Financial Statements Unlike Any You've Seen (Part 1)

BY BRUCE POUNDER, CMA, CFM

If you haven't yet read the financial statements of ToolCo and Bank Corp, you should—your company's financial statements may soon look like theirs.

Financial statements of the fictitious ToolCo and Bank Corp appear as illustrative examples in a discussion paper issued last month by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Titled "Preliminary Views on Financial Statement Presentation," it describes significant changes that the Boards believe should be made to the contents and formats of principal financial statements.

The discussion paper is a "must read" if you prepare financial statements in accordance with U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). It takes only a quick glance at the ToolCo and Bank Corp examples to realize that the FASB and the IASB are proposing a complete overhaul of the balance sheet, income statement, and cash flow statement as we know them today under both U.S. GAAP and IFRS.

This month's column is the first of two that will introduce you to the dramatic changes described and illustrated in the discussion paper. Next month's column will continue to examine the changes and will explain how you can help influence the Boards' ongoing standards-setting efforts in the area of financial statement presentation.

Background

The recently issued discussion paper represents the first major milestone attained after many years of collaboration between the FASB and the IASB on the topic of financial statement presentation. The Boards' financial statement presentation project is just one of many ongoing joint projects that the two have undertaken with the objective of converging U.S. GAAP and IFRS. In particular, the financial statement presentation project is an example of multilateral, standard-level Convergence, which is one of several ways in which the global Convergence of financial reporting standards can occur and is occurring. As I explain in *The Convergence Guidebook* (Wiley, forthcoming 2009), multilateral, standard-level Convergence happens when two standards setters work to replace their existing, dissimilar standards on a specific topic with a common standard that is unlike either existing standard.

Publication of a discussion paper on a standards-setting issue is an optional but common step in the due process that the FASB and the IASB follow as they develop and revise financial reporting standards. Discussion papers are generally published early in the standards-setting process to share the Boards' preliminary views on issues that they have researched before attempting to draft a new standard or draft revisions to an existing standard. As such, discussion papers represent opportunities for interested parties to help shape the standards that affect the individuals and organizations that make up the financial reporting supply chain.

What's So Different?

The proposed balance sheet, or as it is formally called in the discussion paper, the "Statement of Financial

Position," exhibits a number of striking features. First, the Statement of Financial Position isn't organized into the traditional sections of assets, liabilities, and equity. Rather, it is organized into five sections: Business, Financing, Income Taxes, Discontinued Operations, and Equity.

The Business section of the Statement of Financial Position presents both assets and liabilities that are related to the reporting entity's "business activities," i.e., the operating and investing activities through which the entity creates value. The Financing section lists assets and liabilities that relate to how the reporting entity funds or finances its business activities from *nonowner* sources of capital. Financing from *owner* sources is detailed in the Equity section.

Together, the Business and Financing sections contain assets and liabilities associated with the reporting entity's continuing operations, and assets and liabilities associated with discontinued operations are contained in their own section. The only exception to the foregoing arises with regard to income-tax assets and liabilities, which are presented separately in the Income Taxes section.

Of course, the commingling of assets and liabilities within new categories on the Statement of Financial Position is a dramatic change from current practice. But the "method to the madness" becomes more apparent when you look at the proposed Statement of Comprehensive Income, which is also organized into five sections—Business, Financing, Income Taxes, Discontinued Operations, and Other Comprehensive Income—that largely parallel the sections appearing in the Statement of Financial Position.

The Business and Financing sections of the Statement of Comprehensive Income present items of income and expense relating to the entity's ongoing business and financing activities. The income-tax effects of those activities on comprehensive income are presented in a separate section, while income and expense items relating to discontinued operations are presented by themselves on an after-tax basis. Finally, items of Other Comprehensive Income (OCI) are presented separately from the traditional components of Net Income (under U.S. GAAP) or Profit or Loss (under IFRS).

The basic structure of the Statements of Financial Position and Comprehensive Income is repeated in the proposed Statement of Cash Flows. Specifically, the Statement of Cash Flows is organized into Business, Financing, Income Taxes, Discontinued Operations, and Equity sections. The traditional distinction between operating and investing cash flows is preserved within the Business section, paralleling a new distinction that's made between operating and investing items within the Business section of the Statements of Financial Position and Comprehensive Income as well. Separating cash flows associated with income taxes, discontinued operations, and transactions with equity holders into their own new categories is certainly a significant difference from current practice. Additionally, the proposed Statement of Cash Flows would be prepared on a direct basis, which is currently recommended by both the FASB and the IASB but rarely seen in practice.

The remaining principal financial statement, the Statement of Changes in Equity, won't change and will continue to be required as part of a complete set of financial statements. There are many additional changes that the FASB and the IASB have proposed, however, relating to all of the financial statements, and those changes will be explored next month. But before I conclude this month's column, a few words are in order about why the Boards are proposing such profound changes to the most visible and most fundamental elements of the financial reporting supply chain.

Some Perspective

Recent turmoil in global financial markets has been interpreted by many observers as evidence that existing financial statements fail to convey an entity's expected returns and the riskiness of those returns in an accurate manner. The Boards believe that the changes they are proposing would "improve the usefulness of the information provided in an entity's financial statements and help users make decisions in their capacity as capital providers." To the extent that the Boards can convince their constituents of the benefits of changing the contents and formats of the financial statements, we may soon find ourselves entering a new era of financial reporting under truly global standards. ■

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