



LETTER OF COMMENT NO. 24

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Thank you for the opportunity to comment on the proposed changes for presenting financial statements under IFRS. This is the first time I have made a submission. Like most accountants I have been busy earning my living and finding time to comment is awkward. I am concerned that people involved in the accounting standard setting process are too removed from living in the stories, ie the actual businesses, etc. Those commenting are too often the preparers that have their agendas, the major accounting firms, academics and sophisticated analysts. Thus, the 'Mum and Dad' shareholders are being further and further alienated by this approach.

*Simplicity needs to be made a major principle in the standard setting process.*

This is my main argument. The idea of the three financial statements linking is an admirable ambition, but it results in too much complexity and clustering levels in the balance sheet and cash flow in particular. I recommend that simplicity be followed using the rule of 3, which I describe below.

Simplicity should be used in naming the financial statements. The current names are too long. The balance sheet is called the statement of financial position. As a minimum it is only fair to call it 'a statement of financial position'. The assets are stated on at least two bases being cost or fair value. What would an individual define as their financial position regarding assets? Probably use market value.

I believe the names should be limited to two words as a general principle with clearly distinguished initials: balance sheet, income statement and cash flow statement are my preferences. It does not matter if extra items are added on to the income statement after net profit. It does not need to be called 'statement of comprehensive income'. Isn't this a bit incomprehensible? [On the cynical level, which I use in my seminars, the balance sheet initials 'BS' often describe the quality of what is presented.]

Thus, my submission is framed from the perspective of 'ordinary' users as much as I can do so legitimately, being an accountant myself. Since 1991 I have been writing and presenting seminars on understanding financial statements for non-accountants. I am author of *Financial Statements Demystified*, 4th edition, Allen & Unwin, 2006 and the CD ROM, *Assessing Company Performance*, Kaplan, 3rd edition 2008. I also write a subject on Financial Statements Analysis for Kaplan (since 1985) and the financial modules of the Company Directors Course offered by the Australian Institute of Company Directors (since 2002). My comments come from this experience and 15 years of auditing plus 6.5 years as National Director of Education for Ernst & Young to early 1991.

### **General Formatting Approach**

I think each statement should fit (in minimum 9 point font size) on one (A4) page. The proposed format has more detailed lines and is in danger of taking more than one page per statement. The proposed line descriptions are an

improvement (as shown in the example financial statements) because they are plain language. But I would prefer some of the detail to be in the notes. For instance the cash flow statement is providing more description of the types of operating payments. The face of the statement could still be 'payments to suppliers and employees' with the breakdown in a note.

My main general disclosure principle is 3, where each statement should contain three main elements. This is easy with the balance sheet being assets, liabilities and equity and the cash flow statement being operating, investing and financing but harder for the income statement.

### **Balance Sheet**

For corporations the prime audience should be the owners (shareholders). Hence, equity **must** be kept as a prime category. How can a company shareholder see their net position otherwise? (I agree that equity contributions need to be clearly delineated from borrowings.) The proposed various levels of net assets flowing down to a total net asset equals equity removes that fundamental distinction of assets versus liabilities. The basic formula of the balance sheet is  $E+L=A$  or  $E=A-L$  and this should be crystal clear so an ordinary person can see it. Ratios use total assets and total liabilities and equity. They also use current assets and current liabilities. I believe that only the format separating assets and liabilities into current and non-current should be allowed and liquidity listing banned. So, lets stay with the traditional on the balance sheet.

### **Cash Flow Statement**

I think the existing cash flow standard is the best of all the accounting standards but only the direct format should be allowed. [Indeed indirect makes the name of the statement a lie as operating activities does not show the cash flows.] The proposed format creates a lot more than three categories with tax being at the end. Other than capital gains tax, income tax is strongly related to operating and **must** be under operating cash flows. I think the current format provides a wonderful means of thinking about how cash flows through an enterprise:

- operating – the cash coming from trading, which is generally expected to be positive
- investing – what is being put into the future, which is generally expected to be cash flowing out
- financing – how it is being financed – likely to be positive in times of expansion and negative if successful operations (due to dividend payments and repayments of borrowings)

Under this approach, I think payments for property, plant and equipment are more interpretive shown under investing, rather than the proposal to put them under operating. While they are 'operating assets' they are assets acquired to provide infrastructure – the ability to continue to produce goods and services. Thus, I see them more as an investment.

The pattern of flow I advocate in my seminars for a mature successful business is that net operating cash flow should be sufficient to pay for property, plant and equipment (under investing) and dividends (under financing). I generally prefer

interest paid and received to be included under operating, as there should be positive operating cash flow after paying the interest.

I think part of the reason there is resistance to the direct format is because accounting systems do not automatically generate cash flow statements. This can be overcome if the accounting systems tagged all cash transactions so that reports could then be generated in the accounting standard format. This would be a fantastic improvement in helping management and boards so they would automatically be given a statement showing them how they are travelling cash-wise – eg helping spot insolvency issues more readily.

