

To: International Accounting Standards Board (IASB), London

Copy to: Financial Reporting Standards Board (FRSB) New Zealand

Submission on

Preliminary Views on Financial Statement Presentation, October 2008

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LETTER OF COMMENT NO. 35

Contents:

- **Introduction**
- **Letter of support from New Zealand Shareholders Association**
- **Recast Toolco Accounting Statements**

Introduction

This submission is in response to your discussion question 1 in that it does not go into fine detail on matters of principle, but rather proposes a set of accounting statements that a wide spectrum of readers can understand, thus leading to an informed market across a broad range of participants. This follows comments in your discussion paper:

Para 2.1 (a) – The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers.

Para 2.6 – Financial statements that are consistent with the cohesiveness objective would display data in a way that clearly associates related information across the statements so that *the information is understandable*. (My emphasis)

In my view, the way to achieve these objectives is to have a standardised format for the main summarised statements, with technical details contained in the notes to the accounts. For instance, instead of getting into a learned argument about cash and cash equivalents (your discussion question 12), the total of both could be included in the body of the Statement of Financial Position, with the detailed split being shown in the notes.

Similarly, if the indirect method is used for cash flow (or funds) statements, (which I strongly favour), the gross operating cash receipts and payments could be included in the notes if this is deemed desirable. The same argument applies to such matters as short and long term assets and liabilities.

This submission is therefore in the form of re-drafted statements for Toolco, with comments on the reasoning behind each one. Accounts for financial companies have not been attempted in the interests of brevity, but the same principle of splitting information between accounting statements and notes to the accounts could no doubt apply.

The examples that follow are of course only one of many possible solutions to the problem of producing understandable statements. But once the basic principle of splitting information between the statements and notes is agreed, a logical system could evolve, always based on the overriding aim of communicating essential data to as wide a section of the community as possible.

Financial illiteracy of the investing public has been said to be one of the major causes of the excesses of the credit crunch. The suggestions in this submission are designed to go some way to correcting that.

For further information refer to the following books by the author:

The Accounting Jungle and How to Find your Way Through It.
Rothery Press, Auckland, NZ, 1999, ISBN 0 473 05884 7

The Accounting Jungle and How to Find your way Through It
Wrightbooks, Elsternwick, Australia, 1995, ISBN 1 875857 11 7

The Accounting Jungle and How to Find your Way Through It.
Management Books 2000, Chalford, UK, ISBN 1 85252 299 2

01 April 2009

New Zealand Institute of Chartered Accountants
PO Box 11342
Wellington 6142

IASC
30 Cannon Street
London
EC4M6XH

Dear Sir

We are aware, that IASC is collecting submissions in respect of the presentation of financial statements for issuers.

We have drawn to your attention in earlier submissions on various aspects of *International Financial Reporting Standards, the deficiency in the process, arising from a lack of involvement in the setting of such standards by the users of financial statements.*

Philosophically, the Institute of Chartered Accountants and its sister associations should understand that they exist to serve the public, not their members.

The users of financial statements consist of business operators and investors, and the bodies that have set the International Financial Reporting Standards have not involved these groups. As a result we have standards set that suit the technicians rather than the users. Certainly this has ensured that the accounting professions globally have increased their revenues at the cost of the community, with questionable benefits as a result.

In respect of external financial statements, the end user is the investor. We consider it inappropriate for you to design such financial statements without at least soliciting direct input from investors as the ultimate user.

We are aware that Bill Jamison has provided a detailed submission to you in respect of a recommended presentation for financial statements that are to be issued to investors. We have reviewed his submission.

We write this letter in support to Bill Jamison's submission and suggest to you that his proposed simple format for financial statements would provide relevant information to investors in a digestible format. We commend his submission to you.

Please note that all correspondence from the New Zealand Shareholders Association is published on our website (www.nzshareholders.co.nz) along with any replies received.

Yours faithfully
NEW ZEALAND SHAREHOLDERS ASSOCIATION

Bruce Sheppard
Chairman

TOOLCO STATEMENT OF COMPREHENSIVE INCOME - \$000s		
Years ended 31 December	2010	2009
Income:		
Sales revenue	3,487	3,239
Interest received	9	5
Dividends received	54	50
Earnings before funding costs and tax (EBIT)	947	858
Funding and leasing costs	(126)	(127)
Operating profit before tax	821	731
Tax provision	(334)	(295)
Operating profit after tax	487	436
Unrealised profit/(loss) after tax		
Goodwill write-off		(35)
Equity profits	31	25
Asset revaluations	23	14
Net profit after tax	541	440
Extraordinary items		
Profit on sale of assets	21	22
Comprehensive income for the year	562	462
Appropriations		
Dividends paid or provided for	(86)	(80)
Retained earnings for the year	476	382

Comments:

Income: Sales revenue is from goods sold and not other sources. Interest and dividends received show the income received from activities outside the main operations of the Toolco group. They are included in general profits to allow calculation of key ratios such as funding cost cover.

