

14<sup>th</sup> April 2009

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International Accounting Standard Board  
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Mr. Robert Herz,  
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Financial Accounting Standard Board  
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**Re: Comment Letter on Preliminary Views on Financial Statement Presentation (FSP)**

Dear Sir David and Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the IASB and FASB's joint project-*Preliminary Views on Financial Statement Presentation- Discussion Paper (DP)*.

The CFA Institute Centre represents the views of its worldwide members, including portfolio managers, investment analysts, and advisors. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

## **EXECUTIVE SUMMARY**

### **Proposal Summary**

The DP states the following as the objectives of the financial statement presentation project (FSP)

- Present a cohesive financial picture of an entity's activities.
  - *Relationship between items across financial statements is clear and the different statements complement each other as much as possible.*
- Disaggregation of information so that it is useful in predicting an entity's future cash flows.
  - *Analysis aimed at objectives such as assessing the amount, timing, and uncertainty of future cash flows requires information that is segregated into reasonably homogeneous groups of items.*
- Help users assess an entity's liquidity and financial flexibility.
  - *“Liquidity” is considered in terms of an entity having resources to fulfill its financial commitments.*
  - *“Financial flexibility” is broader: it relates to an entity's ability to earn investment returns and fund future growth, and to take effective action to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.*

### **Key Changes and Summary of CFA Institute Positions**

We believe that the proposals in the DP would address major shortcomings with current financial statement presentation (FSP). We include a detailed list of these shortcomings in the appendix including the limited transparency of the cash flow from operations in financial statements. The key changes in the DP are

- The requirement to present a cash flow statement using the direct method. **We strongly support this proposal as it would improve the transparency of operating cash flow and its components.**
- The requirement to present a schedule in the notes to financial statements that reconciles cash flows to comprehensive income and disaggregates comprehensive income into four components: (a) cash received or paid other than in transactions with owners, (b) accruals other than remeasurements, (c) remeasurements that are recurring fair value changes or valuation adjustments, and (d) remeasurements that are not recurring fair value changes or valuation adjustments. We would not get information on operating changes versus investing decisions versus foreign exchange rate effects – currently provided (albeit poorly and/or incompletely) in the indirect cash flow statement reconciliation. **We recommend and strongly prefer the statement of financial position reconciliation as it provides more comprehensive information and includes the statement of financial position and direct cash flow statement.**

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- We support the portrayal of a cohesive financial picture of an entity's business by classifying its activities into operating, investing and financing categories across the statements of financial position, comprehensive income and cash flows to enhance an understanding of an entity's a business.
- Classification across the three main statements will be done through the eyes of management (subject to general principles) reflecting the management view of how its assets and liabilities create value. **We support this approach as it will help convey relevant information and faithful representation of economic reality.**
- A single statement of comprehensive income will be required. While we support this change as it gives prominence and increased transparency of other comprehensive income (OCI), **we are concerned by the failure to deal with the treatment of other comprehensive income items.** There are significant transactions accounted for through the OCI and the deferral and subsequent recycling of items through the OCI makes it difficult for investors to fully evaluate the economic meaning of these transactions. As an interim measure, when improving related recognition and measurement standards, we would propose that the Boards aim to restrict the deferral to and subsequent recycling from the OCI. In our comment letter to the IASB on 'reducing complexity for financial instruments', we stated our support for limiting deferral periods of cash flow hedging items. For the same reason, we articulated our concerns about the recent FASB amendment to defer, amortise and recycle non credit risk impairment charges of held to maturity items.

## **GENERAL COMMENTS**

We welcome the efforts by the IASB and FASB to improve FSP through the proposals contained in the discussion paper (DP). FSP improvements are required to enable investors and other users of financial reporting information to understand the performance, risk and financial condition of reporting entities. We laud the IASB and FASB staff for developing a comprehensive discussion paper that addresses a number of the key issues pertaining to FSP. We commend the Boards for the numerous outreach and education efforts undertaken and encourage the standard setters to make the most of this window of opportunity to enhance a key aspect of financial reporting. In the continued evaluation of costs and benefits, it is especially important for the Boards to conduct the field testing in a fully transparent manner with regards to methodology, preparer and user sample selection and results dissemination. The process should involve experienced active investment professionals. Thus far **it is not clear how the field testing is being conducted** and this could significantly undermine the validity of any conclusions derived.

We believe that the proposed FSP contains a number of major changes that would more fully meet the financial statement information needs of investors. For example, the disaggregation approach will help investors to differentiate flows with different earnings qualities, persistence and cash flow realisation prospects and thus enable investors to segregate fair value re-measurement gains and losses from

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operating earnings. This can facilitate the transition from the mixed attribute model for measuring financial instruments to full fair value through earnings and, in the interim, provide useful information in a mixed measurement attribute world.

### ***Integration with other financial reporting projects***

Despite the cross cutting character of FSP, the projects appears to have been handled on a compartmentalised basis. While attempting to resolve FSP issues, the Boards should ensure the directional consistency of ongoing recognition and measurement amendments. In particular, they should avoid changes that entrench the peripheral treatment of OCI. As an example, a recent FSP issued by the Financial Accounting Standards Board (FASB) separating credit risk losses from non-credit changes in fair value seems predicated on OCI being a peripheral statement that investors ignore. Unfortunately, if the Boards continue to make compromises based on the assumed primacy and targeted low volatility of net income, they will only perpetuate the false notion that amounts put into OCI are irrelevant. The Boards need to demonstrate a consistent, self-reinforcing approach in the overhaul and comprehensive review of key standards e.g. financial instrument and retirement benefit accounting. In addition, as far as possible, as changes to other key standards are deliberated and exposed for comment, the effect of the new proposals on the current financial statement presentation proposals should be discussed and illustrated, e.g., it would be helpful to have the effects of the financial instruments with characteristics of equity on the proposed separate equity section illustrated.

### ***Key Areas in DP***

Overall, the proposals would represent major improvements that would redress current presentation shortcomings. A number of the enhancements proposed would increase the amount and quality of information available to investors and thus contribute to capital market information efficiency. However, there are several key elements, where the DP falls short and failing to incorporate them would be a missed opportunity that could partially undermine the ultimate usefulness of the proposed new presentation format.

We see the following issues as the most significant aspects of the DP and summarise our views on each below. In the appendix we have a more detailed evaluation of these aspects plus other areas covered in the discussion paper.

#### ***a) Cash flow presentation and disclosure***

The 2007 Corporate Disclosure Survey (CDS) (*Detailed description in Appendix under cash flow section*) of our membership shows that many of our members consider current cash flow disclosure to be sub-optimal. The DP focuses its improvement proposals on the provision of the direct method (DM) cash flow statement. **We strongly support the adoption of the direct method cash flow statement as it would be a significant step towards improving financial reporting.** The DM offers insights into the quality of revenues, earnings and the characteristics of the cash conversion cycle, which are not available from an indirect method of reporting cash flow from operating activities. The DM is also consistent with

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and achieves the greater relevance of disclosure of gross rather than net amounts. We strongly believe that the benefits outweigh the costs of adopting this method. In addition, we believe that the information provided by DM cash flows would be beneficial to management as well as investors.

However, to complement this improvement, it will be necessary to also improve other aspects of cash flow disclosure including the disclosure of non cash transactions and commitments for contractual inflows and outflows. We support the provision of the net debt to cash flow reconciliation proposed by the Corporate Reporting User Forum (CRUF) because that would enhance the transparency of cash flows associated with debt including any acquired company debt.

**b) *Inter-connectedness of financial statements***

Financial statement presentation should enable investors to understand the relationships among the different financial statements. Significant tools of financial analysis, like rates of return and turnover analysis depend on and exploit interrelationships between statements and their components. **We therefore strongly endorse the proposed cohesiveness and disaggregation principles.** In addition, disaggregation can help alleviate concerns about volatility associated with fair value measurement basis. One of the reservations sometimes raised about fair value is that re-measurement volatility could taint ‘core earnings’; disaggregation mitigates this concern.

