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Investor Perspectives

Patrick Finnegan: What would Shakespeare say about Financial Statement Presentation

If Shakespeare were alive to add his flair to the joint IASB-FASB project dealing with Financial Statement Presentation, he might have said: 'That which we call a financial statement by any other name might be as useful'. If that view is about as clear or transparent as some of the financial reports you have read, then fear not, for there are potential improvements in our philosophy that may be of interest to you (and yes, more than you have dreamt of as well). In this entry in our investors' perspectives, we would like to know whether there is value for investors in modifying and enhancing the presentation of financial information in the primary financial statements. Our project challenges some of the oldest conventions in financial reporting, such as the structure and content of the balance sheet. We believe that Shakespeare would have agreed that it is what lies beneath a name, not the name itself, that matters. Please let us know whether you agree.

A quick snapshot

A summary of the project's current status, the results of our discussions, and why we believe our preliminary ideas would improve financial reporting, follows. We have recently posted staff drafts of proposed standards on both the IASB and FASB which discuss the boards' respective views in depth. While neither the IASB nor the FASB are formally inviting comments they welcome input from interested parties.

You may be wondering why the boards have published only staff drafts, and not exposure drafts, after going through lengthy deliberations of the October 2008 joint IASB-FASB discussion paper. In the recently issued

Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, the boards committed themselves to engaging in a focused and targeted outreach programme on the joint Financial Statement Presentation (FSP) project before finalising and publishing an exposure draft. The boards decided that a staff draft of the proposed standards would be an effective way of facilitating their outreach efforts - in effect, a starting point for further discussions with interested parties. The staff drafts reflect the cumulative, tentative decisions made by the two boards up to and including those made at their joint meeting in April 2010. However, work on the project is continuing, and the staff drafts are subject to change. The staff drafts have not been formally endorsed by either board.

The boards' planned outreach activities will focus primarily on two issues: (1) the perceived benefits and costs of the tentative decisions, and (2) the implications of those decisions for financial reporting by financial institutions.

After completing their outreach activities, the boards will consider whether to change any of their tentative decisions in response to the input received. The boards plan to complete those efforts and publish exposure drafts in 2011.

What changes are under consideration?

<table>
<tr><th>Statement of financial position</th><th>*Statement of comprehensive income</th><th>Statement of cash flows</th></tr>
<tr><td>Business section</td><td>Business section</td><td>Business section</td></tr>
<tr><td>Operating category</td><td>Operating category</td><td rowspan="2">Operating subcategory</td></tr>
<tr><td>Operating finance subcategory</td><td>Operating finance subcategory</td></tr>
<tr><td>Investing category</td><td>Investing category</td><td>Investing category</td></tr>
<tr><td>Financing section</td><td>Financing section</td><td>Financing section</td></tr>
<tr><td>Debt category</td><td>Debt category</td><td></td></tr>
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Equity category		
	Multi-category transaction section	Multi-category transaction section
Income tax section	Income tax section	Income tax section
Discontinued operation section	Discontinued operation section	Discontinued operation section
	Other comprehensive income, net of tax	

As illustrated in the table above, the staff draft considers whether to standardise the manner in which financial statements are presented, with the aim of portraying a **cohesive** financial picture of an entity's activities. The paper explores possible options for making the relationships between the elements of the financial statements clearer, and how the statements themselves could also better complement each other. The staff drafts explore a modified 'cohesiveness' principle at the category level, not at the line item level. This change reflects the desire to improve cohesiveness across financial statements without introducing unnecessary rigidity.

Such changes impose some degree of standardisation in the way that information is presented in the financial statements, particularly in regard to how information is classified, and the degree to which it is **disaggregated.**

Let's examine a few ways in which we believe our proposals would improve reporting for investors:

Standardisation of financial statement presentation

Today, it is possible to present financial statements in many ways. This makes it difficult to compare the financial statements of different companies within the same geographical area or across borders. For example, some companies choose to provide a significant level of line item detail, while others do not. By creating a single common standard, we would provide investors with an improved starting point for generating analysis.

Cohesiveness facilitates analysis and understanding

A set of financial statements includes several individual statements, such as the income statement, statement of financial position, and statement of cash flows. However, the current formats of those statements do not make it easy to see how the information is linked. As the table above illustrates, the staff paper proposes a clearer separation between an entity's financing activities (how it obtains capital) and its business activities (day to day and other activities that generate income). The table further separates business activities into those that are conducted as part of the core operations (operating) and those that are not considered part of its core operations (investing).

For the statement of cash flows, the paper proposes that the statement itself would comprise only actual cash inflows or outflows, thereby avoiding the current confusing mix of cash and non-cash components. The reconciliation of operating profit to operating cash flow is important to the understanding of those cash flows, and would therefore be presented alongside, but clearly separated from, the cash flow statement itself, thus emphasising the different but related information that it provides. The presentation of this reconciliation would also be made more consistent. One of the most difficult cost-benefit issues in this project is the appropriate level of disaggregation of cash flows, particularly operating cash flows. This is something that we will be focusing on during our outreach.

The proposals in the boards' exposure drafts on the presentation of other comprehensive income, together with the presentation changes in this project, seek to improve the understandability of comprehensive income and of the relationships between changes in the statement of financial position, components of other comprehensive income, and components of profit or loss for each period.**

Disaggregation – the key to a deeper understanding of a company's underlying economics

Summary reports are useful to the extent that they provide an overall picture of a company's financial position, but investors' ability to gain a deeper understanding of a company's economics is conditional upon obtaining disaggregated information from the elements of the primary financial statements and the notes. That is why the paper proposes that the statement of comprehensive income and the related notes would include more subtotals than are currently presented. Those additional subtotals would allow for the comparison of effects across the financial statements. For example, investors would be better able to assess how operating assets and liabilities generate operating income and cash flows. More detailed information would be provided in the notes on changes arising from amounts reported in income that are the result of remeasurements (for example, the effects of fair value remeasurements, as well as the effects of changes in estimates of the value of assets and liabilities, such as goodwill impairment).

The notes to financial statements would include analyses (or roll-forwards) of changes between the opening and closing balances of those asset or liability line items (or group of line items) that management regards as important for understanding the current period change in the entity's financial position. Those disclosures highlight changes in amounts, including payment/collection, accruals, and remeasurements of values. More detailed information about these different components of income allows investors to apply their own judgements about if and how they will be realised in cash in the future (and thus how they will ultimately affect investment value).

Weighing the proposed benefits against the costs

The foregoing discussion makes it clear how financial statement analysis would be enhanced if these changes were to be implemented. Nevertheless, such changes could carry significant costs for adapting reporting processes and systems to make them capable of presenting financial statements in the proposed formats. As a result, the boards wish to gather additional information about benefits and costs by doing more field work on the tentative decisions, including additional field testing or experimental research. As we stated at the beginning, the two boards decided that a draft of proposed standards would be an effective way of communicating our collective thinking to date; but we are continuing to work on the project and the staff drafts are subject to change. The staff drafts, which are available on the boards' websites, have not been formally endorsed by either board. After completing our outreach activities, we will consider whether to change any of our tentative decisions.

* The title, 'Statement of Comprehensive Income' is illustrative. The statement may also be labelled the 'Statement of Profit or Loss and Other Comprehensive Income'.

** For further discussion of this exposure draft, please refer to our June 4 2010 entry in Investor Perspectives, 'Improving the picture of performance for investors'.

Patrick Finnegan is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.