

Investor Perspectives

Patricia McConnell: Financial Statement Presentation—are the proposals in the staff draft an improvement over the discussion paper?



The objective of our financial statement presentation (FSP) project is to establish a global standard that will guide the organisation and presentation of the financial statements. This article summarises some of the main differences between the proposals laid out in our 2008 discussion paper (DP) on financial statement presentation and our tentative decisions as reflected in the staff draft posted to our website in July.

The main differences, discussed in more detail below, are:

- The cohesiveness principle in the staff draft is less rigid than the principle in the DP. Rather than line-by-line cohesiveness, the various sections, categories and subcategories of each statement will display related information.
- The staff draft does not require disaggregation of income and expense information by both function and nature on the face of the income statement. Rather, it proposes that by-nature information should be presented in the notes.
- The definitions of the sections, categories and subcategories in the staff draft are more specific than in the DP.
- The staff draft continues to propose a cash flow statement that presents cash receipts and payments, but these will be disaggregated only by nature. It also proposes that deposit-taking businesses, such as banks, should display the cash flows that occur between them and their depositors, as if these were settled in cash. In addition, the staff draft permits more aggregation of cash flow information, as well as requiring a reconciliation of operating income to operating cash flows.

- In lieu of the schedule reconciling items of profit and loss to cash flows as proposed in the DP, the staff draft proposes that the notes should include an analysis of the changes between the opening and closing balance of important assets and liabilities.
- The staff draft also proposes a single note analysing changes in line items that normally constitute net debt.

These differences are also discussed by board member, Pat Finnegan, in a podcast.

Why is there a staff draft?

The FSP project is a joint project of the IASB and FASB, which is covered by the 2006 (updated 2008) Memorandum of Understanding (MoU) between the two boards. Earlier this year, the boards' stakeholders voiced concerns about their ability to provide high-quality input on the large number of major exposure drafts (EDs) that were planned for publication in the second quarter of this year as a result of the MoU. To address those concerns, the boards developed a modified work plan that phases publication of the EDs so that no more than four major EDs will be issued in any one quarter. As a result, the FSP ED, which was originally planned to be published for consultation in July 2010, is now scheduled to be published in the first quarter of 2011.

The boards decided to use the period before the publication of the ED to get a better understanding of the costs and benefits of the proposed model, as well as of its implications for financial services companies. To accomplish this, we will be engaging in targeted and focused outreach activities. Those activities will include investor outreach, as well as field visits and field testing with companies.

The staff draft will be used to facilitate these activities, and will be the basis for discussions during the outreach activities.

Core principles

The FSP proposals in the staff draft establish a common structure for the statements of financial position (formerly known as a balance sheet), comprehensive income, and cash flows. The structure of the statements is based on two core principles – cohesiveness and disaggregation.

Cohesiveness means that the relationship between items in the financial statements is clear and that the financial statements complement each other as much as possible. In the DP, cohesiveness was applied on a line-by-line basis. Our tentative principle in the staff draft is much less rigid. Rather than line-by-line cohesiveness, the financial statements will display related information in the same sections, categories and subcategories in each statement, so that the information is more easily associated.

We have also made some changes to the disaggregation principle. Disaggregation means separating resources by the activity in which they are used (function) and by their economic characteristics (nature). The DP proposed that, in addition to disaggregating by function and nature, a company should disaggregate otherwise similar assets and liabilities in its balance sheet by measurement bases. For example, items measured at fair value should be shown separately from those that are measured at amortised cost. We have carried this proposal forward.

In addition, the DP had proposed that income and expense information should be disaggregated in the income statement by both function (ie revenue, cost of sales, administrative expenses, etc) and nature (wholesale revenue, retail revenue, salary expense, raw materials purchases, etc). Under our tentative decisions, income and expense must still be disaggregated by nature and function. However, disaggregated by-nature income and expense information no longer needs to be presented on the face of the income statement. It can be presented in the notes instead. In fact, the FASB is proposing that the information should be disaggregated in the segment note.

We are also proposing less disaggregation in the cash flow statement. Cash flow information will not have to be disaggregated in the same detail as income and expense information which, as mentioned above, is disaggregated by nature and by function. Cash flows will be disaggregated only by nature. The cash flow statement is discussed in more detail below.

