



Investors Technical Advisory Committee

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1630-100
Comment Letter No. 226

Via Email

July 1, 2009

Mr. Russell Golden
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Financial Accounting Standards Board
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director@fasb.org

Re: File Reference No. 1630-100: *Discussion Paper: Preliminary Views on Financial Statement Presentation*

Dear Mr. Golden:

The Investors Technical Advisory Committee ("ITAC") appreciates the opportunity to express its views on the FASB's File Reference No. 1630-100 Discussion Paper: *Preliminary Views on Financial Statement Presentation* ("DP"). Our input is based upon our perceptions as users of financial statements and our goal is to improve the clarity, completeness, and usefulness of financial statements.¹

ITAC supports the use by all companies of highly transparent, timely and comparable reporting of transactions and events in the primary financial statements. Consequently, the ITAC has strongly supported the FASB's decision to add a reconsideration of all financial statement presentation standards and pronouncements to its agenda, including related recognition and measurement issues. We commend the FASB members and staff for bringing forward this initial proposal for discussion and comment.

¹ This letter represents the views of the ITAC and does not necessarily represent the views of its individual members, or the organizations by which they are employed. ITAC views are developed by the members of the Committee independent of the views of the FASB and its staff. For more information about the ITAC, including a listing of the current members and the organizations in which they are employed, see http://www.fasb.org/investors_technical_advisory_committee/itac_members.shtml

General Comments

To state the obvious, the current financial statement presentation “model” is not a coherent model in any sense of the word. Rather, it is an amalgamation of thousands of disparate, incomplete, inconsistent and conflicting practices and decisions, some centuries old, others made as recently as the last few weeks. While occasional decisions and practices have improved transparency, timeliness, consistency, and comparability, others have obscured or delayed the reporting of important information. Taken as a whole, the disparate decisions have resulted in a presentation that fails to present the information capital providers require to value investments.

Although we have some suggestions for tightening and improving the clarity and consistency of statement presentation as proposed under this DP, **our broad conclusion is that the main DP proposals are a major step forward, a sound and much-needed platform for revising our current antiquated financial statement presentation system.** Perhaps its single greatest strength is that this proposed model better aligns the information required by investors and other capital providers in their financial decision making with the presentation and display of financial information required to be provided by companies in the primary financial statements. Indeed, we firmly believe it may not be too strong a statement to say that the model, if developed and implemented along the lines proposed, will make an order of magnitude improvement in the quality of financial reporting. We believe that it also will provide a clear structure for continuous improvement in financial reporting in the future in response to changing business and market innovation. Thus, if both the proposals in this DP and our recommendations come to full fruition, the improvements may well represent the single greatest improvement to financial reporting in decades if not longer and greatly enhance transparency for investors and the financial markets.²

We do have some suggestions that we believe will substantially strengthen the current model, reduce ambiguity and inconsistency, and enhance the robustness of the proposed model. First, the Boards have chosen to require in the notes to the financial statements only a direct method cash flow statement to income statement reconciliation rather than a balance-sheet-to-balance-sheet reconciliation. We believe that this decision will prove very problematic in application and serve as a real hindrance in achieving the three proposed objectives, with which we strongly concur, of cohesiveness, disaggregation, and providing the information necessary for assessing the company’s ability to meet commitments as they come due and to take advantage of business opportunities as they arise. That is, if the requirement to tie changes in balance sheet accounts directly to the

² We believe that the strong structure proposed in this Financial Statement Presentation Project may substantially improve the prospects for success of the Extensible Business Reporting Language (XBRL) project by providing a clear and robust model for the development of the XBRL taxonomy.

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corresponding changes in the cash flow and income statements is relaxed, then it is highly likely that the information presented in the reconciliation not only will be aggregated differently from the balance sheet accounts associated with the changes, but that the information will be much more highly aggregated and summarized, as it is today. In other words, the information available to users of the financial statements will not be likely to change significantly from what we have today. So, in our view, the balance-sheet-to-balance-sheet-reconciliation is not an option; rather it is a core building block of the model, and necessary to achieve the stated objectives of the model. We will discuss our views further in our response to questions 23-25.

