

COMPLIANCE WEEK

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Will Revamped Financial Statement Benefit Valuation?

By Colleen Cunningham — February 24, 2009

The International Accounting Standards Board and the U.S. Financial Accounting Standards Board recently published a discussion paper for public comment on financial statement presentation. The paper presents the boards' initial thinking on a possible future format.

Comments on the paper are due to the boards by April 14, 2009. What's to comment on? The boards have identified three objectives for financial statement presentation:

- *Cohesiveness*, to ensure that a reader of financial statements can follow the flow of information through the different statements a company produces.
- *Disaggregation*, to ensure that items that respond differently to economic events are shown separately.
- *Ability to assess liquidity and cash flow*, by reporting information that helps users assess the ability to meet financial commitments and financial flexibility.

As contemplated by the boards' paper, a company would be required to present information about the way it creates value (its business activities) separately from information about the way it funds or finances those business activities (its financing activities). Companies would further separate information about business activities by presenting *operating* activities separately from *investing* activities.

Additionally, information about non-owner sources of finance should be presented separately from owner sources of finance. Discontinued operations and income taxes should also be presented separately, and classification would be consistent with the way that management uses the item. For example, if inventory is an operating asset, purchases and sales of inventory would be included in the operating cash flows and the operating section of the statement of comprehensive income.

More specifically, the Statement of Financial Position would be grouped by major activities noted above—not by assets, liabilities, and equity, as it is today. Assets and liabilities would be disaggregated into short-term and long-term sub-categories within each category. Totals for assets and liabilities and sub-totals for short-term and long-term

assets and liabilities would be presented in the statement or in the notes. The concept of “balancing the balance sheet” would no longer exist.

All companies would present a single statement of comprehensive income, with items of other comprehensive income presented in a separate section. This statement would include a sub-total of *profit or loss* or *net income* and a total for *comprehensive income* for the period. (Some feared that this project would kill “net income.” Based on the discussion paper, reports of the death of “net income” were grossly exaggerated!)

Additionally, a company would disaggregate line items when that presentation would enhance the usefulness of the information. In addition to classifying income and expense items into operating, investing, and financing categories, a company would disaggregate those items based on function within those categories. A company would further distill its income and expense items by nature within those functions to the extent this disaggregation will help users in predicting future cash flows. *Function* refers to the primary activities, such as selling goods, providing services, manufacturing, marketing, business development, and administration. *Nature* refers to the economic characteristics, such as separating total revenue into wholesale revenues and retail revenues, or disaggregating cost of sales into materials, labor, transport, and energy costs. This effectively means a much longer statement of comprehensive income. One has to wonder whether all of this additional “data” will take away from the real “information” on the face of the statement.

Only the direct method (presenting separately the main categories of its cash receipts and payments for operating activities) would be used to prepare the cash-flow statement. The indirect method (reconciling net income to net operating cash flows) would no longer be permitted.

A new schedule that reconciles cash flows to comprehensive income will be required in the notes to the financial statements. This reconciliation will disaggregate income items into cash, accrual other than remeasurements, and remeasurement components.

Why Are We Doing This?

One of the three stated objectives of this overhaul is to provide investors with the ability to assess liquidity and cash flow by reporting information that helps them assess the ability to meet financial commitments and financial flexibility. To me, that is a critical objective for all of financial reporting. After all, at the end of the day, isn't the important metric for users how much cash this business has the ability to generate?

Call me a simpleton, but I have a lot of trouble understanding the relevance of a value that someone else would put on my assets, if I intend to hold them, rather than the amount of cash I expect those assets to generate for my business. The valuation methods I learned when taking finance classes all focused on discounted cash flows. In my simple world, returns to investors come in the form of cash dividends and the cash realized from

market appreciation. When someone invests, a judgment is made as to whether that cash investment will provide an appropriate return.

One of my favorite professors from graduate school, Robert Howell, has written several thoughtful articles on this topic over the years. To quote from an article that Howell wrote several years ago: “There are only three ways management may increase the real market, or ‘intrinsic’ value of a firm. First, increase the amount of cash flows expected at any point in time. Second, accelerate cash flows, given the time-value of money; cash received earlier has a higher present value. Third, if a firm is able to lower the discount rate that it applies to its cash flows—which it frequently can—it can raise its net present value.”

Howell and I recently caught up and discussed the financial statement presentation proposal. He noted that the proposal does distinguish between the operating, investing, financing, and tax activities throughout the financial statements. But other than giving more detail, it still maintains the manufacturing model for the income statement, de-emphasizes the focus on net income, heightens the emphasis on comprehensive income, and still fails to capture some of the more value-creating assets on the balance sheet, *and* fails to distinguish the cash flows generated for creditors and investors. You can’t buy a cup of coffee with comprehensive income; you need cash!

So while I find it hard to disagree with the *stated* objectives of the proposal, the devil is in the details. As I researched this column, I came across a summary of interviews that FASB did with users of financial statements in 2002. One of the most interesting findings: there was “no widespread dissatisfaction with or demand for sweeping change in financial statement display.” So why the dramatic change? Who exactly is asking for it?

The underlying premise in FASB’s stated goal is that management currently has all of the additional information the proposal contemplates, but just isn’t sharing it. I assure you, for the most part companies aren’t withholding information; they just don’t have it. As an example, the direct method of presenting the cash-flow statement has been permitted for years. If companies believed that the benefit of accumulating and reporting this information outweighed the related cost, companies would already be preparing this information internally. But much of the information needed for the direct method is simply not available; the systems needed to accumulate the information have not been developed; and, from a management approach perspective, the information isn’t currently used in internal decision making. Since I don’t believe I have ever actually seen a company prepare a direct method cash-flow statement, I question why the boards believe this would add value. The required information is generally not captured by companies and isn’t used by management, so why would others find it valuable? It would be instructive for the boards to explain the reasons why the direct method would benefit investors.

The direct method would require companies to create the cash-flow statement from transactional data. Most companies’ systems just are not designed to capture this and

would need to be completely redesigned. This is especially true of companies that use various general ledger and sub-ledger systems. Add complications associated with transactional data in other currencies and inter-company transactions, and it becomes even more complicated. Perhaps consideration should be given to providing additional information on certain items, such as cash-flow expectations on working capital, and other data that would provide users with useful information without companies having to revamp their entire reporting systems to gather the information required for the direct method cash-flow statement. Similarly, the reconciliation of the direct method cash-flow statement to the comprehensive income statement would require massive changes to the current reporting environment, with likely little benefit.

The proposed requirement to further disaggregate income and expense items by nature is also problematic. Most systems provide information by *function*, and are simply not configured to accumulate information by *nature*. It may be captured at a low level so that department managers can review their information, but it is generally not appropriately accumulated and consolidated. Companies just aren't managed this way. They are managed based on functions, and that is how the information systems are designed.

Some companies tell me that they suspect the changes contemplated in this proposal could dwarf the costs that companies would spend in total to implement International Financial Reporting Standards. We can't lose sight of the fact that financial reporting is not an end in itself; it is a means to communicate information. The boards are field-testing the proposal to understand the implementation issues and the costs associated with the proposed changes.

There are important implications for preparers of financial statements as well as investors in the discussion paper. I encourage all parties to get engaged in the debate, and more particularly, to ensure that the actual analysts who follow your company understand the implications of the changes and get engaged in the debate. Too often we hear from the "real" users of financial statements too late in the process.

I would also encourage FASB and IASB to link this effort to the Securities and Exchange Commission's recent mandate that companies use XBRL technology in financial reporting. Perhaps users can get a lot of this information through the XBRL information filed, rather than the face of the financial statements.

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