Shaking Up Financial Statement Presentation
Guy McClain; Andrew J McLelland
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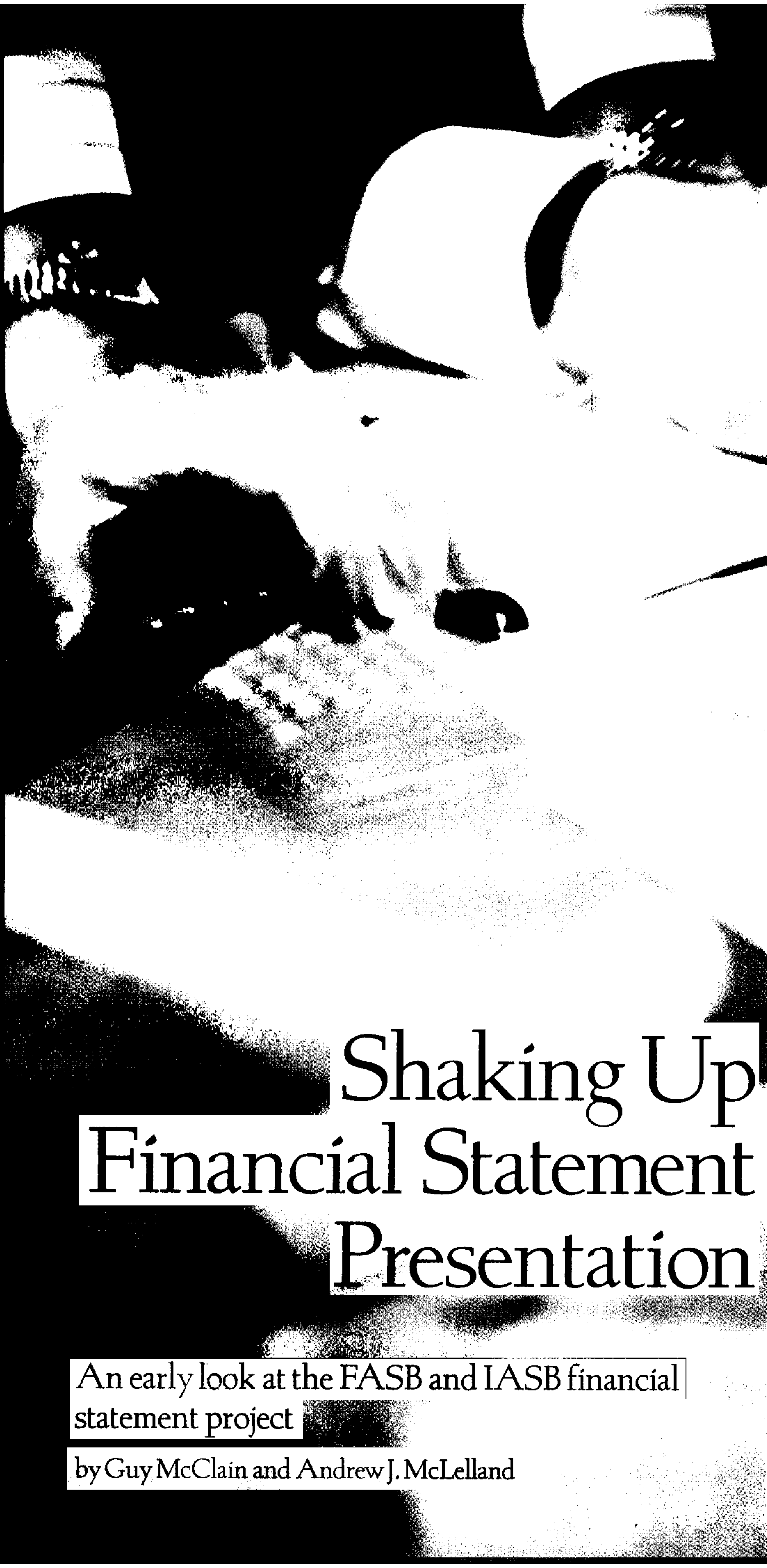

Shaking Up Financial Statement Presentation

An early look at the FASB and IASB financial statement project

by Guy McClain and Andrew J. McLelland

In April 2004, FASB and the International Accounting Standards Board (IASB) created a joint project on financial statement presentation. The project is part of the memorandum of understanding between the two bodies that set out a road map for convergence between IFRS and U.S. GAAP. The goal is to create a common standard for the form, content, classification, aggregation and display of line items on the face of financial statements. The new guidelines are intended to help equity investors and other financial statement users better understand a business's past and present financial position and assess potential future cash flow.