Second, and very closely related to the first, is our concern about what is meant by a direct method cash flow statement. A handful of companies today, to their merit, have chosen to present a direct method cash flow statement. However, these statements are very highly aggregated, similar to or even more aggregated than the typical income statement. If the information in the direct method cash flow statement is to be useful to investors and others who rely on financial statements in their analyses, then this statement should be disaggregated by nature of the item, as should the income statement. Also, if the cash flow statement is to be useful, it should not be developed using the so-called “indirect-direct” method. This approach is a holdover from old ad hoc attempts to **estimate** cash flows using accruals, estimates, approximations and other means. Unfortunately, this approach brings forward all of the errors, inaccuracies, incompletenesses, and other difficulties inherent in such estimation systems, but at the same time *appears* to have a precision that is lacking in the numbers. We discuss this further in question 16 and elsewhere.

A third concern is the adoption of the “management approach,” or management view,” concept as a prominent feature of the model. Unfortunately, as we discuss throughout the letter, this concept is undefined, is left entirely to managers’ discretion, and introduces substantial inconsistency in reporting and lack of comparability among companies’ financial statements. As we note, allowing this flexibility does much to water down or even eliminate the otherwise very clear and rational structure proposed by the Boards in the DP. In short, it largely negates the improvements proposed in the model and returns us to the very amorphous model we have today. Finally, as we also observe, introduction of the concept not only is problematic for the structure of the model, but greatly increases the complexity of the explication of the model and appears at several junctures in the DP to have been an effective barrier to the Boards’ resolution of important issues. Consequently, we would recommend that the Boards lay this concept aside, and refocus their deliberations on the definitions and other concepts that we believe provide a clear and workable structure for the model. This concept can be reconsidered later in conjunction with segment disclosures. We discuss the management approach throughout the letter where relevant.

Specific Questions

Chapter 2: Objectives and Principles of Financial Statement Presentation

1. *Would the **objectives of financial statement presentation** proposed in paragraphs 2.5-2.13 improve the usefulness of the information provided in an entity's financial statements and help users make better decisions in their capacity as capital providers? Why or why not? Should the Boards consider any other objectives of financial statement presentation in addition to or instead of the objectives proposed in this Discussion Paper? If so, please describe and explain.*

The three objectives of financial statement presentation as briefly summarized in paragraph 2.4, are “that information should be presented in financial statements in a manner that:

- a. Portrays a **cohesive** financial picture of an entity's activities;
- b. **Disaggregates** information so that it is useful in assessing the amount[s], timing and uncertainty of an entity's future cash flows; [and]
- c. Helps users to assess an entity's **ability to meet its financial commitments as they become due and to invest in business opportunities.** [Emphasis added.] [Summary in paragraph 2.4]

We believe that these objectives provide a sound basis for a comprehensive and robust financial statement model. Such a model must be structured so as to accommodate the complexities of today's internationally diversified corporation:

1. With operations across different industries, products and services;
2. That alters its operational and financial risk exposures with a broad array of structured financial products and other risk management activities; and
3. That funds its operations with a variety of capital sources and instruments.

Paragraphs 2.15 and 2.16 explain what the Boards intend by the term cohesiveness:

To present a cohesive set of financial statements, an entity should align the line items, their descriptions, and the order in which information is presented in the statements of financial position, comprehensive income, and cash flows.

*The Boards' preliminary view is that, ideally, financial statements should be cohesive **at the line item level**. Aligning line items across the financial statements should provide more information and increase the transparency of the information provided—something that users have requested repeatedly. [Emphasis added]*

The goal of line-item cohesiveness is for a user to find an asset or liability and the effects of a change in that asset or liability in the same or similar location in each financial statement and to be able to identify related information in different statements. In presenting information in its financial statements, an entity should comply with the spirit of the goal.