Coupled with the direct method cash flow, the provision of a statement showing the interconnectedness of the main financial statements would be a significant improvement to current financial reporting. **However, we do believe that a reconciliation of the statement of financial position rather than the proposed alternative of a reconciliation of cash flows to comprehensive income would be the most effective way of achieving cohesiveness, transparency, quality and simplicity in financial statement presentation from the investor perspective.** While the reconciliation proposed in the DP contains several useful elements and provides a cohesive depiction of how cash flows interconnect with comprehensive income it bears the glaring omission of excluding the balance sheet component. This proposed approach would appear to assign a greater importance to the income statement as a means of assessing the amount, timing and uncertainty of future cash flows, which may often mislead investors. In our view, it would be a grave mistake to reduce the prominence of the balance sheet, especially when we consider the fact that the current severe global financial crisis probably is most accurately described as a balance-sheet-focused crisis.

The implied primacy of the income statement is questionable at best. **There is no conceptual basis to assume that the statement of comprehensive income is of higher importance than the statement of financial position, the statement of cash flows, or equivalently, that any one statement is more relevant than any other statement.** In addition survey results<sup>3</sup> show that our membership finds each of the key financial statements to be highly important with no significant difference in the importance attached to each statement. While some analysts may focus mainly on the income statement in their

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<sup>3</sup> 2007, 2003 and 1999 CFA Institute corporate disclosure survey results shown in Appendix- Page 25

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valuation models, **it is perilous to ignore balance sheet analysis as is evident from the current market crisis**. One reason is that different investors use various approaches to make investment decisions. In addition, the relative importance of different financial statements may vary over time as well as by industry. It is equally true that investment risk increases as one emphasizes data from one statement over related information available in other statements. Besides, we are not aware of any empirical evidence that the balance sheet has intrinsically lower information content than the income statement for the purposes of valuation and risk analysis or that all of its information can be meaningfully ignored entirely. Hence, it is inappropriate to accord greater importance to one financial statement over the other. Unfortunately, the proposed reconciliation could perpetuate the false notion that the statement of financial position is less relevant than the statement of comprehensive income.

Rather than the proposed format, the reconciliation of the statement of financial position would most effectively achieve and integrate the proposed improvement objectives. It conveys the connectedness and cohesiveness of all three primary statements, provides the elements of a direct cash flow statement and allows the disaggregation necessary for investors to monitor items with different earnings quality.

We are aware that several objections have been raised in relation to this reconciliation. These include the:

- Anticipated implementation difficulty, especially for multinationals with foreign subsidiaries or companies engaging in multiple acquisitions and dispositions, and the
- Risk of information overload if every element of the statement of financial position is reconciled

We acknowledge that the proposed FSP would require financial statement preparers to make changes in their reporting systems. However, that is true of all changes in financial reporting standards; we have never heard a preparer complain about the cost of implementing a new standard that it considers beneficial despite how radical or complex the changes may be. We believe that preparers, given sufficient time, can change their systems to implement the proposed FSP and that it is much less costly for a preparer to change its systems once than for each of many thousands of financial statement users to attempt to estimate the currently undisclosed data year after year.

The objections of information overload fail to take into account the possibilities presented by interactive technologies. The provision of decision useful information should not be constrained by whether information can fit into a print media such as A4 or 8.5x11 piece of paper, as investor analytical tools are capable of processing multiple columnar inputs. The application of the materiality principle should help to find the right level of meaningful and informative aggregation. In the near future, XBRL will make it much easier to use the expanded data set resulting from the FSP.

On the issue of aggregation difficulties for multinational companies, these objections reflect the reality that foreign currency translation adjustments are currently derived as plug figures and that there is little transparency around the disclosed amounts. The modification of systems required for a reconciliation of a



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statement of financial position provides a window of opportunity to significantly enhance the internal and external transparency of the cash flow effects of foreign currency translation adjustments and acquisitions by streamlining extant sub-optimal accounting processes. Reconciliations (roll ups) make the effects of foreign currency, acquisitions and divestitures, and re-measurement much more transparent, allowing investors to distinguish operating changes from non-operating changes. While we fully recognize that these issues are complex, we believe that arriving at decision-useful presentations for these difficult areas is perhaps one of the most important aspects of this project and among the greatest opportunities for true advancements in transparency.

Hence, while we acknowledge that the proposed reconciliation of cash flows to comprehensive income would comprise some degree of improvement, **we strongly recommend<sup>4</sup> that the reconciliation of the statement of financial position should be required instead. If the Boards were to adopt the reconciliation of cash flows to comprehensive income, however, then companies should be required to reconcile in the notes all key elements of the statement of financial position such as:** Accounts receivable, Inventory, Accounts payable, Accrued expenses, Income tax and Gross debt. Roll forwards have been shown to be an efficient way of showing both operating and non-operating changes and both preparers and investors are used to them. Roll forwards of key balance sheet accounts would provide some of the transparency that would have been obtained from statement of financial position reconciliation.

### ***c) Resolution of the Other Comprehensive Income (OCI) statement***

We are generally supportive of the proposed changes to the statement of comprehensive income. We support a single statement of comprehensive income as it enhances accessibility and transparency of OCI information for investors<sup>5</sup>. Coupled with the provision of a supplementary reconciliation, it may in the long run help to reduce the functional fixation<sup>6</sup> with net income. However, we are concerned by the failure to deal with the treatment of other comprehensive income items.

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<sup>4</sup> Disclosure does not equate to recognising on the face of financial statements. Ahmed.A.S, Kilic.E and Lobo.G, 2006, 'Does Recognition versus Disclosure Matter? Evidence from value relevance of banks recognised and disclosed derivative financial instruments', *The Accounting Review*, Vol. 81, No.3, Pg 567-588

<sup>5</sup> Chambers, Linsmeier, Shakespeare, and Sougiannis, 2006, 'An evaluation of SFAS 130 Comprehensive Income Disclosures', Working Paper.

<sup>6</sup> There is an observable functional fixation by preparers on net income. Graham, Harvey and Rajgopal (2005), in a survey of 401 executives, found that a majority of Chief Financial Officers (CFOs) believes earnings to be the most important performance measure for outsiders. They found that 51% ranked earnings as most important followed by 12% each ranking revenues, cash flow from operations and free cash flow. They also found that 96.9% of CFOs prefer a smooth earnings path and that 78% of CFOs would sacrifice real economic value in order to ensure a smooth earnings path. The obsession with reported net income permeates many discussions on financial reporting improvements.

The functional fixation on earnings is accompanied by the belief that net income volatility needs to be managed. Thus there is a disproportionate focus on a single amount although no single number can fully convey the performance, risk and prospects of reporting entities. The functional fixation is in part an artefact of the historical development of current financial statements. The promulgation of standards pertaining to different elements of the financial statement has not always been based on a well developed conceptual framework. It also arises due to managerial incentives to smooth earnings, for example compensation.

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The OCI statement has no conceptual basis; it is an artefact of compromise-based standard setting as it has often been used as a repository for items that conceptually belong in the income statement. These include fair value changes associated with so-called available for sale securities, gains and losses on cash flow hedges, foreign currency translation effects and postretirement benefit adjustments. Thus, the OCI bears semblance to a suspense account that, contains key elements of a reporting entity's performance and risk and, in essence, renders less meaningful income statement figures. The effect of the OCI category is to disconnect the inherent volatility associated with a business from the volatility of its earnings – that is, earnings are being enhanced to artificially appear less volatile than they truly are. We believe this suspension of reality does a considerable disservice to investors.

The significant transactions accounted for through OCI require higher levels of visibility and monitoring by investors. The DP proposes a single comprehensive income statement as opposed to the option of two statements, which is certainly an improvement. **However, the discussion paper does not address and adequately tackle the various difficulties associated with OCI.** For example, the matter of recycling of OCI items to the income statement is not addressed at all. This is a significant missed opportunity as OCI contains decision useful<sup>7</sup> information that investors do not understand and view with significant scepticism thereby impairing the credibility of financial reports and penalizing security valuations.

