurement, in particular for non-financial assets and liabilities used in the operating processes of a company.

A more appropriate reflection on the above important questions is missing in the CFA Paper except for the above mentioned statement, that if all financial decisions are based on fair values, information should be reported at current fair value. [p. 12]

d) Question to the SAC members

Q 2.1: "Do you agree with the underlying reasoning by the CFA for a full fair value model, in particular do you support the statement that all financial decisions are based on fair value?"

Q 2.2: "Do you agree with carrying all assets and liabilities at current fair value?"

3. Issue: Income statement/Statement of changes in net assets

a) Thesis

All changes in net assets have to be recognised in the income statement as they occur. There should be no distinction between profit/loss and other changes in net assets (e.g. "other comprehensive income"). Transactions with shareowners should be reported separately within this statement, named "Statement of changes in net assets available to common shareowners". (Principle 7 + 8)

b) CFA Centre's views

The CFA is of the opinion, that there should not be any distinction of the total change in net assets, due to the fact that all changes could be relevant to measure the performance of the company. The focus on a single, arbitrary performance indicator (net income) should be deemphasized.

"We believe that performance assessment is the responsibility of the investor, not managers. The statement of net assets will allow the investor to select those items that are pertinent to the investor's particular perspective, analytic requirements, and objectives. Such a statement would continue to meet the needs of all users of financial statements and at the same time provide the richer dataset that long-term common equity investors need." [p. 30]

"Under the current model, accrual net income or earnings is an accounting construct, not an economic measure. Net income is the result of the recognition of *some* revenues and gains on accounting transactions less *some* expenses and losses. As long as a single summary statistic—the net income number—is reported and reporting standards allow managers flexibility in reporting choices, we believe managers will continue to manipulate the number to suit their needs rather than those of shareowners. Therefore, we are proposing a financial reporting model that does not focus on a single earnings number. This will require investors to analyze the individual reported items and the financial statements as a whole to determine which information is relevant to their financial decision making. We would observe that investors routinely make these assessments in evaluating their investment opportunities." [p. 15]

"One implication of this principle [all changes in fair values should be recorded in the Statement as they occur] is that so-called recycling of gains and losses will be eliminated. That is, there will be no deferral of recognition of fair value changes by recording such changes in equity, contingent upon future events. An example of such delayed recognition is the current treatment of available-for-sale securities. Although these securities are marked to fair value in the balance sheet, the resulting period-to-period changes in fair values do not flow to the income statement for immediate recognition but rather bypass the income statement and are deferred in equity until they are sold." [p. 16]

c) Own considerations

The exposure draft, resulting from phase A of the Financial Statement Presentation-project proposes a wider income statement than under current IAS 1: Other recognised income and expense shall be included, but the distinction between profit/loss and other recognised income and expense is still kept. However, it is a step in the direction of the CFA proposal.

The illustrative example on page 32 of the Paper indicates that according to the proposed concept, i. e. dividing the line items into three categories (operating, investing, financing), it is conceptually not possible to present a subtotal “profit/loss” (or similar, e.g. net income). Rather, the sum of all line items results in the total “Net change in net assets before transactions with owners”.

As noted during the previous Performance Project of the IASB many took views opposed to the CFA-opinion: many, in particular preparers but also others, believed that profit/loss is an if not the most important performance indicator. There was also an extensive discussion about the allocations to the above mentioned categories. Finally the discussion is obviously impacted by the discussion about the full fair value model and the impact on the performance of a company. The IASB will discuss these issues in Phase B of its project.

d) Question to the SAC members

Q 3.1: “Do you agree with the paper’s underlying assumption that all changes in net assets measured at fair value represent a more appropriate performance indicator when compared to net income?”

Q 3.2: “Do you agree with reporting all changes in net assets in one statement without distinguishing profit/loss and other changes?”

4. Issue: Direct method for the cash flow statement

a) Thesis

“The cash flow statement should be prepared using the direct method only.” (Principle 9)

b) CFA Centre’s views

“Ultimately, investors value their investments by forecasting the company’s future cash flows.” A clear picture of the pattern of inflows and outflows is only provided by using the direct method as it is more informative. [p. 6]

“The indirect method chosen by the vast majority of companies fails to provide adequate information for analysis. Instead of providing the essential information on cash inflows and outflows the indirect method begins with net income and “patches” the income number purging noncash elements and adjusting for changes in cash flows not reflected in current-period income. Put simply, the only pure cash flow number in the operating cash flow section of an indirect method cash flow statement is the total, Cash Flows from Operations.” [p. 17]

c) Own considerations

The assessment of the direct method being more informative than the indirect method is understandable. However, it is expected that preparation costs to comply with the requirements will significantly expand which raises concerns about the cost/benefit analysis.

d) Question to the SAC members

Q 4.1: "Do you agree with the reasoning for requiring presenting the operating cash flow using the direct method?"

Q 4.2: "Do you expect preparation costs to increase significantly?"