The importance of cohesiveness as defined by the DP cannot be overstated. Investors need to fully understand the implications of the various factors on a company's future prospects, its value creation activities and the transformation of the value into cash flows. Thus, to the extent the cohesiveness objective is achieved, application of the model in practice will **better align the information and its presentation in the financial statements with the fundamental analyses investors and analysts must perform as a basis for their financial decision-making**. That is, if these objectives are fully met, not only will investors have better quality and more transparent information readily available for their review and consideration, but a **substantial amount of the costly effort currently needed to generate the information, if it can be generated at all, will be avoided**.

Informational cohesiveness across the statements is essential if investors are to be able to fully understand the effects of transactions and events on the company's financial position and operations, and assess the implications of these effects on its current and future risk exposures and returns. Disaggregation into more economically homogeneous line items will provide a better basis for evaluating trends and making forecasts. As we have recently been reminded in the current crisis, characterized by a lack of liquidity and available credit, it is a given that investors must be able to assess an entity's ability to meet its financial commitments and to invest in new and evolving business opportunities.

We believe that a fourth objective is essential if the three stated objectives are to achieve their goal: **Completeness or comprehensiveness**. We would provide a working definition of completeness as the requirement that:

The effects of all events *and* transactions that can affect the amounts, timing, and riskiness of future cash flows must be recognized, measured and presented in a timely fashion in the primary financial statements.

That is, no effects of transactions and events that can affect the company's cash flows and its value creation should be allowed to circumvent recognition in the primary financial statements, be disclosed only in the notes, or not disclosed altogether. Such failure has been a conspicuous feature of each of the financial collapses in the last dozen or so years. Thus, all contingencies, current off balance sheet activities, liquidity puts, executory contracts, and other commitments, whether written or not, should be fully recognized in the primary financial statements. Investors should not learn when it is too late that companies that they thought to be sound in fact had tens or hundreds of billions of highly risky investments or other commitments and too little capital to absorb the losses from those risks.

We would note that a tendency in standard setting in recent decades has been to permit inconvenient information or exposures with potentially negative consequences such as pension and postretirement obligations, securitization commitments, stock option compensation, derivative instruments, lawsuits, and other such items to first be disclosed only in the notes if they are disclosed at all, thus by-passing the financial statements. If financial statements are to serve their fundamental purpose as a means of providing investors and other users with a clear, complete and accurate picture of the financial position of the company and the results of its operations, then at a minimum, the financial statements must provide a complete picture of the effects of transactions, events, and obligations. Put simply, if the statements are incomplete, they are by definition misleading and represent a source of risk, possibly catastrophic risk, to those who rely upon them. Thus, no matter how meritorious the provisions of the DP, and we strongly support them as far as they go, if the statements are in the end incomplete and fail to reflect highly material information that could affect investors' and other users' decisions, then the model cannot succeed.

We recognize that although substantial improvements in the deficient reporting areas cited above have been made in recent years, some transactions, events and activities, including those contributing to the current global financial crisis,

remain off the balance sheet and are not recognized in earnings until the obligations come due or other regulatory actions compel such recognition. The FASB and IASB have important agenda projects in most of these areas and we would encourage them to move forward expeditiously to close these gaps. In fact, these could help to prevent further crises.

Finally, paragraph 2.2 contains language, extracted from the Framework ED, that we believe should be reconsidered:

*...The buying, producing, selling, and other operations of an entity during a period, as well as changes in fair value and other events that affect its economic resources and the claims to them, often do not coincide with the cash receipts and payments of the period. **Information in financial reports about an entity's resources and claims and changes in resources and claims generally provides a better basis for assessing past performance and future prospects than information solely about the entity's current period cash receipts and payments.*** [Emphasis added]

First, this language is drawn from debates going back more than a half century about whether investors should want or care about cash flow information if they are provided with traditional accrual disclosure in the financial statements. This discussion was largely settled by a series of major company collapses, and the *post mortem* analyses that followed, revealing that only operating cash flow information would have disclosed the perilous conditions of the companies. The analyses further demonstrated that it was extremely difficult to virtually impossible for investors to generate accurate cash flow information from the data they were provided. Managers' optimistic accruals had successfully pulled the curtains over the bad news.