The project applies to public and private business entities, but not to nonbusiness entities such as not-for-profits or defined-benefit plans. It addresses the organization and presentation of information and the need for totals and subtotals in the financial statements, including the net income or loss subtotal.

Phase A

The work is being conducted in three phases. The boards completed deliberations on Phase A in December 2005, and on Sept. 6, 2007, the IASB published a revised version of IAS 1, *Presentation of Financial Statements*. This brought IAS 1 largely in line with FASB Statement no. 130, *Reporting Comprehensive Income*. FASB decided not to issue an exposure draft on its Phase A conclusions, but rather to issue a combined exposure draft for Phases A and B.

FASB, however, did issue a set of tentative conclusions. Most significantly, a complete set of financial statements for a reporting period should include a statement of financial position, a statement of comprehensive income, a statement of changes in equity and a statement of cash flows. In addition, each financial statement should be shown with equal prominence, and a minimum of two years comparative information is required.

In contrast to IAS 1 (revised 2007), FASB would require a single statement of earnings and comprehensive income and require a subtotal for net income. IAS 1 (revised 2007) allows the presentation of nonowner changes in assets and liabilities to be presented in a single statement of comprehensive income or in two statements—a statement of profit or loss and a second statement starting with profit or loss and presenting components of other comprehensive income.

FASB also tentatively decided to allow (but provides no guidance for) voluntary presentation of financial information beyond the required two-year minimum for annual reports and to require the presentation of basic and diluted earnings per share on the statement of earnings and comprehensive income as the only per-share measure. FASB decided to continue to allow (but not require) the disclosure of basic and diluted comprehensive income per share in the notes and to require the disclosure of the weighted average number of shares used as the denominator in the calculation of per-share ratios in the notes.

Exhibit 1 Working Format for Presenting Information in the Financial Statements

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business • Operating assets and liabilities • Investing assets and liabilities	**Business** • Operating income and expense • Investing income and expense	**Business** • Operating cash flows • Investing cash flows
Financing • Financing assets • Financing liabilities	**Financing** • Financing asset income • Financing liability expense	**Financing** • Financing asset cash flows • Financing liability cash flows
Income Taxes	**Income Taxes (related to business and financing)**	**Income Taxes**
Discontinued operations	**Discontinued Operations, Net of Tax**	**Discontinued Operations**
Equity	**Other Comprehensive Income, Net of Tax**	**Equity**

PHASE B

On June 30, 2008, the boards issued tentative and preliminary views on how financial information will be presented. The first working principle is that financial statements should portray a cohesive financial picture of an entity. Ideally, financial statements should be cohesive at the line-item level, thus to the extent practical, an entity would label line items similarly across the financial statements and present categories and sections in the same order in each financial statement. Classifications are based on the different functional activities of an entity using terminology similar to today's cash flow statements (see Exhibit 1).

The business section includes both operating and investing categories. Operating assets and liabilities are those that management views as related to the central purpose or purposes for which the entity is in business and changes in those assets and liabilities. The investing category would include all assets and liabilities

EXECUTIVE SUMMARY

■ **The proposed financial statements are intended** to help predict cash flows for equity valuation. These statements shift focus from net income to total comprehensive income, as all other comprehensive income items are now presented on the face of the statement.

■ **On June 30, 2008, FASB and the IASB issued** tentative and preliminary views on how financial information will be presented. The first working principle is that financial statements should portray a cohesive financial picture of an entity. An entity would label line items similarly across the financial statements and present categories and sections in the same order in each of the financial statements.

■ **The boards decided that the financial statement presentation project** should not seek to alter existing standards relating to what items are recognized outside of profit or loss. Because of that stance, existing guidance remains unchanged on presentation of other comprehensive income (OCI) items in a statement of comprehensive income and on the recycling mechanism.

■ **The proposed format of the cash flow statement** is similar to FASB Statement no. 95 and IAS 7 with two major changes. First, the notion of cash equivalents is scrapped. In addition, cash flow will be presented in the direct method.