As an interim measure, when improving related recognition and measurement standards, we would propose that the Boards aim to restrict the deferral to and subsequent recycling from the OCI. In our comment letter to the IASB, on 'reducing complexity for financial instruments', we stated our support to limit the deferral periods of cash flow hedging items.<sup>8</sup> For the same reason, we articulated our concerns about the recent FASB amendment to defer, amortise and recycle non credit risk impairment charges of held to maturity items.

#### **d) Classification approach**

The discussion paper proposes a classification trichotomy, namely operating, investing and financing. The DP proposes that this trichotomy be applied cohesively across the three main statements, based on a management approach (i.e. classification should be determined through the eyes of management). We

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<sup>7</sup> There is empirical research showing that retrospective data analysis of foreign currency translation adjustments can be a lead indicator of EPS in future periods-( Pinto (2005), 'How Comprehensive is comprehensive income?', The value relevance of foreign currency translation adjustments', Journal of International Financial Management & Accounting, 16, 97-122.)

<sup>8</sup> The 'Reducing Complexity for Financial Instruments' discussion paper proposed that reporting entities should state at inception when a hedged transaction is expected to affect earnings and to reclassify gains and losses at that time regardless of the realisation of the forecasted transaction. We would support this proposal as it can limit lengthy deferral periods.



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would support the application of the management approach as long as there are sound principles that govern classification (management can have some leeway around the edges). We acknowledge that there may be some tension between comparability versus relevance. However, we believe that **presentation and disclosure through the eyes of management can convey useful and relevant business model information to investors. Our support of the management approach, however, does not extend to recognition and measurement based on management intent as the latter is more amenable to subjective distortions of performance.**

We support the consistent classification at the entity and reportable segment level as this aligns with the management approach classification. We support the trichotomy classification in the statement of financial position as this will help investors perform key ratio analysis.

We support the disaggregation of the income statement by nature and function, rather than only by function. This will allow managers to provide a relevant and informative depiction of performance. It will significantly increase the usefulness, attribution and predictability of future earnings and cash flows.

### **Cost-Benefit Evaluation of the proposals**

We acknowledge that both Boards have reached out to their many constituencies, including investors, and provided education on key aspects of the proposals. Despite the compelling conceptual justification for various enhancements such as the direct method of reporting cash flows, it is clear that the Boards are grappling with whether there is a market demand for these proposals and have thus imposed a burden of proof on investors who support these changes. Regarding the mindset that users have to demonstrate the benefits prior to enacting change, we have the following observations:

- By the very nature of information, it is much more difficult to quantify the benefits of its provision (subject to testing a datum not currently available) than it is to quantify its processing costs (subject to assertions and claims that may not be verifiable until after a requirement has been imposed). The costs in any case, are borne by investors in the entity. On this basis, there should also be a burden of proof on the suppliers of information to substantiate any claims of significant costs associated with the proposals. This is especially necessary as preparers have, with hindsight, overstated the cost and implementation difficulties associated with almost every proposed financial reporting improvement.
- **Investors face significant costs by not having this information, including the costs of a) reprocessing information and b) misallocating capital.** Hence, just because the costs that investors face are not visible and are difficult to measure does not mean they do not exist nor that they should be ignored in the cost/benefit analysis. From a perspective of total cost for all parties, it is easier for preparers to generate information and often impossible for investors to accurately reconstruct such data.
- The parameters of sufficient benefits should also be better defined. **There is the risk that standard setters might impose on investors an arbitrary and insurmountable burden of proof of sufficient benefits.** It is not clear whether the provision of corporate case studies,

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analytical examples, and academic empirical evidence showing the usefulness of direct cash flow will be considered sufficient evidence of benefit. And if not- why not?

- As suppliers of capital, investors ultimately bear the cost of any changes made by preparers. That is, those are costs to investors and not the managements that act as custodians of assets and liabilities of investors. While there may be incremental costs that investors will have to take on to upgrade or replace outdated financial reporting technology at the companies they invest in, investors will also likely receive greater transparency into their holdings which should reduce the cost of capital of companies and thus increase equity values. It is our expectation that in most cases the benefits from a lower cost of capital would more than offset any costs associated with system upgrades.
- Standard setters should also be aware of the limitation of an approach that seeks to validate benefits based on whether investors currently use a particular information set that is not currently available. Such an approach is inherently tautological. This is because valuation and risk analysis models are dynamic and their design is influenced by the available financial reporting information. These models are modified when new information becomes available.
- The difficulties and complexities associated with the enhancements for complex business models (e.g. multinationals and acquisitive businesses) make it all the more necessary to have these changes. It is for precisely such complex business models that many investors face huge information disadvantages and this creates capital market information inefficiency. Hence **business model and corresponding information processing complexity should not be used as a reason for avoiding change.**

### **Areas *Not* Addressed by the Financial Statement Presentation Project**

The DP does not address

- A conceptual basis for which items must or may be presented in other comprehensive income outside of profit or loss or net income.
- Whether, when, and how items of other comprehensive income must be reclassified to profit or loss or net income.
- Management commentary or management's discussion and analysis, nonfinancial information, and forecasts of financial information.
- The risk, return, liquidity, and financial flexibility consequences of the many remaining off-balance sheet assets, liabilities, and activities.

The failure to deal with the risk, return, liquidity, and financial flexibility consequences of the many remaining off-balance sheet assets, liabilities, and activities, other comprehensive income and the recycling issue are among the most substantive omissions.

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We recognise that the FSP is not a panacea for all the difficulties that investors encounter with financial reporting and it is understandable that the FSP cannot address all shortfalls within a single project. Nevertheless, presentation is an important aspect of financial reporting as it influences how effectively reporting entities convey their performance, risks and financial condition. From experience, it is clear that shortcomings in presentation tend to cascade across standards and also influence short term, ad-hoc and conceptually inconsistent changes. Hence **it should remain a priority to address key items not included within the scope of the current FSP project.** We strongly support a single comprehensive income statement and we encourage the Boards to resurrect this issue in subsequent stages of this project, consistent with the increased application of fair value.

We recognise that disclosures are mostly addressed within specific standards and that the DP proposes the presentation of assets and liabilities in the statement of financial position in order of liquidity or maturity. However, we observe that the question of liquidity risk seems to be dealt with by the Boards on a fragmentary basis. The need for better information on the risk, return, liquidity, and financial flexibility consequences of off balance sheet assets and liabilities is evident from our member survey feedback (see page 15 and 16). The results show that there is a need to improve the disclosure of contingent cash flows related to contractual commitments.

### **Next Steps-Field Testing and Investor Outreach**

We recognise the field testing to be an important part of the due process of this key project. It was for this reason that CFA Institute helped to identify volunteers to participate in the field testing. We believe field testing is a necessary step as it should verify the implementation feasibility as well as to provide the sample users with a before and after comparative analysis based on real company data.

However, the efficacy and credibility of the field testing hinges on it being conducted on a transparent, rigorous and representative basis. We recognise that the Boards may be constrained by needing to ensure the confidentiality of preparer data. However, regardless of any such constraints, there should be full transparency to all stakeholders on

- Objectives of field testing
- Methodology applied
- Preparer Sample Criteria
- Investor selection criteria. We would expect this to be experienced active users of financial statements
- Data analysis approach

If the field testing is conducted purely as an internal exercise, it will be difficult to make independent judgements on the validity of any conclusions derived.

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Going forward, CFA Institute is willing to assist in any outreach and education required of our membership to enable their participation and input.