Second, information theory, accompanied by a good bit of academic empirical research, has established that, in general, the time series of the data item itself is its own best predictor. Other information may be useful, but only to the extent that the secondary information *accurately reflects and leads the underlying drivers of the data series of interest*. Put differently, accruals (managers' estimates) of changes in accounts receivable will be useful in predicting future collections on receivables and sales to the extent that they reflect in an accurate and unbiased way the revenue and cash collection drivers relevant to the company's operations.

So, while we would certainly agree that accrual information can be and frequently is a very useful complementary source of information on future cash flows, we would not agree that accruals “provide a **better basis** for assessing past performance and future prospects than information solely about the entity’s current period cash receipts and payments.”

2. *Would the separation of business activities from financing activities provide information that is more decision useful than that provided in the financial statement formats used today (see paragraph 2.19)? Why or why not?*

The DP states in paragraph 2.19:

*An entity should present information about **the way it creates value (its business activities)** separately from information **about the way it funds or finances those business activities (its financing activities)**. [Emphasis added]*

- a. *An entity should further separate information about its business activities by presenting information about its operating activities separately from information about its investing activities. (See paragraphs 2.31-2.33.)*
- b. *An entity should present information about the financing of its business activities separately depending on the source of that financing. Specifically, information about nonowner sources of finance (and related changes) should be presented separately from owner sources of finance and related changes. (See paragraphs 2.34-2.36.)*

The DP further elaborates:

*Business activities are those conducted with the intention of creating value, such as producing goods or providing services. The business section normally would include assets and liabilities that are related to transactions with customers, suppliers, and employees (**in their capacities as such**) because such transactions usually relate directly to an entity’s value-creating activities. [Paragraph 2.31] [Emphasis added.]*

We agree that assets and liabilities and changes in those items **deriving from fundamentally different economic activities and driven by different economic factors** should be clearly separated in the financial statements. This will enable investors and other users to better evaluate the risks and returns of the differing items and their implications for the company's financial position and performance.

Specifically, we agree that core business or value-creating activities should be separated from financing or funding activities. The question, of course, is how to provide a meaningful and justifiable separation between the two, given that many of the world's largest internationally diversified companies routinely engage in financing activities with their own suppliers or customers as a mutually beneficial way to develop and cement strong business relationships with a major supplier or customer. In fact, some Dow Jones and similar size companies receive a preponderance of their funding in this manner. The difficulty is that typically the terms are less than arms-length, favorable to the borrower, and represent an integral part of the basic business supplier/customer relationship. An example is the extension by a supplier of exceedingly long payment terms on a major customer's receivables (compared to those provided to other customers), for example, six months or an operating cycle or more for otherwise ordinary accounts. So, it is not clear to us how the phrase in the quote above, "customers, suppliers, and employees (**in their capacities as such**)," is intended to be or can be defined. The relationship is much more complex than most principles and intermediate accounting texts would suggest.

This problem is not clearly addressed in the DP although some discussion may allude to it. We would propose that **to provide a more economically meaningful separation between business and financing activities that the Board might consider restricting the financing category to those funding transactions that involve no other material supplier or customer relationship, e.g., issuance of bonds, notes, or commercial paper in the public markets.** The latter are more likely to be transacted on an arms-length basis on market terms and not be as susceptible to modification or dependence on core business activities and relationships.