■ **A proposed new schedule would offer investors and analysts** more information for predicting future cash flows. This schedule reconciles the cash flow statement less transactions from equity using the direct method to the statement of comprehensive income and includes three reconciling columns.

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Exhibit 2 Hutch Manufacturing Co. Consolidated Balance Sheets

	2007	2006
BUSINESS		
Operating assets and liabilities		
Short term		
Receivables	$68,000	$54,000
Less: Allowance for bad debts	(2,000)	(1,000)
Inventories	26,000	20,000
Prepaid expenses	19,000	24,000
Short-term assets	111,000	97,000
Accounts payable	(19,000)	(16,000)
Accrued liabilities and other	(56,000)	(74,000)
Short-term liabilities	(75,000)	(90,000)
Long term		
Property, plant, and equipment	34,000	24,000
Less: Accumulated depreciation	(9,000)	(6,000)
Goodwill	20,000	25,000
Intangibles	82,000	82,000
Less: Accumulated amortization	(21,000)	(14,000)
Other assets and liabilities, net	(5,000)	(3,000)
Net long-term assets	101,000	108,000
Net operating assets	$137,000	$115,000
Investing assets and liabilities		
Long term		
Available-for-sale securities	2,000	3,000
Investment in affiliate – equity method	6,000	5,000
Total investing assets	$8,000	$8,000
Net business assets	$145,000	$123,000
FINANCING		
Financing assets		
Short term		
Cash	92,000	94,000
Total financing assets	92,000	94,000
Financing liabilities		
Short term		
Dividends payable	(3,000)	(3,000)
Short-term debt and current portion of long-term	(14,000)	(1,000)
Short-term financing liabilities	(17,000)	(4,000)
Long term		
Long-term debt	(71,000)	(49,000)
Long-term financing liabilities	(71,000)	(49,000)
Net financing assets	$4,000	$41,000
INCOME TAXES		
Short term		
Income tax payable	(8,000)	(12,000)
Long term		
Deferred tax assets, net	10,500	13,500
Net income tax assets	$2,500	$1,500
DISCONTINUED OPERATIONS		
Assets classified as held for sale	20,000	22,000
Liabilities classified as held for sale	(8,000)	(8,000)
Net assets held for sale	$12,000	$14,000
EQUITY		
Common stock and additional paid in capital	(47,000)	(40,000)
Treasury stock	142,000	97,000
Retained earnings	(250,750)	(228,000)
Accumulated other comprehensive income	(7,750)	(8,500)
Total equity	$(163,500)	$(179,500)

that management views as unrelated to the central purpose for which the entity is in business and any changes in those assets and liabilities.

An entity would use its investing assets and liabilities to generate a return but would not use them in its primary revenue and expense generating activities. The financing section would include only financial assets and financial liabilities that management views as part of the financing of the entity's business activities. Those are referred to as financing assets and liabilities.

Management would choose the classification that best reflects their views of what constitutes its business (operating and investing) and financing activities and would explain them as a matter of accounting policy in the footnotes. Any changes in classification will be implemented through retrospective application to prior periods consistent with FASB Statement no. 154, *Accounting Changes and Error Corrections*, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Extraordinary items (see "Extraordinary Items Share Exclusive Company," *JofA*, May 07, page 80) will not be presented in a separate section or category because the concept of extraordinary items is being eliminated. See the set of financial statements for a hypothetical manufacturing company in Exhibits 2–5, which highlight the proposed changes.

Statement of Financial Position (Balance Sheet): Exhibit 2

The first major difference in the statement of financial position (balance sheet) is that assets and liabilities are not separated into distinct sections—no assets on the left side of the page with liabilities and equity on the right side or assets on the top half of the page with liabilities and equity below. The sections and categories contain both assets and liabilities that are netted together.

Assets are positive numbers, while liabilities and equity are negative. Totals are presented for each category and section, but subtotals for short-term assets/liabilities or grand totals for assets/liabilities will be disclosed either at the bottom of the statement or in the footnotes.

The balance sheet, of course, still balances. In the hypothetical example used in Exhibit 2, total assets in 2007 for the hypothetical Hutch Manufacturing Co. are $347,500, total liabilities are $184,000, and the resulting equity is $163,500. Totals for short-term assets, short-term liabilities, long-term assets and long-term liabilities may be disclosed either at the bottom of the statement or in the footnotes. Each separate line item should use only one measurement basis.