### **Detailed Analysis**

We have in the appendix a detailed evaluation of key aspects of the discussion paper

- Shortcomings of financial statement presentation
- Cash flow presentation and disclosure
- Supplementary Reconciliation format
- Statement of Comprehensive Income
- Classification of items in balance sheet, comprehensive income statement and cash flow
- Other Aspects of the Discussion Paper

### **CLOSING REMARKS**

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at [vincent.papa@cfainstitute.org](mailto:vincent.papa@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

Kurt N. Schacht, CFA  
Managing Director  
CFA Centre For Financial  
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*/s/ Nitin Mehta*

Nitin Mehta  
Managing Director  
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*/s/ Gerald I. White*

Gerald I. White, CFA  
Chair, Corporate Disclosure  
Policy Council

Cc: Corporate Disclosure Policy  
Council

## **APPENDIX: DETAILED COMMENTS**

### **SHORTCOMINGS OF FINANCIAL STATEMENT PRESENTATION**

- Information is not presented consistently in financial statements.
- Under US GAAP, the statement of cash flows requires cash receipts and payments to be classified according to whether they stem from operating, investing, or financing activities and provides definitions of each category, however, IFRS and U.S. GAAP standards do not require such classifications in the statements of comprehensive income or financial position.
- Both IFRS and U.S. GAAP allow presentation alternatives, decreasing comparability. For example:
  - Direct or indirect method of presenting cash flows
  - One or two statement presentation of comprehensive income
- Information is not sufficiently disaggregated in financial statements.
- Low prominence and underutilization of other comprehensive income items (foreign currency translation adjustments, cash flow hedges, pension expenses, available for sale fair value adjustments).
- Recycling of items between earnings or profits and other comprehensive income distorts users' judgments of economic performance, risks and prospects.
- Diminished transparency of operating cash flows because inflows and outflows are netted.
- Use of terms like "miscellaneous" and "other" obscure the nature and significance of substantial elements of the financial statements. Application of the coherence principle should reduce the use of these terms and better indicate the nature of the activities now hidden.
- The effects of foreign currency rate changes, acquisitions, and divestitures often distort measures of firm performance and make it impossible to separate economic effects. The reconciliation of the statement of financial position would make those effects more transparent.
- The relationship between the risk, return, liquidity, and financial flexibility consequences of the many remaining off-balance sheet assets, liabilities, and activities with the risk, return, liquidity, and financial flexibility indicators of related on-balance sheet assets, liabilities, and activities. For example, consider the measurement of borrowing costs when derived from on-balance sheet financing obligations without consideration of the impact of borrowing through securitization

trusts and structured vehicles. The same can be said of reported effective tax rates when viewed in conjunction with the deferred and other tax consequences of off-balance sheet activities.

## DETAILED COMMENTS ON PROPOSALS

### 1. CASH FLOW PRESENTATION AND DISCLOSURE

Ultimately, investors value their investments by forecasting a company's future cash flows and cash flow generating ability. A clear picture of the company's current means of generating cash flows, the individual patterns of inflows and outflows resulting from transactions and events, and the company's effectiveness in producing cash is essential to this analysis (Comprehensive Business Reporting Model (CBRM) - Principle 9). IAS 7 describes some of the benefits of cash flow information:

*'A cash flow statement, when used in conjunction with the rest of the financial statements, provides information that enables investors to evaluate changes in net assets of an enterprise, its financial structure (including liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables investors to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.'* In addition to the obvious reasons of cash being the lifeblood of a durable business, it is an area which investors need to track more carefully and need to be better equipped to do so. In the 2007 CDS survey, 97 percent of the respondents identified the cash flow statement as an integral part of their valuation analysis.

#### Shortcomings of current cash flow information

A recent US Audit analytics report<sup>9</sup> shows that cash flow related restatements have had an increasing trend line and are currently the third highest cause of restatements with 14% of the firms evaluated in 2008 having cash flow statement classification errors. In the 2007 survey we sought respondent feedback on the importance and quality of 1) cash inflow and outflow related disclosures and 2) disaggregation categories that are deemed to provide decision useful information. Tables 1 to 3 below outline the findings on importance attached and distribution of responses. At an aggregate level, the results show that the highest importance and largest perceived information gap (i.e. quality less importance) relates to the note disclosures about contractual or future commitments for cash outflows followed by the requirement for operating cash flow by nature.

#### Cash Flow Disclosure Survey Findings

Ratings assigned to the importance, quality, usefulness, or other subjective terms are frequently expressed on a scale of 1 to 5, with 1 representing the lowest and 5 representing the highest scores.

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<sup>9</sup> Audit Analytics, February 2009, '2008 Financial Restatements: An Eight Year Comparison'



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**Table 1: Importance ratings of cash flow disclosure**

Importance	Mean	Rating				
		1	2	3	4	5
Note disclosures about contractual or future commitments for cash outflows	4.3	1%	2%	10%	38%	49%
Operating cash flow by nature	4.3	1%	2%	14%	32%	52%
Information provided or derived from income statement	4.3	0%	2%	13%	39%	47%
Note disclosures about contractual or future commitments for cash inflows	4.2	2%	3%	12%	38%	46%
Financing cash flows by nature	4.2	1%	3%	16%	39%	41%
Investing cash flows by nature	4.2	1%	4%	16%	38%	41%
Changes in current assets and current liabilities	4.0	1%	4%	22%	38%	34%

**Table 2: Quality ratings**

Quality	Mean	Rating				
		1	2	3	4	5
Note disclosures about contractual or future commitments for cash outflows	3.1	4%	25%	37%	23%	11%
Operating cash flow by nature	3.1	5%	22%	39%	23%	11%
Information provided or derived from income statement	3.4	5%	12%	37%	32%	14%
Note disclosures about contractual or future commitments for cash inflows	3.6	2%	8%	31%	45%	14%
Financing cash flows by nature	3.6	1%	8%	38%	37%	16%
Investing cash flows by nature	3.4	2%	12%	41%	33%	12%
Changes in current assets and current liabilities	3.5	2%	9%	39%	37%	14%

**Table 3: Gap (Importance –Quality) ratings**

Gap	Importance	Quality	Gap
Note disclosures about contractual or future commitments for cash outflows	4.3	3.1	1.2
Operating cash flow by nature	4.3	3.1	1.2
Information provided or derived from income statement	4.3	3.4	0.9
Note disclosures about contractual or future commitments for cash inflows	4.2	3.6	0.6
Financing cash flows by nature	4.2	3.6	0.6
Investing cash flows by nature	4.1	3.4	0.7
Changes in current assets and current liabilities	4.0	3.5	0.5

To address the cash flow presentation and disclosure shortcomings, the DP proposes the following improvements:

- Cash receipts and payments will be classified within the statement of cash flow based on the classification of the related asset or liability in the statement of financial position.
  - This may change classifications within current statements of cash flow, especially in the area of investing cash flows. The proposal would change their classifications to operating cash flows.
- Cash will *not* include cash equivalents.

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- In the cash flow statement, the disaggregation of cash receipts and payments into operating, investing and financing categories would be displayed using the direct method (DM) of presentation.
- Only the direct method of cash flow would be allowed. This differs from the current situation where the option to provide both has resulted in the provision of mainly the indirect cash flow statement.
- The DM is more consistent with objectives of financial statement presentation than the indirect method.
- The DM helps to connect information about operating assets and liabilities and operating income and expenses with operating cash receipts and payments.
  - The statement of cash flows would also be segregated in the same fashion as the statements of financial position and comprehensive income making activities as defined by management comparable throughout.
- The indirect method is less useful for investors because it provides no disaggregated information about the elements of operating cash flows; however, the indirect method can be retained as supplemental information for those who wish to use it.
- The DM presents a conceptually consistent approach. The disaggregation of financing and investing cash flows is done on a direct basis and there is no conceptual justification of exempting operating cash flows from a similar direct disaggregation.