### **Income Statement**

The income statement is more difficult to prescribe three main chunks. Rather it cascades from sales to net profit (plus odds and sods shown after that as required under accounting standards). I understand the thrust of standard setters towards thinking of income and expenses as being all equity changes except transactions between the entity and the owners, however, this will not be the way those interpreting performance will view it. Thus, standard setters need to think about 'ongoing' as well as total profit. I think it is very hard to specify the format of the income statement.

Under the current approach there are many income statements showing very little detail on the face of the statement, requiring lots of access to the notes to get a sense of the income and expenses. I think this needs to change. I have attached two Australian insurance company income statements: IAG I rate as an excellent income statement format and QBE as poor on these grounds.

I see the challenge as being how we foster meaningfully clustered disclosures on the face of the income statement, rather than prescribing the entire format. How organisations earn profit varies – the income statement should give insight into that.

### **Statement of Changes in Equity**

I do not have any comments on the statement of changes in equity, other than I support a tabular format that shows how each part of equity has changed and links to where readers can find further information.

### **Final Comments**

I know these comments have not been presented in accordance with the questions but I am hoping they will be taken seriously. I am very glad that IFRS are being adopted around the world. However, I am distressed by the growing complexity resulting in accountants having to specialise and finding them hard to understand. After all, accounting is a human created analogy – a story telling mechanism. It is not the actual story but represents the story. It can never be perfect. It does not involve any natural laws which means there is no absolute 'truth' in accounting. Hence, the level of pursuit of a perfect system will fail. IFRS standards used to be straightforward and readable (when I first wrote my book complying with IAS, second edition 2002) but they have become difficult to read. Please do not do the same with unnecessarily complex formats for the three financial statements that give readers insight to the story.

## IAG income statement for year ended 30 June 2008

(Re-keyed as could not attach as a pdf due to protection on document downloaded from website, parent company columns omitted)

	NOTES	CONSOLIDATED	
		2008 \$m	2007 \$m
Premium revenue	3	7,765	7,207
Outwards reinsurance premium expense	4	(470)	(464)
Net premium revenue (i)		7,295	6,743
Claims expense	4	(5,593)	(5,345)
Reinsurance and other recoveries revenue	3	438	871
Net claims expense (ii)	11	(5,155)	(4,474)
Acquisition costs	4	(1,318)	(1,223)
Other underwriting expenses	4	(590)	(421)
Fire service levies	4	(216)	(218)
Underwriting expenses (iii)		(2,124)	(1,862)
Underwriting profit (i)+(ii)+(iii)		16	407
Investment income on assets backing insurance liabilities	3	456	381
Investment expenses on assets backing insurance liabilities	4	(24)	(21)
Insurance profit		448	767
Investment income on equity holders' funds	3	(1)	343
Fee and other income	3	556	463
Share of net profit/(loss) of associates	3	(3)	5
Finance costs	4	(101)	(119)
Fee based, corporate and other expenses	4	(1,017)	(532)
Net income attributable to minority interests in unit funds	4	(18)	(19)
Profit/(loss) before income tax		(136)	908
Income tax (expense)/credit	6	(90)	(279)
Profit/(loss) for the year		(226)	629
Profit/(loss) for the year attributable to Equity holders of the Parent		(261)	552
Minority interest		35	77
Profit/(loss) for the year		(226)	629
	NOTES	CONSOLIDATED	
		2008 cents	2007 cents
Basic earnings per ordinary share	8	(14.29)	32.79
Diluted earnings per ordinary share	8	(14.18)	32.59

The above income statements should be read in conjunction with the notes to the financial statements

# Income statements

	NOTE	THE COMPANY		CONSOLIDATED	
		2008 \$M	2007 \$M	2008 \$M	2007 \$M
<b>REVENUE</b>					
Premium revenue		-		12,853	12,361
Other revenue		1,481	2,941	2,866	2,153
Net fair value gains on financial assets		24	2	-	354
Net fair value gains on investment properties		-	-	-	2
Realised gains on sale of controlled entities		1	-	-	2
Investment income – ABC financial assets pledged for funds at Lloyd's		96	19	222	94
	6	1,602	2,962	15,941	14,966
<b>EXPENSES</b>					
Outward reinsurance premium expense		-	-	1,766	2,151
Gross claims incurred		-	-	7,743	6,651
Other expenses	7(C)	31	16	3,494	3,294
Net fair value losses on financial assets		-	-	33	-
Impairment of investment in controlled entities		2,410	-	-	-
Expenses – ABC securities for funds at Lloyd's		111	47	245	103
Finance costs		98	99	240	218
<b>(Loss) profit before income tax</b>	7	<b>(1,048)</b>	2,800	<b>2,420</b>	2,549
Income tax expense	8	22	2	554	615
<b>(Loss) profit after income tax</b>		<b>(1,070)</b>	2,798	<b>1,866</b>	1,934
Net profit attributable to minority interest		-	-	7	9
<b>Net (loss) profit after income tax attributable to members of the company</b>		<b>(1,070)</b>	2,798	<b>1,859</b>	1,925

	NOTE	CONSOLIDATED	
		2008 CENTS	2007 CENTS
Basic earnings per share	36	208.8	225.7
Diluted earnings per share	36	205.5	217.0

The above income statements should be read in conjunction with the accompanying notes