3. *Should equity be presented as a section separate from the financing section or should it be included as a category in the financing section (see paragraphs 2.19(b), 2.36, and 2.52-2.55)? Why or why not?*

We believe that equity should be presented as a separate section, and should be restricted to common shares outstanding, treasury stock, and retained earnings. The common shareowners, the actual owners of the company who hold the last residual interest in the net assets, and whose investments are exposed to **all** of the risks assumed by the company's operations, investing activities, and financing decisions, must have a clear, complete, accurate and up-to-date picture of the effects of these activities on their investments in the company.

The importance of this was made abundantly clear just weeks ago when one of the largest financial institutions on the globe announced with some fanfare that its first quarter 2009 earnings would be \$1.6 billion, the first positive performance in five quarters. The market responded positively to the news until investors and analysts had an opportunity to peruse the earnings release. They discovered, to their considerable disappointment, that the earnings actually available to the common shareowners was a **loss** of \$966 million, or a decline from the announced earnings of roughly \$2.5 billion. The difference was explained by various charges related to the company's increasingly complex capital structure, including more than \$1.2 billion for preferred stock dividends, \$50 million for the amortization of TARP warrants discount, and a contractually required \$1.3 billion reset of the price of convertible preferred stock issued in January 2008. The market price of the company's stock declined as shareowners registered their disappointment at the expanded news.

As this and other recent examples make clear, it is essential that the common equity owners, the ultimate owners of the company, have a clear reporting of the effects of both balance sheet and income statement changes on their residual interest in the company. This argues as well for an entirely separate section for common equity with all types of preferred shares, warrants, options, and other instruments that have claims senior to those of the common equity reported in the separate financing section.³

Thus, we agree with the Boards' conclusion that equity should be reported in a separate section. We also believe that the project presents an opportune time to narrow the concept of equity to include only common equity, treasury shares and retained earnings. That is, the information reported in this section should not be distorted or otherwise obscured by including instruments with senior claims against the net assets of the company. From the perspective of the common

³ To clarify, employee stock options would be expensed in the operating section, and the obligation for the compensation also would be recorded in the operating section until exercised.

shareholder, the most junior member of the capital structure, all of these senior claims are essentially liabilities.

4. *In the proposed presentation model, an entity would present its **discontinued operations** in a separate section (see paragraphs 2.20, 2.37, and 2.71-2.73). Does this presentation provide decision-useful information? Instead of presenting this information in a separate section, should an entity present information about its discontinued operations in the relevant categories (operating, investing, financing assets, and financing liabilities)? Why or why not?*

We believe that presentation of discontinued operations in a single separate section that maintains the business (operating and investing) and financing categories of the financial statements will provide decision-useful information. By segregating this information from that related to continuing operations, investors and other users will be better able to assess the company's future prospects, exclusive of the discontinued elements, and the prospective risks and returns associated with those prospects.

By maintaining the operating, investing and financing categories, investors will be able to evaluate the effects of divestiture or disposal on the major categories of activities, the company's continuing value creation and cash flow generation, its investments for the future, and its capital structure.

5. *The proposed presentation model relies on a management approach to classification of assets and liabilities and the related changes in those items in the sections and categories in order to reflect the way an item is used within the entity or its reportable segment (see paragraphs 2.27, 2.34, and 2.39-2.41).*
- a. *Would a management approach provide the most useful view of an entity to users of its financial statements?*
- b. *Would the potential for reduced comparability of financial statements resulting from a management approach to classification outweigh the benefits of that approach? Why or why not?*

We do not agree that a “management approach” would provide the most useful view of an entity. We would agree that the potential for reduced comparability of financial statements resulting from a management

approach to classification would outweigh the benefits of that approach. However, as we will explain, our primary concern with the elevation of the “management view” construct as a formal element of the proposed financial reporting model is the inherent unbounded subjectivity of the concept, and the lack of any economic underpinnings or other rigorous criteria to restrain the generous interpretation of the concept (and changes in the interpretation) from period to period. Thus, we believe that much of the potential improvement to transparency that the DP model promises could be undone or even overwhelmed by the introduction of this undefined and unobservable construct

At first glance, the “management approach to classification of assets and liabilities and the related changes in those items in the sections and categories in order to reflect the way an item is used within the entity or its reportable segment” would appear to be an appealing construct. It seemingly promises the potential to provide valuable information about economically distinct aspects of the activities of a diversified global company. We are aware of some cases where such a promise is sometimes fulfilled in a meaningful way, e.g., where the classifications are determined by operations with similar or identical economic drivers, or by unrelated customer groups, or other attributes, and which are characterized by widely differing risk exposures and returns profiles. A large diversified pharmaceutical that classifies its operations into consumer products, pharmaceuticals, and medical devices divisions comes immediately to mind.