## WORKING CAPITAL CHANGES

The changes in current assets and current liabilities that are provided under an indirect cash flow statement were rated in our 2007 survey. The survey results show that respondents seem to attach the highest importance to information on operating cash flow by nature which would be provided in a direct cash flow statement. That is not to say that the indirect cash flow information such as working capital changes is not useful but rather that it should be provided as a complement to direct cash flow. Working capital changes can be provided in the notes to the accounts. These findings provide **indirect evidence for the likely support of a direct rather than indirect cash flow statement**. One of the motivations for support of the indirect cash flow statement is the assumption that information about changes in current assets and current liabilities is of importance. This is because there is a disparity in the working capital changes in the balance sheet versus the cash flow statement because of acquisitions, dispositions and foreign currency translation adjustments.

Some users have expressed their preference for an enhancement of the indirect method, for example through determining a net operating cash flow starting with operating earnings rather than net income. We would agree that operating profit as a starting point rather than net income may result in fewer indirect method adjustments and would be an enhancement of the current indirect method. However, such a change is not enough. **While working capital information is useful and a refined depiction of adjustments under the indirect method is desirable, the primary incremental information required from the DM is gross information on operating cash flow (i.e. both outflows and inflows). The indirect method does not provide this information and no variant of it can substitute for the DM.**

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## **DIRECT versus INDIRECT-DIRECT DISAGGREGATION OF OPERATING CASH FLOW**

Preparers<sup>10</sup> who currently provide a direct method cash flow statement typically rely on what is referred to as the “indirect-direct” approach. That approach relies on an accrual to cash analysis – often at a consolidated level – which we believe provides less reliable and comprehensive information compared with a “direct-direct” approach in which cash-based records are maintained at the parent and subsidiary levels. Critics of the DM often base their objections on a) the prohibitive costs of providing such information on a direct-direct basis and b) the perceived unreliability of the disaggregation of indirect-direct cash flow from operations. We respond to those objections as follows:

- Cash flow transparency matters: Systems modification necessary to derive the direct-direct approach presents a window of opportunity to enhance internal and external transparency of enterprise wide cash flows. We believe that the most appropriate way for an entity to prepare a DM cash flow statement is to require an accrual to cash analysis of operating accounts at each subsidiary or division and to use that information (roll it up) to prepare a cash flow statement for each. This would also permit an entity to capture the true effects of foreign currency changes reflected in the changes in operating assets and liabilities. Moreover, that approach would help to reduce the number of restatement errors related to the statement of cash flows, which have increased in recent years. It would also enhance controls around consolidation procedures.
- Critics claim the complexity associated with extracting cash flows makes it a less important metric for either internal or external purposes. The implication of this assertion is that the more complex a business model is, with greater exposure to foreign operations or acquisitive activities, the more necessary it becomes to ignore or avoid precisely tracking the cash flows. It is contradictory and counterintuitive to allege that ‘**cash is king**’ for businesses and to concurrently have such a mindset. Such a mindset simply enhances the risk of investors misallocating their capital as they are unlikely to correctly price in liquidity risk associated with reporting enterprises.
- Providing disaggregated operating cash flow would be an enhancement from current practice even if the outflow/inflow information is derived indirectly. Public corporations around the globe do not prepare their accounting books and records on a cash basis. Hence in such circumstances, it is reasonable to assume that the preparation of a statement of cash flows would be performed by adjusting accrual based information to cash based information. The concern about an indirect-direct approach is needless because if accrual records are maintained accurately, adjusting them to arrive at cash basis information is a reliable approach to arrive at cash flows.

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<sup>10</sup> Australian and New Zealand companies and a few companies in the US (CVS, Publix)

## **Benefits to investors of the Direct Method**

### **Valuation analytics**

Today, investors do not predict future operating cash flows using a DM approach because such data have rarely been available. It is for this reason that investors often resort to the use of crude, alternative proxies for cash flow, such as EBITDA. The DM approach is therefore a significant improvement.

The analytical value to investors of reporting cash flows from operating activities using the DM is straightforward: It offers insights into the quality of revenues and earnings, and the characteristics of the cash conversion cycle, which are not available from an indirect method of reporting cash flow from operating activities. The **provision of cash flow information is a necessary complement to earnings information and not an alternative for forecasting future cash flows.** The DM approach allows an investor to develop questions about how the amount, timing and uncertainty of cash flows differ from revenue and expense elements in the statement of comprehensive income. The DM provides additional benefits in that it:

- Is less confusing than the indirect method: Working capital adjustments shown in the statement of cash flows present only the net effects of changes in balance sheet accounts that are affected by operational factors, business acquisitions and dispositions and foreign currency translation adjustments.
- Provides the ability to compare similar types of cash receipts and payments across companies.
- Provides a better representation of an entity's cash conversion cycle for credit grantors and it makes transparent whether a business has expanding or contracting working capital cycles.
- Enables more meaningful cash flow variance analysis, and
- Facilitates sensitivity analysis of cash flows due to volume changes as gross cash receipts and cash payments may respond differently to changes in activity

### **Liquidity and financial flexibility assessment**

The DM requirements can also facilitate financial risk analysis including liquidity risk. In particular, it facilitates the following:

- Make visible the cash flows related to derivatives and structured financial instruments and provide information about increased or decreased levels of certain financial instruments that carry liquidity risks. There is reduced transparency on associated risks and users can be misled about the cash flow generating capacity of underlying operating business when the net operating cash flow contains structured finance items with no corresponding disaggregation.

## ILLUSTRATION OF ANALYTICAL BENEFITS OF DIRECT CASH FLOW

### *Liquidity risk analysis and bankruptcy prediction - the case of Enron*

In the late 1990's the primary engine of Enron's growth and profitability was its wholesale services business. These included buying and selling of contracts for the supply of power and strategic investments in energy and technology related businesses. However, Enron's operating performance came under pressure because of increased competition in the market for futures contracts and because many of its overseas projects were unsuccessful. It was this backdrop that likely brought pressures for Enron's managers to manipulate its reported performance. The case study of Enron exemplifies numerous blind spots and levers of misrepresenting financial statements.

Table 4 below lays out several key adjustments made based on the retrospective analysis of Enron's audited financial statements for the year ended 31<sup>st</sup> December 2000. This data is extracted from the Bankruptcy's examiner report and Enron case study analysis<sup>11</sup>. This case study shows that the net operating cash flow, reported under an indirect method is limited in the extent to which it can assist investors assess earnings quality.

**Table 4: Enron – Year 2000 financial statement adjustments**

	Net income	Funds flow from operations	Debt
As reported	979.0	3010.0	10229.0
Adjustments for			
FAS 140 transactions (Off balance sheet structured entities)	-351.6	-1158.3	1353.4
Tax transactions	-269.1	-60.6	
Non economic hedges	-345.7		-150.0
Share trusts (non consolidation vehicles)	29.7	-418.0	4871.0
Minority interests (debt represented as a minority interest)			1740.0
Prepay transactions		-1527.0	4016.3
Total Adjustments	-936.7	-3163.9	11830.7
Total after adjustments	42.3	-153.9	22059.7
Adjustments as % of amount originally reported	96%	-105%	116%

<sup>11</sup> Gwillian, D, Jackson.R.H.G, Fair value in financial reporting: Problems and pitfalls in practice. Accounting forum (2008)



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- The various and significant adjustments in Table 4 convey the extent to which the use of financial engineering particularly the use of prepay transactions and SFAS 140 transactions were applied as a means of inflating the net operating cash flow. Between 1992 and 2001 at least \$8.6 billion in cash was obtained from prepay transactions. The prepay transactions produced operating cash flow equal to virtually all Enron's net operating cash flow in 1999 and 32% of its net operating cash flow in 2000.
- The extent to which Enron's managers engaged in elaborate financial engineering simply to inflate the reported operating cash flow (i.e. 105% overstatement) is revealing as it shows they did not anticipate investors to readily identify and focus on the deteriorating core operating cash flows. The indirect cash flow method clearly made it more difficult for investors to be aware of any disconnect between core operating cash flows and the reported net operating cash flows. This strengthens the case for disaggregation through the DM as it would have allowed investors to be aware of the cash flows from financial engineering activities and to raise questions on the viability of the overall business on a timely basis.