Earnings before funding and leasing costs (EBIT) : These are realised earnings, being received in cash, or realisable in cash in the near future. The term 'funding' is used in order to cover all costs of servicing borrowed funds, including items such as dividends on preference shares. The description EBIT is included in the subheading as it is commonly used in financial parlance to describe basic earnings.

Dividing EBIT by the funding and leasing costs gives the funding cost cover, which is one of the key ratios for assessing the credit standing of the company. In 2010 the cover was 7.5x which is very high, showing at once that the company is not highly geared.

Operating profit before tax: This is the cash flow plus cash equivalents from operations of Toolco before payment of tax and other items. It is therefore the start point of the funds statement (replacing the cash flow statement) which follows.

Unrealised profit/(loss) after tax: This section is for accounting items that are not backed by a cash transaction

Net profit after tax: This represents earnings from a year's normal operations

Extraordinary items: This category has been re-introduced to cover one-off transactions outside the mainstream operations of the company

Comprehensive income for the year: The total of all transactions for the year

TOOLCO STATEMENT OF FINANCIAL POSITION - \$000s		
As at 31 December	2010	2009
Share capital		
No. of shares on issue – 000s	7,950	7,520
Source of funds		
Shareholders equity	2,690	2,130
Interest bearing debt	2,922	2,795
Accounts payable and provisions	1,921	2,204
	7,533	7,129
Assets employed		
Property, plant and equipment	3,701	3,942
Long term investments	309	279
Inventory	679	767
Accounts receivable and prepayments	1,002	602
Cash and liquid investments	1,648	1,347
Goodwill	155	155
FX contracts	6	3
Other intangible assets	33	34
	7,533	7,129

Comments

Share capital: Number of shares on issue are shown to assist calculation of per share earnings and asset backing. (Not shown in your example: derived from eps and comprehensive income)

Source of funds: Summarised into equity which is serviced by way of dividend; debt on which interest or the equivalent is paid (such as finance leases and preference shares); and accounts payable and provisions which provide funding at no cost to the company.

Funds Employed:

Property, plant and equipment: Includes assets held for resale, on the basis that assets should be classified by type, rather than intent.

Long term investments: Those for which there is no ready market, or investments in companies which are held as part of the operations of the group but with a shareholding under 50 %.

Cash and liquid investments: Includes cash on hand or in the bank, and financial investments that can be readily realised, such as Government Stock. This shows surplus funds of the company that are held in a readily available form.

Other categories: Conventional definitions.

General: The layout in the form of Source of Funds and Assets Employed allows instant recognition of where the company obtained its funds and what it did with them, rather than clouding the issue with a series of obscure additions and subtractions. It shows the gearing of the company, capital intensiveness, working capital requirements and other key balance sheet figures on one easily understood page.

TOOLCO STATEMENT OF CHANGES IN EQUITY - \$000s		
Year ended 31 December	2010	2009
Comprehensive income for the year	562	462
Dividends paid or provided	(86)	(80)
Share issues	84	78
Total change for the year	560	460

Comments

This format shows the movements for the year only, without opening and closing balances of equity. It also follows the two-column vertical format, facilitating inter-year comparisons. It clearly shows the directors' policies as regards dividend payouts in relation to earnings, and the shareholders' continuing contribution to equity.

Much of the information in the *Statement of Changes in Equity in the discussion paper* has already been included in the *Statement of Comprehensive Income*, so there seems little point in repeating it here. Its exclusion makes this statement much shorter, and so easier to understand.

TOOLCO FUNDS STATEMENT - \$000s		
For the year ended 31 December	2010	2009
Funds from operations		
Operating profit before tax	821	
Tax paid	(281)	
Add back non-cash charges		
Depreciation	60	
	673	
Working capital requirement		
Accounts receivable increase	(400)	
Inventory decrease	88	
Accounts payable decrease	(336)	
Total funds from operations	25	
Investments		
Property plant and equipment – net sales	181	
Other investments – net purchases	(30)	
Total funding surplus	176	
Source/(disposition) of funds		
Interest bearing debt – net increase	127	
Share issues	84	
Dividends paid	(86)	
Cash and liquid investments - increase	(301)	
	(176)	