5. Issue: Reconciliation statement

a) Thesis

An additional statement should reconcile every balance sheet item in detail. (Principle 10)

b) CFA Centre's views

Every balance sheet item should be reconciled from the beginning of the period to the end of the period by showing

- cash effects (divided into current period transactions and accruals),
- accruals and
- valuation adjustments (divided into estimates and fair value)

for every single type of transaction within a balance sheet item, building a bridge between balance sheet, cash flow statement and income statement. This is central to reaching transparent and understandable financial statements. [p. 35-37]

"For investors to be able to understand the changes that have occurred in financial statements and, consequently, to their wealth, it is essential that they be able to analyze the individual forces at work that affect the company's performance. Accounting standards currently permit assets and related liabilities, revenues, and expenses, as well as investing and financing cash inflows and outflows, to be reported on a highly aggregated or netted basis, causing much important information to be obscured or lost altogether. The information loss can result in misleading analyses, distorted conclusions, and suboptimal investment decisions. Such aggregation and netting should not be permitted." [p. 17]

"Similarly, we do not believe that netting should be permitted for individual line items. For example, changes in the property, plant, and equipment account can arise as a result of (1) purchases and exchanges, (2) sales and abandonment, (3) self-construction, (4) mergers and divestitures, (5) leases, (6) foreign currency changes, (7) depreciation, and (8) impairment write-downs. Clearly, information as to the precise source of the change is essential if investors and other users are to evaluate managers' investments in productive capital, the effectiveness of managers' decisions to invest scarce capital, and the value of the company's capital." [p. 17]

The reconciliation-disclosures for property, plant and equipment in IAS 16 are explicitly mentioned as a good example, but they should to be applicable for all items.

With regard to the obviously expected counter-argument of the resulting additional costs the paper outlines on page 35 the following: "Arguments about costs of preparation are not relevant to this presentation. The cost is in the data production, all of which is currently available to managers, not the data display. Investor should not be forced to expend additional costs to put the puzzle back together. See Figures 4A and 4B."

c) Own considerations

The proposed reconciliation statement certainly improves transparency. On the other hand we are not convinced whether all the data is truly available, in particular taking into account the consolidation procedures necessary to present such a reconciliation on a consolidated basis. The paper does not refer to any evidence for the above statement made.

We are also not certain whether the very much detailed information contained in the reconciliation would actually be used by all investors or financial Analysts for each company.

d) Question to the SAC members

Q 5.1: “Do you agree with the usefulness of presenting an additional reconciliation statement?”

Q 5.2: “Do you believe that all data needed are already available or does it cause significant additional requirements and costs?”

6. Issue: Disclosures

a) Thesis

More relevant disclosures have to be made. (Principle 12)

b) CFA Centre’s views

The CFA Centre is of the opinion that more respectively other disclosures have to be made: it is assumed that currently there is an overload of *useless* information. Instead, *useful* information is never overloaded. [p. 46]

“Investors require sufficient disclosure to be able to understand and properly evaluate changes in the wealth of the company, the quality of reported earnings and other financial statement metrics, and to make forecasts about the future prospects of the company. In this chapter, we will discuss the types of disclosures investors need and will propose new disclosures that will help us to better meet these needs.” [p. 46]

With regard to the obviously expected counter-argument of an information overload the paper outlines the following: “A protest that is frequently launched, either when additional disclosures are sought by investors or when standard setters propose to require them, is that investors are already overloaded with disclosures and cannot suffer the burden of any more. We would hasten to assure standard setters that useful information is never overload, Indeed, investors cannot properly conduct their analyses and make their financial investment decisions without it.” [p. 46]

The CFA Centre therefore provides a concept of 11 disclosure objectives and following up several criteria for a development of effective and useful disclosures. [p. 47-62]

Disclosure objectives:

1. Managers’ accounting policy choices;
2. The methods and valuation models (including assumptions, inputs, and other judgments) managers have used to implement the policy choices;
3. How these decisions have affected the recognition and measurement of individual financial statement items;
4. How they have affected the amounts and timing of items recognized in the financial statements;
5. What degree of uncertainty is associated with individual measurements;
6. How to disaggregate the reported financial statement information into components that:
a. Exhibit different economic characteristics and trends; and that
b. Have differential and sometimes offsetting effects on the financial statements;
7. How the company’s risk exposures, including market, price, currency, and event risk, might affect the company’s operations and financial position;

8. How economic assets and liabilities that are not reported in the financial statements may affect the company's operations;
9. How the nonfinancial drivers influence financial statement results;
10. The implications of the economics for the investor's forecasts of future events; and
11. How the investor's event forecasts will affect forecasts of financial statement components.

Criteria for a development of effective and useful disclosures:

1. Disclosure Is Not a Substitute for Recognition and Measurement, and Recognition and Measurement Do Not Remove the Need for Disclosure.
2. Standards for Recognition and Measurement of Financial Statement Items and Their Related Disclosures Must Be Developed Concurrently.
3. Policy Choices, Assumptions, Judgments, and Methods Must Be Fully and Clearly Disclosed.
4. Disclosures Should Provide Sufficient Disaggregated Information for Investors to Be Able to Fully Understand and Interpret the Summary Information in the Financial Statements.
5. Risk Disclosures.
6. Investors Must Have Clear and Complete Disclosure of All Off-Balance-Sheet Assets, Liabilities, and Other Financial Arrangements and Commitments.
7. Investors Require Clear and Complete Information about Intangible Assets Held By a Company.
8. Investors Require Clear and Complete Information about a Company's Contingencies and Other Risk Exposures.

c) Own considerations

More disclosures certainly improve the ability to understand information presented and to derive forecasts about the future.

Many of the proposed disclosures are already mandatory under current IFRS. The main differences between current disclosure requirements and proposed disclosures concern the following issues:

- estimates should be better explained (e.g. disclosure of all relevant assumptions), even sensitivity analyses of point estimates should be presented,
- information regarding the revenue recognition process and more details of the figures are required – see page 52.

Similarly to our concerns raised under Issue 5 we are not certain whether the additional detailed disclosure information requested would actually be used by all investors or financial analysts for each company.

d) Question to the SAC members

Q 6.1: "Do you agree that notes currently presented are often overloaded with useless information?

Q 6.2: "Do you agree with the disclosure objectives and criteria?"

Q 6.3: "Do you agree that especially the two issues mentioned above need significant improvement?"

12. June 2006
Jochen Pape