However, we know of many other companies whose sections and categories are unstable and inconsistent over time, appear not to be based on any clearly discernible economic drivers, and are apparently a product of the experience, interests, or even desired lifestyle of a particular manager at a particular time rather than any essential characteristic of the business or the underlying economics driving the value creation in the business. Thus, we are somewhat skeptical about the broad operationality and potential usefulness of this distinction. We also recognize, as does the question itself and the related discussion, that with many companies, consistency as well as comparability will suffer.

The discussion suggests that a policy statement would be required in the accounting policies section of the notes. We question the usefulness of such disclosures. Accounting policy statements usually comprise simple declarative statements, e.g., “The company depreciates long-lived assets using any of the declining balance, sum-of-the-years’-digits or straight-line methods over a period of five to fifty years.” Were managers to be required to provide a separate full discussion in the notes of the judgments made by managers and their auditors, the

characteristics that have caused managers to decide to organize the business along certain lines, the economic drivers underlying the separate divisions, and how these judgments lead to differing risk and return profiles that will be reflected in the reporting of financial position, income and cash flows, then investors and other users may realize a positive benefit from the reporting and disclosure. As experience has shown, mandating full disclosure and realizing it in practice are rather different matters.

If such full discussion and disclosure were not to be required and effectively enforced by the regulatory authorities, then we are concerned that “management approach” based reporting may elevate an otherwise unobservable and unauditible construct, i.e., an accounting fiction like “management intent,” to a position that is unwarranted in the financial reporting hierarchy and provide little if any useful information. We will discuss our concerns further in question 6.

Finally, a thorough critical reading of the DP makes clear that the addition of “management approach” as a characteristic not only adds inconsistency and lack of comparability to the proposed model **but also is responsible for a substantial increase in the ambiguity and complexity of the proposed model itself.** We certainly do not want bright lines and we are not proposing any, but a surprisingly large proportion of the text is devoted solely to discussing potential problems and issues that arise from the introduction of the concept.

We also note that in a number of places, the DP states that the Boards have not themselves resolved an issue that arises because of the introduction of the concept. In other words, the Boards’ own decision-making has foundered as a result of the ambiguity and complexity introduced by the concept that also concern us. Thus, we would recommend that the concept be set aside, for now, and that attention be given to structuring clearer guidance for the separate sections, such as we propose in question 6 regarding the distinction between business and financing assets and liabilities.

6. *Paragraph 2.27 proposes that both assets and liabilities should be presented in the business section and in the financing section of the statement of financial position. Would this change in presentation coupled with the separation of business and financing activities in the statements of comprehensive income and cash flows make it easier for users to calculate some key financial ratios for an entity’s business activities or its financing activities? Why or why not?*

Please see our response to question 2. We agree that both assets and liabilities associated with business activities should be presented in the business section, and similar presentation should be required in the financing section. This will better enable investors and other users to assess the risks, returns, claims and other obligations associated with the various activities within a company.

This discussion on this topic refers repeatedly to the “management view” or “management approach” construct as a distinguishing criterion for determining how items should be classified within sections and across sections in the financial statements. We have commented on our concerns with this approach in question 5.

However, we note in paragraph 2.31 the following discussion:

*The business section should include assets and liabilities that management views as part of its continuing business activities and changes in those assets and liabilities. **Business activities are those conducted with the intention of creating value, such as producing goods or providing services. The business section normally would include assets and liabilities that are related to transactions with customers, suppliers, and employees (in their capacities as such) because such transactions usually related directly to an entity’s value-creating activities.*** [Emphasis added.]