Exhibit 3 Hutch Manufacturing Co. Consolidated Statements of Comprehensive Income

	2007	2006
BUSINESS		
Operating		
Sales	$384,000	$315,000
Cost of goods sold		
Change in inventory	6,000	2,000
Materials	(135,000)	(108,000)
Labor	(28,000)	(23,000)
Overhead–Depreciation	(1,000)	(1,000)
Total	(158,000)	(130,000)
Gross profit on sales	226,000	185,000
Selling expenses		
Compensation expense	(5,000)	(5,000)
Advertising expense	(43,000)	(37,000)
Bad debt expense	(1,000)	-0-
Other selling expenses	(27,000)	(15,000)
Total	(76,000)	(57,000)
General and administrative expenses		
Compensation expense	(15,000)	(12,000)
Rent expense	(5,000)	(5,000)
Amortization expense	(7,000)	(8,000)
Other G&A expenses	(46,000)	(38,000)
Depreciation	(2,000)	(1,000)
Total	(75,000)	(64,000)
Other operating expenses		
Research and development	(16,000)	(17,000)
Other operating expenses	(7,000)	(13,000)
Total	(23,000)	(30,000)
Operating income	$52,000	$34,000
Investing		
Equity in earnings of affiliate	2,000	2,000
Dividend income on available-for-sale securities	1,000	1,00
Investing income	$3,000	$3,000
Business income	$55,000	$37,000
FINANCING		
Interest expense	(5,000)	(3,000)
Financing expense	$(5,000)	$(3,000)
INCOME TAXES		
Current tax expense	(9,000)	(7,000)
Deferred tax expense	(4,000)	(2,000)
Income tax (expense)	$(13,000)	$(9,000)
DISCONTINUED OPERATIONS		
Loss on discontinued operations, net of $750 of income tax benefit	$(2,250)	$-0-
Net Income	$34,750	$25,000
OTHER COMPREHENSIVE INCOME		
Unrealized loss on available-for-sale securities (Investing), net of $250 and $500 of income tax benefit, respectively	$(750)	$(1,500)
Total Comprehensive Income	$34,000	$23,500

STATEMENT OF COMPREHENSIVE INCOME: EXHIBIT 3

Within the sections and categories an entity will present its revenues, expenses, gains and losses based on its primary activities or functions (selling, general, administrative, etc.). Further disaggregation based on nature (labor and benefits, materials, energy, occupancy, etc.) may be shown if it improves the usefulness of the statement or if the company does not engage in a variety of functions such as providing mainly services.

FASB and the IASB decided that the financial statement presentation project should not alter existing standards relating to what items are recognized outside of profit or loss. Because of that stance, existing guidance remains unchanged on presentation of other comprehensive income items in a statement of comprehensive income and on the recycling mechanism. An entity should present a stand-alone statement of comprehensive income with OCI items presented in a separate section. Within that OCI section an entity should indicate, parenthetically or otherwise, which category—operating, investing or financing—each OCI item relates to.

The income taxes section in the statement of financial position would include current and deferred income tax assets and liabilities recognized pursuant to FASB Statement no. 109, *Accounting for Income Taxes*, and IAS 12, *Income Taxes*. Cash flows related to those assets and liabilities would be presented in the income tax section of the statement of cash flows. In the statement of comprehensive income, income taxes would continue to be allocated among continuing operations, discontinued operations, items of other comprehensive income, and items charged or credited directly to equity using existing guidance on intraperiod tax allocation.

Consistent with the statement of financial position, a total would be presented for each category and section, and this statement would include a total for comprehensive income.

Statement of Cash Flows: Exhibit 4

The format is similar to FASB Statement no. 95, *Statement of Cash Flows*, and IAS 7, *Cash Flow Statements*, with two major changes. First, the notion of cash equivalents is scrapped. It is cash only. In addition, cash flow will be presented in the direct method. Under Statement no. 95, cash flow is reported under either the indirect method (starting with net income) or the direct method (starting with top-line revenue). The new model will start at the top of the statement of comprehensive income and work through each new section.