#### *Key Ratio Analysis*

In the illustrations below there are a number of key ratios that would aid user analysis of earnings quality. The examples compare the analysis of companies using the direct versus indirect cash flow. As evident from the ratios, any potential mismatch between the earnings process and cash flow generation will be transparent to users under the DM because it is infinitely more difficult, if not impossible, to glean similar accurate information from the indirect cash flow approach.

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Cash Flow Statement Analysis (\$ in millions)	Direct Cash Flow Statement				Indirect Cash Flow Statement			
	Publix				Safeway			
	2008	2007	2006	2005	2008	2007	2006	2005
<b>Cash Receipts:</b>								
Cash received from customers	\$23,956.3	\$23,057.7	\$21,683.2	\$20,560.2	\$44,115.7	\$42,283.0	\$40,139.9	\$38,415.0
<b>Accrual Revenues:</b>					*Sales (SWY combines sales and other revenues) + change in accounts receivable			
Sales	\$23,929.1	\$23,016.6	\$21,654.8	\$20,589.1	\$44,104.0	\$42,286.0	\$40,185.0	\$38,416.0
<i>Cash received from customers / Sales</i>	<b>100.1%</b>	<b>100.2%</b>	<b>100.1%</b>	<b>99.9%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>99.9%</b>	<b>100.0%</b>
<b>Cash Payments:</b>								
Cash paid to employees & suppliers	\$21,570.7	\$20,695.1	\$19,355.0	\$18,309.5	NA	NA	NA	NA
Payments for self-insured claims	267.8	228.2	205.1	200.5	NA	NA	NA	NA
Income taxes paid	641.3	672.8	735.3	678.2	NA	NA	NA	NA
Other operating cash payments	9.1	13.1	11.2	8.2	NA	NA	NA	NA
Total operating cash payments	\$22,488.9	\$21,609.3	\$20,306.6	\$19,196.3	NA	NA	NA	NA
<b>Accrual Expenses:</b>								
Costs of merchandise sold	\$17,486.8	\$16,805.8	\$15,812.0	\$15,059.7	\$31,589.2	\$30,133.1	\$28,604.0	\$27,303.1
Other operating & admin. expenses	5,057.0	4,743.5	4,457.1	4,230.4	10,662.1	10,380.8	9,981.2	9,898.2
Total accrual expenses	\$22,543.8	\$21,549.3	\$20,269.1	\$19,290.1	\$42,251.3	\$40,513.9	\$38,585.2	\$37,201.3
<i>Total op. cash payments / Sales</i>	<b>94.0%</b>	<b>93.9%</b>	<b>93.8%</b>	<b>93.2%</b>	NA	NA	NA	NA
<i>Total op. cash payments / Total accrual expenses</i>	<b>99.8%</b>	<b>100.3%</b>	<b>100.2%</b>	<b>99.5%</b>	NA	NA	NA	NA
<i>Total op. cash payments / Cash received from customers</i>	<b>93.9%</b>	<b>93.7%</b>	<b>93.7%</b>	<b>93.4%</b>	NA	NA	NA	NA

(\$ in millions)	CVS Caremark			Walgreen		
	2008	2007	2006	2008	2007	2006
<b>Cash Receipts:</b>						
Cash received from customers*	\$69,493.7	\$61,986.3	\$43,273.7	\$58,669.0	\$53,722.0	\$46,790.0
<b>Accrual Revenues:</b>						
Sales	\$87,471.9	\$76,329.5	\$43,821.4	\$59,034.0	\$53,762.0	\$47,409.0
<i>Cash received from customers / Sales</i>	<b>79.4%</b>	<b>81.2%</b>	<b>98.8%</b>	<b>99.4%</b>	<b>99.9%</b>	<b>98.7%</b>
<b>Cash Payments:</b>						
Cash paid for inventory	\$51,374.7	\$45,772.6	\$31,422.1	NA	NA	NA
Cash paid to other suppliers and employees	11,832.0	10,768.6	9,065.3	NA	NA	NA
Interest paid	573.7	468.2	228.1	30.0	7.0	0.0
Income taxes paid	1,786.5	1,780.8	831.7	1,235.0	1,204.0	1,111.0
Total operating cash payments	\$65,566.9	\$58,790.2	\$41,547.2	NA	NA	NA
<b>Accrual Expenses:</b>						
Costs of merchandise sold	\$69,181.5	\$60,221.8	\$32,079.2	\$42,391.0	\$38,518.0	\$34,240.0
Other operating expenses	12,244.2	11,314.4	9,300.6	13,202.0	12,093.0	10,467.0
Total accrual expenses	\$81,425.7	\$71,536.2	\$41,379.8	\$55,593.0	\$50,611.0	\$44,707.0
<i>Total op. cash payments / Sales</i>	<b>75.0%</b>	<b>77.0%</b>	<b>94.8%</b>	NA	NA	NA
<i>Total op. cash payments / Total accrual expenses</i>	<b>80.5%</b>	<b>82.2%</b>	<b>100.4%</b>	NA	NA	NA
<i>Total op. cash payments / Cash received from customers</i>	<b>94.3%</b>	<b>94.8%</b>	<b>96.0%</b>	NA	NA	NA

\* Walgreen estimated cash received from customers = Sales + Change in accounts receivable

## **TRANSITION COSTS - CONSTRAINT ANALYSIS**

Financial statement preparers often cite the anticipated implementation and transition costs associated with systems modification, as a reason for the pushback towards and low current utilisation of the DM. However, in general, there is poor visibility of these costs and thus there is a need for a greater verification of these costs so as to have a meaningful cost-benefit analysis. This is especially necessary as preparers have, with hindsight, tended to overstate implementation difficulties associated with almost every financial reporting proposed improvement.

There is also a need to consider the incremental cost of preparing a DM statement of cash flows versus the current inadequacies of the indirect method. The indirect method requires estimates of adjustments for the effects of non operating transactions, business acquisitions and dispositions and foreign currency rate fluctuations, and these are cumbersome. Finally, as noted in the analysis of the 'direct versus indirect-direct' approach, the anticipated transition costs are largely a function of current flaws in the method of preparation.

## **DISCLOSURE OF NON CASH ITEMS**

- Non cash transactions: Non cash transactions have economic significance for shareholders and creditors. (Acquiring a fixed asset using a finance lease, barter transactions, share based payments, unfunded pension obligations and acquisitions where consideration is in the form of equity). We would propose that the disclosure of these items should be in the statement of cash flows because it would help users to conduct an as-if analysis of potential future cash flow patterns.
- The survey feedback from our members (see page 15 and 16) shows that there is a need to improve the disclosure of cash flows about contractual commitments. The highest importance is attached to cash outflows as this especially has a bearing on liquidity risk.
- We would also support the disclosure of a net debt to cash reconciliation proposed by the Corporate Reporting Users Forum (CRUF) because that would enhance the transparency of cash flows associated with debt including any acquired company debt.

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## 2. RECONCILIATION FORMAT

To show the interconnectedness of the financial statements, the DP proposes to reconcile cash flows to comprehensive income, as a supplementary disclosure. The reconciliation schedule would disaggregate income into different components:

- Cash received or paid other than in owner transactions.
- Accruals other than remeasurements, including contractual accruals and allocations like depreciation.
- Remeasurements that are recurring fair value changes or valuation adjustments.
- Remeasurements that are *not* recurring fair value changes or valuation adjustments.
- Unusual or infrequent events or transactions.

The columnar disaggregation aims to allow users to analyze the various components and to use it to predict future cash flows and assess earnings quality. In addition, disaggregation can help alleviate concerns about the volatility caused by reporting fair values. One of the reservations sometimes raised about fair value is that re-measurement volatility could taint 'core earnings', disaggregation mitigates this concern.