Structure of the financial statements

The proposals in the staff draft establish a common structure for the financial statements, in the form of required sections, categories or subcategories and related subtotals. The DP proposed a management approach to classifying assets and liabilities. That is, management would classify assets and liabilities into sections and categories on the basis of

how management used those assets or liabilities in its business. The staff draft maintains the notion of classifying items on the basis of the activity in which they are used. However, the definitions of the sections, categories and subcategories are more specific than in the DP. This is to promote consistent application.

Business and financing activities will be presented in separate sections. The business section will include items that are part of a company's day-to-day and other income-generating activities. A change from the DP is that treasury assets will now be in the business section, not within the financing section.

Business activities will be further segregated into operating and investing categories. In addition, we have added a subcategory within the operating category called 'operating finance'. This will contain certain liabilities directly related to operating activities, such as a pension obligation, that are a source of long-term financing.

The financing section will include items that are part of a company's activities to obtain or repay capital, and will be further disaggregated into debt and equity categories.

Discontinued operations and income taxes will be presented in their own separate sections.

The following table shows the sections, categories and subcategories in each financial statement to illustrate their cohesiveness.

Statement of financial position	Statement of comprehensive income	Statement of cash flows
Business section	Business section	Business section
Operating category	Operating category	Operating category
Operating finance subcategory	Operating finance subcategory	
Investing category	Investing category	Investing category
Financing section	Financing section	Financing section
Debt category	Debt category	
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, net of tax	Discontinued operation section
	Other comprehensive income, net of tax	

Cash flow statement

We continue to propose a cash flow statement that presents all cash receipts and payments (a direct method statement), but, as mentioned above, we are proposing less disaggregation than was envisioned in the DP. The DP described and illustrated a direct method statement that was aligned with the disaggregated by-nature and by-function income and expense information presented in the income statement. The boards have now tentatively decided not to require this. Instead, we propose that cash flows should be disaggregated only by nature. In addition, the staff draft includes guidance on when it is appropriate to aggregate cash flows. The revised requirements may enable companies to use a derived (indirect-direct) approach to prepare cash flows. During our extended outreach activities, we will be focusing on the right level of disaggregation of operating cash flows.

We are also proposing to require a reconciliation of operating income to operating cash flows, as a supplement to the statement of cash flows. This reconciliation will begin with income from operating activities, as defined in the staff draft, rather than starting with profit or loss (net income) as is often the practice today. In a change to the DP, companies will not be permitted to present the reconciliation in the notes to the financial statements.

We are also proposing changes to cash flow statement for companies with deposit-taking activities such as banks. For these companies, we are proposing that they should incorporate cash flows that occur between them and their deposit accounts as if these amounts were settled by external funds.

Analyses of changes in assets and liabilities rather than a reconciliation schedule

In lieu of the multicolumn schedule reconciling comprehensive income items to cash flows proposed in the DP, the staff draft proposes that the financial statement notes should include an analysis of the changes to important asset and liability line items between the opening balance and the closing balance. As part of that analysis, the following changes will be shown separately: cash transactions, non-cash transactions such as reclassifications, accounting allocations such as depreciation, write-downs or impairment losses, acquisitions or dispositions, and other remeasurements such as fair value changes.

Net debt information

As part of the analyses of changes in assets and liabilities discussed above, we also propose a single note analysing changes in cash, short-term investments, finance leases and all line items in the debt category. There was no similar proposal in the DP. However, a number of European financial statement users requested that an analysis of net debt should be included in the FSP project. We agree that information about net debt should be apparent in the financial statements. Consequently, we are proposing this analysis of the changes in line items that normally constitute net debt.

What do you think?

We would like to hear what you think about the changes that we have made to our tentative FSP proposals since our 2008 discussion paper.

Do you believe that cohesiveness at the section and category level (rather than at the line item level) will enhance your understanding of the relationships between the numbers in the various financial statements? Why or why not?

Will disclosure of income and expense items disaggregated by nature in the notes rather than on the face of the income statement enhance the understandability and usefulness of the statement? Why or why not?

Will having a direct method cash flow statement that incorporates the indirect method reconciliation of operating income to operating cash flows provide better information than is generally available today? Why or why not? What do you think is the right level of disaggregation of operating cash flows?

Do you believe that the proposed note disclosure that analyses the changes in the balances of asset and liability line items achieves the objective of increasing your understanding of a company's cash flows and earnings potential, while providing additional insight into changes in balance sheet line items?

Patricia McConnell 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.