Comments

This statement uses the so-called ‘indirect’ method and provides a link with the Statement of Comprehensive Income by starting with operating profit before tax. The arguments for and against the indirect method are fully canvassed in the Discussion Paper. Its adoption here is based on the following perceived advantages:

- There is a clear link between two major accounting statements. This may provide answers to the fundamental question “if we made so much money, where has it all gone?”.
- It shows funds generated from the basic operations of the company before working capital requirements. Those requirements are highlighted and, in this case, show a major negative effect on funds available to the company. This may be affected by assumptions made on the classification of some balance sheet items.
- The layout of Total Funding Surplus (or deficit) balanced against Source/(disposition) of Funds gives a clearer picture of funds generated and what the company did with them.
- As the Discussion Paper states, indirect funds statements are easily compiled from existing accounting records. The difficulty in using the direct method has led to cash flow statements being excluded from final accounts for SMEs on the grounds that the costs exceed the benefit. Rather than deprive smaller enterprises of this important management tool, particularly as regards working capital, it is surely better to adopt a format that is readily understood and easily compiled, rather than discard it altogether.

TOOLCO KEY RATIOS		
Year ended, or as at, 31 December	2010	2009
Funding and leasing cost cover – times	7.5	6.8
Average interest rate - %	4.3	4.5
Equity ratio - %	35.7	29.9
Net tangible assets per share	1.85	0.98
Share price - \$	1.06	0.92
Earnings per share – cents		
On operating profit after tax	6.13	5.79
On net profit after tax	6.81	5.85
On comprehensive income	7.07	6.14
Price/earnings ratio - times		
On operating profit after tax	17.3	15.9
On net profit after tax	15.6	15.7
On comprehensive income	15.0	15.0
Dividends per share – cents	1.1	1.1
Dividend yield - %	1.0	1.1

Comments

This is a new table that includes ratios designed to assist in assessing annual performance and credit standing.

Funding and leasing cost cover: Shows the ability to meet loan obligations – in this case, exceptionally strong

Average interest rate: A check on whether all loans have been included in their proper category, and on the financial standing of the company

Equity ratio: Indicates basic financial gearing. There are several ways of expressing this, but at least it should be standardised instead of the present mix of debt to equity as a ratio, debt to debt plus equity as a percentage, and the equity ratio used here.

Net tangible assets and share price (if available): Show the market assessment of the company's assets.

Earnings per share: Calculated on the three different levels of the Statement of Comprehensive Income. The move to comprehensive income has caused confusion with the investing public, with many companies referring to 'underlying profit' or similar terms to explain the ongoing performance before accounting adjustments. Showing eps on three levels would give the investing public consistent bases to assess performance. The same comments apply to price/earnings calculations.

Dividends per share: A key figure that is hard to extract from many annual reports. Highlighting it here allows easy calculation of the dividend yield.

TOOLCO SEGMENTAL ANALYSIS - \$000s		
For the year ended 31 December	2010	2009
Sales		
Wholesale	2,050	2,001
Retail	647	647
Discontinued	790	591
	<u>3,487</u>	<u>3,239</u>
EBIT		
Wholesale	750	700
Retail	229	193
Discontinued	(32)	(35)
	<u>947</u>	<u>858</u>
Net assets employed		
Wholesale	3,367	2,955
Retail	2,245	1,970
	<u>5,612</u>	<u>4,925</u>
EBIT/Net assets employed - %		
Wholesale	22.3	23.7
Retail	10.2	9.8
	<u>16.9</u>	<u>17.4</u>

Comments:

This statement is also additional to those in your proposed format, and so makes assumptions on the sales and other splits between wholesale and retail operations. This type of information is vital to an understanding of the company's operations and so should have the same prominence as the other statements, rather than being buried in the notes to the accounts, which is often the case.

Sales

Sales on discontinued operations are included here in order to show revenues from ongoing operations. This information is not available in your example.

EBIT

The total tallies with that in the Statement of Comprehensive Income and so provides a link between the two. It shows the basic earnings of the various segments before any distortions from variations in funding costs and tax.

Net assets employed

These are based on the total of shareholders funds and interest bearing debt in the Statement of Financial Position. These are the funds on which the company has to make a return in order to provide a return to investors and other providers of finance, and so excludes accounts payables and provisions. A split of 60/40 between wholesale and retail has been assumed.

EBIT to Net assets employed - %

Dividing EBIT by the net assets used to produce it, gives the percentage earnings on the funds which the company has to service by way of dividends, interest and other funding costs. Comparison with the returns available from riskless investments such as Government stock gives the margin for risk the company is achieving. In this case, retail is employing a disproportionate share of the net assets, and so has a significantly lower rate of return.