COMPLIANCE WEEK

A Weekly Newsletter On Corporate Governance, Risk And Compliance

This is the Future of Financial Statements?

By Tammy Whitehouse — September 25, 2007

Accounting standards setters plan to unveil early next year an entirely new way to present financial statements, establishing some potentially radical new concepts in how the markets digest corporate financial information.

The Financial Accounting Standards Board and the International Accounting Standards Board are on a mission to create a more orderly, cohesive presentation of financial information, where readers can better discern business results from financing activities and numbers from one statement readily relate to the numbers in another.

Their ideas so far promise to produce lively debate over long-entrenched thinking about core concepts, like how to report and calculate "income," how a company relates that income to operating, financing, and investing, and how a company reports information that arises from different business segments.

Users of financial statements are salivating over the initial concepts.

Jonas

"This is among the most important projects of any that the boards are working on," says Greg Jonas, managing director at Moody's Investors Service. "The boards have not given a lot of attention in the past to financial display, so it's low-hanging fruit. A lot can be accomplished here. They can do some things that will be really helpful to people like us who are analyzing financial statements."

Even preparers of financial statements share some of the enthusiasm. "There are some good improvements that are proposed," says Ken Kelly, vice president and controller at McCormick & Co., a $2.7 billion maker of spices and flavorings. "It needs to be done because there is not one standard out there that tells you what should be in a financial statement."

Kelly

Kelly says the current display in financial statements has sprung up haphazardly over generations of financial reporting, based on traditions and various pronouncements by the Securities and Exchange Commission about specific line items that must be included for public companies. "Right now, financial statements are constructed from history and textbooks," he says. "In terms of U.S. Generally Accepted Accounting Principles, there is no standard out there that says this is what a financial statement or a balance sheet should look like."

RELATED RESOURCES

- Boards' Handout on Financial Presentation (Sept. 14, 2007)
- Archived Webcast of Meeting (Sept. 14, 2007)
- Summary of Joint Financial Presentation Project

Related Coverage

- A Simpler Way to Set Standards (Sept. 25, 2007)

The two boards met recently with two advisory panels that have helped steer the project, to hash out some details of the preliminary proposal. They expect to publish their ideas in a discussion document in early 2008, says Kim Petrone, senior project manager for FASB. "The purpose is to create financial statements that give a more complete financial picture, to make it easier, not harder, to understand the financial picture," she says.

The working proposal will require companies to organize information into three separate statements: a statement of financial position, a statement of comprehensive income, and a statement of cash flows. Companies would provide breakouts in each statement for business activities (including operating and investing activities), discontinued operations, financing activities, income taxes, and equity.

The boards are looking for a cohesive approach so that if management classifies an item as belonging to assets, liabilities or equities in one section in the statement of financial position, it would carry through to the same category in the other statements.

Jonas says such a presentation will be helpful to users. "Cohesion means if an asset is an operating item, changes in that asset will be in the operating section of the income statement, the cash flow statement, and the balance sheet," he says. "Separating operations from financing is something I see our analysts trying to do all the time. Today financials don't break those activities out separately except in the cash flow statement."

Working Without a Net

Perhaps one of the biggest flashpoints, however, will be the presentation of income that results from such an approach. The statement of comprehensive income as proposed so far would *not* lead to the calculation of a bottom line—the sacred "net income" number that has been a bedrock measurement in the equity markets.

Kathryn Cearns, a consultant with the Herbert Smith accounting firm in London, says the significance attached to net income is not conceptually valid. The bottom line number typically omits the effects of gains or losses in pension funds, foreign currency translations, or hedge items, Cearns says.


Cearns

"Net income represents a lot of things, a majority of the gains and losses in the financial period, but it doesn't represent all of them," she says. "Everyone seems to use net income, but it's not the whole picture. There are other gains and losses, and there's no conceptual reason why they would be left out."

Cearns says the IASB and FASB are looking for an approach within a comprehensive income statement

PRESENTATION SCOPE

Below is a description of the scope of the project to revise the presentation of financial statements.

- The resulting standard will apply to all business entities (public and nonpublic) and will not apply to nonbusiness entities (not-for-profit organizations or defined benefit plans). The Boards are attempting to develop a principles-based standard that will apply equally to all entities; however, it will consider whether there should be different presentation provisions for a limited scope of entities (for example, financial institutions).
- The project will address the organization and presentation of financial information on the face of the financial statements; it will not address recognition or measurement guidance provided in other standards for individual assets, liabilities, or transactions.
- The project will address all the financial statements that constitute a complete set of financial statements. Phase C of the project will address interim financial information.
- The project will address the necessity for totals and subtotals within the financial statements including the net income/profit or loss subtotal. The project will assess whether to change the mechanism of recycling as used today.
- The project will not include a comprehensive review of the notes to the financial statements. However, it may result in amendments to existing disclosure requirements as a consequence of changes made to the face of the financial statements. In addition, the project may result in new disclosure requirements when the project objective cannot be achieved on the face of the financial statements.
- The project will not address:
    - Management discussion and

that would present all gains and losses in a structured fashion in one location, but segregated among operating, investing, and financing categories. “It would take a while for people to get used to not having this number,” she says. “People have become very wedded to this notion even though there’s no real conceptual basis for it.”

Kelly is not sure the markets are ready for such a leap. He suspects investors have grown accustomed to a single, benchmark measure for assessing a company’s performance, and they may find it confusing to weigh and assess multiple income figures.

“That may be well and good for the analyst who does this for a living and is really following a corporation and has detailed models,” he says. “For the investor on the streets, net income and earnings per share is a benchmark. It is not a single measure that encompasses all aspects of a corporation, but they know the faults of net income. Comprehensive income is not a substitute for net income.”

The structure the two boards plan to propose also leaves open some debate about how a company will assign various items to operating, investing, or financing activities. Pension plans, for example, can be called an operating expense because they represent a labor cost, or an investing activity because funds are invested for long-term growth.

FASB’s Petrone acknowledges the issue is still sticky. The boards currently are of the view that pension plans should fall within operating activities, she says, but ultimately management may get some leeway to determine where the pension plan belongs.

analysis or management commentary.

- Pro forma measures.
- A comprehensive review of segment reporting requirements. However, the project may result in amendments to the current segment reporting requirements as a consequence of changes made to the financial statements. (Note: the IASB on November 30, 2006, issued IFRS 8, *Operating Segments*, as part of a separate short-term convergence project.)
- Financial ratios (except earnings per share [EPS] and other per-share amounts).
- Forecasts of information.
- Nonfinancial ratios or other nonfinancial information.
- Financial statements for specific industries (except for how the decisions in the project may affect the financial statements of financial institutions).

Source

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The preliminary proposal also is likely to touch off debate over how management can or should present information about specific business segments. Kelly says the proposed direction would require companies to provide more information about specific business segments than management uses, and adds, “If management doesn’t use that information, why would it be useful to an investor?”

Jonas says increased information about business segments will be useful to analysts. “If a company is in two different businesses—for example, guns and butter—analysts like to look at the gun business separate from the butter business,” he says. “Segment reporting in the past has provided limited data on different segments.”