Given our comments in question 5, we believe that the “management view” addition adds little if anything to the discussion and opens the door to inconsistency, lack of comparability, and confusion. Such a perspective may belong in the footnote disclosures and discussion but not in the primary financial statements. We **do** strongly agree with the quote that we’ve highlighted in the paragraph above, that the business activities are those intended to create value and would normally be associated with transactions with customers, suppliers, and employees. Put differently, we believe that the highlighted section is a sufficient criterion for the business section.

If this approach were to be adopted, it would naturally follow that receivables from customers would be shown as business assets, and any financing extended to the company **by** the customer, e.g., advances, construction loans, etc., would be presented as business liabilities. Similar treatment would be accorded to transactions with suppliers; for example both leased assets and the related obligations should be shown as operating items. With employees, both current and future compensation and benefits would be presented in this section. So,

receivables from employees would be recorded as assets, and obligations for compensation as well as postretirement and pension benefits would be treated as business liabilities. Such treatment would provide investors with a more comprehensive view of the entire value creation process, both benefits and costs.

We also strongly believe that managers should not have the flexibility to classify liabilities and other obligations associated with these primary business operations and investing activities outside of the business category, i.e., in the financing section. For example, the risks and potential losses from securitizations of receivables created or purchased by the company should not be separated from the primary operating and investing activities that gave rise to them. This further explains why we believe the financing section should be reserved for those capital sourcing and funding activities **other than those associated with customers, suppliers and employees.**

Note: We will discuss questions 7 and 8 jointly.

7. *Paragraphs 2.27, 2.76, and 2.77 discuss classification of assets and liabilities by entities that have **more than one reportable segment** for segment reporting purposes. Should those entities classify assets and liabilities (and related changes) at the reportable segment level as proposed instead of at the entity level? Please explain.*
8. *The proposed presentation model introduces sections and categories in the statements of financial position, comprehensive income, and cash flows. As discussed in paragraph 1.21(c), the Boards will need to consider making **consequential amendments to existing segment disclosure requirements** as a result of the proposed classification scheme. For example, the Boards may need to clarify which assets should be disclosed by segment: only total assets as required today or assets for each section or category within a section. What, if any, changes in segment disclosures should the Boards consider to make segment information more useful in light of the proposed presentation model? Please explain.*

Subject to the caveats above regarding the management view or management approach to classification, we believe that if economically meaningful segment disclosure is provided then the most useful financial statement presentation would be to require the business (operating and investing) and financing sections for the segments. This would better enable investors and other users to assess the relative value creating activities of each of the economic units and to evaluate how each contributes to the whole. For example, in the pharmaceutical example cited in our

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response to question 5, a careful analysis of the economic segment data reveals that although the consumer products segment has much lower returns than either the pharmaceutical or medical device units, it also is much less risky and development capital intensive, relying on a valuable portfolio of long-term established brands. Hence, despite the lower returns, the segment is a valuable contributor to the value creating activities of the whole as a result of its relatively low risk as well as its reliable cash flow, reducing the overall company's leverage and dependence on outside funding. This lower risk capital structure helps to offset the inherently high R&D and product liability risks in the other two divisions.

In this regard, we believe that segment disclosures, both business and financing, need to be reconciled to the corresponding line items on the face of the financial statements. This would enable investors to better understand corporate performance within an industry of a market segment.

9. *Are the **business section** and the **operating and investing categories** within that section defined appropriately (see paragraphs 2.31-2.33 and 2.63-2.67)? Why or why not?*

We support the separation of operating and investing categories within the business section and we agree with the discussion in paragraph 2.32:

An entity uses its operating assets and liabilities in its primary revenue- and expense-generating activities.