### *Our Preferred option*

While the reconciliation of cash flows to comprehensive income contains several useful elements, it bears the glaring omission of excluding the changes in amounts on the statement of financial position. This would be the most useful analysis because it meets a number of information objectives by providing:

- insight into the principal changes in net assets for a reporting period;
- the elements of a DM cash flow statement;
- the changes in working capital elements, and
- A reconciliation of changes in gross debt.

### *Balance Sheet versus Income Statement*

The reconciliation of cash flows to comprehensive income proposed by the DP appears to assign greater importance to the statement of comprehensive income as a means of assessing the amount, timing and uncertainty of future cash flows. The implied primacy of the income statement is questionable at best. **There is no conceptual basis to assume that the statement of comprehensive income is of higher importance than the statement of financial position the statement of cash flows, or equivalently, any**

**one statement is more relevant than any other statement.** In addition survey results shown in Table 5 below, show that our membership finds each of the financial statements to be highly important with no significant difference in the importance attached to each statement. While some analysts may focus mainly on income statements to prepare valuation models, **it is perilous to ignore balance sheet risk as is evident from the current market crisis.** In addition, the relative importance of different financial statements may vary over time as well as by industry. Besides, we are not aware of any empirical evidence that supports the notion that the balance sheet has intrinsically lower information content than the income statement for the purposes of valuation and risk analysis or that all of its information can be meaningfully ignored entirely. Different investors use different approaches to the analysis of financial data.

In the CBRM we note that the perceived lack of importance of the balance sheet to investment decision making because of the following:

- Models that focus on reported earnings and cash flows rather than accounting net worth;
- Irrelevance of balance sheet numbers due to historical cost and off balance sheet assets and liabilities
- Accounting choices that limit comparability.

Both boards have made major improvements to financial reporting in recent years. We expect that some of the remaining balance sheet deficiencies will be corrected over the next few years and the balance sheet improved as a communicator of essential information about companies. Hence, it would be especially inopportune to denigrate the importance of the balance sheet relative to the other financial statements. Unfortunately the proposed reconciliation could perpetuate the increasingly false notion that the statement of financial position is less relevant than the statement of comprehensive income.

**Table 5: CFA Institute Survey Ranking<sup>12</sup> of Importance of Financial Statements**

<i>Financial Statements:</i>	2007	2003	1999
Cash Flow Statement	4.7	4.6	4.4
Income or Profit and Loss Statement	4.7	4.5	4.6
Balance Sheet or Statement of Financial Position	4.6	4.6	4.4
Footnote disclosures to the financial statements	4.4	4.5	
Management Discussion and Analysis	4.1	4.1	4.3
Statement of Shareholders' Equity	3.5	3.2	3.7

<sup>12</sup> Ratings assigned to the importance are frequently expressed on a scale of 1 to 5, with 1 representing the lowest and 5 representing the highest scores.

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*Investor valuation approaches and financial reporting information*

There are numerous valuation approaches applied by investment professionals, including multiple variants of discounted cash flow and earnings (and its components) approaches. All these approaches have differing starting points or initial data inputs. These include net income, dividends, free cash flow distributable to equity, free cash flow distributable to all capital providers, etc. We understand and agree with the principle of disaggregating different components of earnings based on their subjectivity and persistence as a means of providing a higher quality starting point for the purposes of forecasting future cash flows and valuation. However, we caution the Boards to be careful not to inadvertently extend the functional fixation with different components of financial statements, by endorsing a higher prominence to earnings information as the expected input for valuation.

We note that balance sheet analysis remains an important tool used by creditors (including fixed income investors), ratings agencies, and some equity investors. Such analysis increases in importance during periods of financial distress when the survival of a firm may be in doubt.

The Board should primarily focus on providing fundamental information that is sufficient for the full range of investors using different valuation methods rather than trying to anticipate and match its design to a single valuation approach e.g. a valuation method that is based on reported earnings. A discussion of the merits and limitations of different valuation methods would fall outside the scope of setting accounting standards and by extension this comment letter, but it should be borne in mind that financial reporting information is only one of the required inputs and the DP should not perpetuate the mechanistic application of information because of a simplistic application of the notion of persistence of earnings.

*Row and Column design principles*

We are aware that one of the key objections are often raised in relation to the reconciliation of the statement of financial position is risk of information overload if every possible line item had to be reconciled.

In evaluation of the proposals amongst investors with heterogeneous needs and preferences, it is inevitable that there will be no unanimity on the ideal depiction of columns and rows. There is unlikely to be any single proposal that will satisfy all investors. This **diversity of perspectives should not override the underpinning need for enhancement and that of the Boards and staff to not get caught up in an analytical inertia that will ensure the status quo**. As stated the columnar disaggregation aims to allow users to analyze components separately, because components differ in ability to help users predict future cash flows and assess earnings quality. Similarly, there should be greater emphasis on defining principles of disaggregation rather than being fixated on a one size fits all pre-definition for row disaggregation. For example this should be guided by:



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- *Materiality and significance to business model (e.g. advertising expense is important to a media company but not to a financial institution); and*
- *Classification principles that enable a relevant depiction of the business model performance and risks. Netting should not occur.*

The objections of information overload also fail to take into account the possibilities presented by interactive technologies and investor analytical tools. The provision of **decision useful information should not be constrained by whether information can fit into a print medium such as an A4 paper**, as investor analytical tools would be capable of processing multiple columnar inputs. That is not to say that parsimony of information presentation is not a useful attribute but rather that presentation should not limit the provision of relevant content. The Boards must remember that XBRL will make it much easier to use the expanded data set resulting from the FSP.

### ***Implementation Issues***

Another objection to the reconciliation of statement of financial position is the anticipated implementation difficulty for multinationals with foreign subsidiaries or companies engaging in multiple acquisitions and dispositions.

On the issue of aggregation difficulties for multinational companies, these objections reinforce the window of opportunity to enhance internal and external transparency on key items such as foreign currency translation adjustments. The objections shed light on every likelihood that key figures such as the foreign currency translation adjustments are currently derived as plug figures and that there is little transparency around the disclosed amounts. The modification of systems required for the provision of a reconciliation of the statement of financial position, will significantly enhance the internal and external transparency of the cash flow effects of foreign currency translation adjustments.

Hence, while we acknowledge that the proposed reconciliation of cash flows to comprehensive income would comprise some degree of improvement, **we strongly recommend<sup>13</sup> that the reconciliation of the statement of financial position should be required instead. If the Boards were to adopt the reconciliation of cash flows to comprehensive income, however, then companies should be required to reconcile in the notes all key elements of the statement of financial position such as:** Accounts receivable, Inventory, Accounts payable, Accrued expenses, Income tax and Gross debt. Roll forwards have been shown to be an efficient way of showing both operating and non-operating changes and both preparers and investors are used to them. Roll forwards of key balance sheet accounts would provide

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<sup>13</sup> Disclosure does not equate to recognising on the face of the financial statements. Ahmed.A.S, Kilic.E and Lobo.G, 2006, 'Does Recognition versus Disclosure Matter? Evidence from value relevance of banks recognised and disclosed derivative financial instruments', The Accounting Review, Vol. 81, No.3, Pg 567-588

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some of the transparency that would have been obtained from statement of financial position reconciliation.

### 3. STATEMENT OF COMPREHENSIVE INCOME

- We are generally supportive of the proposed changes to the statement of comprehensive income. We support a single statement of comprehensive income as it enhances accessibility and transparency of OCI information for investors<sup>14</sup>. It may in the long run help to alleviate the functional fixation with the net income number.
- We support the display of one-off elements. This is because the management view of recurring and non recurring items has information content even when non-recurring elements recur. Aggregating all elements can conceal non sustainable sources of earnings and, therefore, the non adjustment of one-off elements can be misleading.
- We support the allocation of foreign currency translation adjustments (FCTAs) and basket transactions under the same asset or liability category. This would be consistent with the cohesive presentation of financial statements. However, the proposed allocation, in contrast to a single number for the FCTA, would not necessarily convey sufficient information about the exposure and hedging effectiveness of foreign subsidiaries. Disclosures should be required to accompany the allocated amounts to help users better understand the foreign currency translation and transaction exposures.