Exhibit 4 Hutch Manufacturing Co. Consolidated Statements of Cash Flow

	2007	2006
CASH FLOWS FROM BUSINESS		
Operating		
Cash received from sales	$370,000	$318,000
Cash paid for goods sold		
Inventory purchases	(132,000)	(101,000)
Labor	(28,000)	(23,000)
Total	(160,000)	(124,000)
Cash paid for selling activities		
Compensation	(5,000)	(5,000)
Advertising	(38,000)	(48,000)
Other selling	(25,000)	(15,000)
Total	(68,000)	(68,000)
Cash paid for general and administrative activities		
Compensation	(15,000)	(13,000)
Rent	(5,000)	(5,000)
Other general and administrative	(59,000)	(39,000)
Total	(79,000)	(57,000)
Cash paid for other operating activities		
Research and development	(16,000)	(17,000)
Capital expenditures	(10,000)	-0-
Other	(7,000)	(13,000)
Total	(33,000)	(30,000)
Net cash provided by operating activities	$30,000	$39,000
Investing		
Dividends received	1,000	1,000
Dividends received	1,000	1,000
Net cash provided from investing activities	$2,000	$2,000
Net cash provided by business activities	$32,000	$41,000
Financing		
Dividends paid	(12,000)	(12,000)
Interest paid	(5,000)	(3,000)
Proceeds from debt	35,000	5,000
Purchases of treasury stock	(45,000)	(2,000)
Proceeds from common stock	7,000	-0-
Net cash used in financing activities	$(20,000)	$(12,000)
Income Taxes		
Income taxes paid	(13,000)	(4,000)
Net cash used in income tax activities	$(13,000)	$(4,000)
Discontinued operations		
Cash flows used in discontinued operations	$(1,000)	$4,000
Change in cash	$(2,000)	$29,000
Beginning cash	$94,000	$65,000
Ending cash	$92,000	$94,000

This does not mean that the indirect method will be eliminated. As currently required by Statement no. 95, cash flows from operations must be reconciled to operating income as a supplement to the direct method. The boards are expected to seek input to determine if this requirement is still needed, given the new reconciliation statement.

Reconciliation Statement: Exhibit 5

A proposed new schedule would supply investors and analysts more information for predicting future cash flows. This schedule, as shown in Exhibit 5, reconciles the cash flow statement less transactions from equity using the direct method (column A) to the statement of comprehensive income (column E) and includes three reconciling columns.

The first reconciling column (B) is accruals, allocations and other charges not from remeasurements. Examples of items in column B include timing differences such as changes in accounts receivable/accounts payable and systematic allocations such as depreciation, purchases of property, plant and equipment, along with other changes in business operating assets and liabilities.

A second reconciling column (C) contains recurring fair value changes (termed valuation adjustment by the IASB) such as changes in the fair value of available-for-sale securities. The final reconciling column (D) is for remeasurements other than recurring fair value changes. This would include asset impairments for items such as goodwill and discontinued operations.

Phase C

The joint project team consists of staff from both boards and the Accounting Standards Board of Japan, which has set a goal with the IASB of converging their respective sets of standards by June 30, 2011. The boards will begin work on Phase C on the presentation and display of interim financial information for U.S. GAAP toward the end of Phase B. Tentatively, Phase C will address:

Exhibit 5 Hutch Manufacturing Co. Reconciliation of the Statement of Cash Flows to the Statement of Comprehensive Income