Clearly the proposals related to the comprehensive income statement contain some key improvements. However, there remain significant unresolved issues **around the OCI that are not addressed in the DP**. The OCI statement has no conceptual basis; it is an artefact of compromise based standard setting; it has often been used to account for items that conceptually belong in the main income statement. These include cumulative translation adjustments, minimum pension liability, unrealized gains and losses on available-for-sale securities and unrealized gains and losses on cash flow hedges. Thus, the OCI bears semblance to a suspense account and in its current form it facilitates the partial depiction of performance and risk. Nevertheless there are various significant transactions accounted for through the OCI that require higher levels of visibility and monitoring by investors. There are number of questions in relation to OCI.

- Should this be eliminated entirely?
- Should it be retained but recycling prohibited? The elimination of recycling is not included in the discussion paper
- Should it be resolved on a standard by standard basis?

We are cognisant that there likely needs to be resolution of the appropriate recognition and measurement approach for cumulative translation adjustments, minimum pension liability, unrealized gains and losses on available-for-sale securities and unrealized gains and losses on cash flow hedges before elimination of

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<sup>14</sup> Archival academic studies show the decision usefulness of centralised comprehensive income information.

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the OCI can occur. The full adoption of fair value would likely resolve the multiple column income statement. However, as an interim measure, when improving related recognition and measurement standards, we would propose that the Boards aim to restrict the deferral to and subsequent recycling from the OCI. In our comment letter to the IASB, on ‘reducing complexity for financial instruments’, we stated our support to limit the deferral periods of cash flow hedging items.<sup>15</sup> For the same reason, we articulated our concerns about the recent FASB amendment to defer, amortise and recycle non credit risk impairment charges of held to maturity items.

We would also support a single comprehensive income statement without OCI and we encourage the Boards to consider this issue in subsequent stages of this project, consistent with the increased application of fair value.

### ***Tax Allocation***

We acknowledge that despite the arbitrary nature of tax allocation, it can facilitate forecasting of future cash flows. Parallel to the allocation we would propose the following accompanying disclosures:

- Disclosure of the basis of the tax allocation.
- Reconciliation of allocated taxes to the cash taxes paid.
- Statutory to effective tax rate reconciliation disclosure, with both rates and amounts disclosed
- The effective tax rate for different sources of income based on jurisdiction, income type, industry or other special circumstances.
- Average and marginal tax rate.
- Any expected future changes to tax rates due to changes in operations or laws; the potential reversal of deferred tax balances; and any other information that might be useful in modeling future cash tax payments.

## **4. CLASSIFICATION APPROACHES**

*Classification: Through the eyes of Management*

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<sup>15</sup> The ‘Reducing Complexity for Financial Instruments’ discussion paper proposed that reporting entities should state at inception when a hedged transaction is expected to affect earnings and to reclassify gains and losses at that time regardless of the realisation of the forecasted transaction. We would support this proposal as it can limit lengthy deferral periods.

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We acknowledge that allowing the determination of classification categories through the eyes of management creates a potential tension between the relevance and comparability of the presentation. There is the risk that providing management with too much discretion would reduce comparability.

We are, however, sanguine with allowing management to develop its view about the classifications of elements in the financial statements. **We believe that presentation and disclosure through the eyes of management can convey useful and relevant business model information to investors. But our support of the management approach does not extend to recognition and measurement based on management intent as the latter is more amenable to subjective distortions of performance.**

We agree that the management approach will likely provide greater relevance but there should be enough guidance in place to ensure any management, given the same facts would report the same classification. There should be transparent disclosure of the underpinning recognition and measurement principles, for example the definition of operating and financial liabilities. In the CBRM we advocate the principle that financing liabilities should only arise when such liabilities relate to third party financing for the purposes of improving clarity and comparability, reducing complexity and eliminating some structuring opportunities. Based on this principle we would categorise all pension expenses as an operating expense.

Disclosures should explain the decision, and it should be very unusual for a classification of the same item to change. We also endorse the principle that if a classification is changed, such change is deemed a change in accounting principle requiring restatement and that change would flow through segment reporting. The DP provides for this disclosure requirement and hence we are comfortable with the proposal.

#### *Disaggregation by nature and function*

We support the disaggregation of the income statement by nature and function, rather than only by function. This will allow managers to provide a relevant and informative depiction of performance. It will significantly increase the usefulness, attribution and predictability of future earnings and cash flows. In the Comprehensive Business Reporting Model (CBRM-page 14) we advocate the display of items by nature. Categorization by nature enhances the comparability across companies and consistency within the statements of a single company. On the other hand aggregation by function obfuscates the recording of key items. Currently, users of financial statements cannot determine from the statements or related disclosures where individual items, such as pension expense and depreciation, are recorded in the income statement.

#### *Segment Classification*

We agree with the proposal that classification should be consistent at entity and reportable segment level. This would align with the objectives of the management approach classification. The way management views assets and liabilities at reporting entity level ought to be the basis in which its business units view the same assets and liabilities. A consistent classification approach would help avoid potential aggregation difficulties.

## 5. OTHER ASPECTS OF THE DISCUSSION PAPER

### STATEMENT OF FINANCIAL POSITION

- **Revised Classification:** We support the revised classification that would require the statement of financial position to be grouped by major activities: operating, investing, and financing. This will show more clearly the net assets employed by management in business and financing activities and facilitate the computation of key analytical ratios by investors.
- **Order of liquidity:** We support the presentation by order of liquidity versus a classified presentation (short term versus long term). In the CBRM we have advocated this approach because it conveys the relative liquidity of resources. We have reservations about the arbitrary nature of short term versus long term distinctions and current versus non-current assets. The order of liquidity conveys useful information and is especially appropriate for investment companies, financial institutions and other highly indebted entities.
- **Separation of cash and cash equivalents:** We support the principle of separating cash from cash equivalents and classifying cash equivalents under short term investments. This is because Cash equivalents may bear market price or liquidity risk. There are a range of exotic instruments that are subject to market price risk, with short term contractual features that are conveniently parked under this category. Besides, the focus on the liquidity risk of an instrument is misleading and it seems demonstrable during the credit crisis that some instruments classified as cash equivalents did not have zero liquidity risk.
- **Disaggregation and distinct presentation of items with different measurement bases:** This is a useful disaggregation approach and can help users' to further work out the economic attributes of reported amounts under a mixed attribute reporting regime.

### STATEMENT OF EQUITY

We are supportive of the separate illustration of the equity component and the proposed reconciliation of statement of equity. This equity categorization will depend on the approach that the Board adopts towards financial instruments with characteristics of equity. The DP should be updated to reflect the approach that the Boards will adopt.

### NOTES DISCLOSURE

We support the proposed disclosures on classification accounting policy. However, we would propose that non cash transactions should be on the face of the cash flow statement. Similar to the philosophy adopted in having comprehensive income information in one location, such an approach would make the information more accessible to investors and facilitate as-if analysis of cash flows. As shown by various academic studies, disclosure does not equate to showing items on the face of the financial statements.

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In relation to the order of liquidity, we agree with the proposal to provide maturity details. However, we observe that the question of liquidity risk seems to be dealt with by the Boards on a fragmentary basis across standards and some thought needs to be developed on a top down basis as to what information investors require to judge liquidity and financial flexibility. The need for better information on the risk, return, liquidity, and financial flexibility consequences of off balance sheet assets and liabilities is evident from our member survey feedback (see page 15 and 16). The results show that there is a need to improve the disclosure of cash flows about contractual commitments. The highest importance is attached to cash outflows as this especially has a bearing on liquidity risk.