	A	B	C	D	E	
		Noncash Items Affecting Income				
		Non-Remeasurements	Remeasurements			
	Cash Flows	Accruals, Allocations and other changes	Recurring Fair Value Changes	Remeasurements Other Than Recurring Fair Value Changes	Comprehensive Income (A+B+C+D)	
CASH FLOWS FROM BUSINESS						**BUSINESS**
Operating						**Operating**
Cash received from sales	$370,000	$14,000			$384,000	Sales
Cash paid for goods sold						Cost of goods sold
		6,000			6,000	Change in inventory
Inventory purchases	(132,000)	(3,000)			(135,000)	Materials
Labor	(28,000)				(28,000)	Labor
		(1,000)			(1,000)	Overhead – Depreciation
Total	(160,000)	2,000			(158,000)	Total
					226,000	Gross profit on sales
Cash paid for selling activities						Selling expenses
Compensation	(5,000)				(5,000)	Compensation expense
Advertising	(38,000)	(5,000)			(43,000)	Advertising expense
		(1,000)			(1,000)	Bad debt expense
Other selling	(25,000)	(2,000)			(27,000)	Other selling expenses
Total	(68,000)	(8,000)			(76,000)	Total
Cash paid for general and administrative activities						General and administrative expenses
Compensation	(15,000)				(15,000)	Compensation expense
Rent	(5,000)				(5,000)	Rent expense
		(7,000)			(7,000)	Amortization expense
Other general and administrative	(59,000)	18,000		(5,000)	(46,000)	Other G&A expenses and goodwill impairment
		(2,000)			(2,000)	Depreciation
Total	(79,000)	9,000		(5,000)	(75,000)	Total
Cash paid for other operating activities						Other operating expenses
Research and development	(16,000)				(16,000)	Research and development
Capital expenditures	(10,000)	10,000				
Other	(7,000)				(7,000)	Other operating expenses
Total	(33,000)	10,000			(23,000)	Total
Net cash provided by operating activities	$30,000	$27,000		$(5,000)	$52,000	Operating income
Investing						**Investing**
Dividends received	1,000	1,000			2,000	Equity in earnings of affiliate
Dividends received	1,000				1,000	Dividend income on AFS securities
Net cash provided from investing activities	$2,000	$1,000			$3,000	Investing income
Net cash provided by business activities	$32,000	$28,000		$(5,000)	$55,000	Business income
Financing						**Financing**
Interest paid	(5,000)				(5,000)	Interest expense
Proceeds from debt	35,000	(35,000)				
					(5,000)	Financing expense
Income Taxes						**Income Taxes**
Income taxes paid	(13,000)	4,000			(9,000)	Current tax expense
		(4,000)			(4,000)	Deferred tax expense
Net cash used in income tax activities	$(13,000)				$(13,000)	Income tax expense
Discontinued Operations						**Discontinued Operations**
Cash flows used in discontinued operations	$(1,000)			$(1,250)	$(2,250)	Loss on discontinued operations
						Other Comprehensive Income
			(750)		(750)	Unrealized loss on AFS securities
Net cash provided by activities with non-equity holders	$48,000	$(7,000)	$(750)	$(6,250)	$34,000	Total Comprehensive Income

- What financial statements should be included in interim financial statements
- Whether interim financial information should be presented in condensed form
- What comparative periods should be required
- Whether guidance for nonpublic companies should differ from public companies

The joint project will not address the recognition or measurement of assets, liabilities or transactions provided in other standards. In addition, the scope of the project does not include the notes to the financial statements, management discussion and analysis, pro forma measures, segment reporting, financial ratios, forecasts, nonfinancial information and ratios, and specific industry financial statements, except for how the decisions of this project may affect the financial statements of financial institutions.

The boards realize, however, that since changes are being made to the face of the financial statements, changes to existing disclosure requirements may be needed in relation to the notes and segment reporting.

CONCLUSION

The proposed financial statements are supposed to help predict cash flows for equity valuation. To be clear, these financial statements shift focus from net income to total comprehensive income, as all other comprehensive income items are now presented on the face of the statement.

Missing from this discussion, however, are the concerns of smaller business entities, both public and nonpublic, that do not use international capital markets. It is unclear whether the reclassification of relevant line items (like current assets and current liabilities) to the footnotes will create additional costs to entities that provide capital to small businesses. ◆

AICPA RESOURCES

***JofA* article**
"Extraordinary Items Share Exclusive Company," May 07, page 80

CPE
Cash Flow Statement: Preparation, Presentation and Use, a CPE self-study course (#731846)

For more information or to place an order, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

OTHER RESOURCE

Web site
FASB/IASB's Joint Project Financial Statement Presentation, **www.fasb.org/project/financial_statement_presentation.shtml**

■ Noncontrolling Interest: Much More Than a Name Change page 46

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Ronald J. Baker began his accounting career with KPMG Peat Marwick's Private Business Advisory Services in San Francisco before founding VeraSage Institute, a think tank dedicated to transforming professional service firms to professional knowledge firms. He speaks frequently at events and conferences, is an educator to professional knowledge firms, and has been an instructor with the California CPA Education Foundation since 1995, having authored 12 courses for them. Also the author of five best-selling books, he was appointed to the AICPA's Group of One Hundred leaders to address the future of the profession, named on *Accounting Today*'s 2001, 2002, 2003, 2004, 2005, 2006 and 2007 Top 100 Most Influential People in the profession, and received the 2003 Award for Instructor Excellence from the California CPA Education Foundation.

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