Passing on the reference to "management views" paragraph 2.33 further clarifies:

An entity may use its investing assets and liabilities to generate a return in the form of interest, dividends, or increased market prices but does not use them in its primary revenue- and expense-generating activities.

We believe that an example of such an investing asset would be excess cash that an automobile and truck manufacturer temporarily invests in liquid income producing financial assets until it is time for the company to liquidate the assets and retool its operations for the next model year's production runs.

We would be concerned, however, if we found that managers chose to transfer receivables arising from their primary operations into the investing section. This

pattern has been observed in the cash flow statement in the past, especially when the growth of receivables substantially outstripped the collections and the company was descending into a period of financial distress. The generation of receivables is a normal and recurring part of the basic operations of many businesses, is part of the normal relationship with customers, and thus, we believe that such transactions should remain in the operating section.

The purchase of land as an investment that is not currently used in the primary operations would also seem a suitable candidate for the investing section. However, land used for primary manufacturing or customer service functions should be better classified as an operating asset.

10. *Are the **financing section** and the **financing assets and financing liabilities categories** within that section defined appropriately (see paragraphs 2.34 and 2.56-2.62)? Should the financing section be restricted to financial assets and financial liabilities as defined in IFRSs and U.S. GAAP as proposed? Why or why not?*

We would generally concur with this proposition. As we have discussed, previously in question 2, we believe that those financial assets and liabilities arising from operating activities, i.e., transactions with customers, suppliers and employees, should be presented in the operating section. The terms of such transactions are likely to be influenced as much by the relationships between the company and its constituents as by more general market conditions.

Those financial assets and liabilities that arise from transactions not involving other business relationships, i.e., those *other than* with customers, suppliers, and employees, and that reflect more general market terms and conditions should be classified as financing assets and liabilities. Thus, we concur broadly with the propositions in paragraph 2.62 regarding the proscription of non-financial assets and liabilities from the financing category and generally agree with the proposal that only financial assets and liabilities as defined in IFRS should be admitted to the category.

Chapter 3: Implications of the Objectives and Principles for Each Financial Statement

11. *Paragraph 3.2 proposes that an entity should present a classified statement of financial position (short-term and long-term subcategories for assets and*

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liabilities) except when a presentation of assets and liabilities in order of liquidity provides information that is more relevant.

- a. *What types of entities would you expect **not** to present a classified statement of financial position? Why?*
- b. *Should there be more guidance for distinguishing which entities should present a **statement of financial position in order of liquidity**? If so, what additional guidance is needed?*

We generally agree with the Boards' decision to change the formal definition of short-term from one cash-to-cash operating cycle to those assets and liabilities for which the shorter of (a) the contractual maturities or (b) expected realization or settlement is one year or less. If, however, the "expected realization or settlement" assessment is based on managers beliefs about what will likely occur, then objective (market) evidence should be required to be provided in support of the proposition.

Classification in the financial statements by short- and long-term categories *based upon maturity* has a long and venerable history, and retains substantial merit today. The concept was inherent in the accounting model developed for the manufacturing, mercantile and trading businesses that largely dominated commerce until the twentieth century. However, we believe it is useful to consider whether the short- vs. long-term distinction is a sufficient criterion in today's markets when various types of structured finance are routinely employed by all but the smallest of companies and are a fundamental characteristic of the operations of the companies that comprise the largest part of the market capitalization of the global markets.

As we recently have been reminded somewhat painfully, the terms "short-term" and "liquid" are not necessarily equivalent or even coincident. Indeed, many "short-term" assets and liabilities were shown to possess substantial liquidity risk that only came to light when valuation and other market pricing pressures began to surface in the current crisis. Thus, we believe that the Boards and staff are correct to consider the advisability of the introduction of liquidity as a classification criterion. We believe that it should be used regardless of the type of firm, i.e., for manufacturing, mercantile and trading, as well as financial institutions. We would note at this juncture that relatively early on in the current crisis as the nature and depth of the global problems were surfacing, some of those members of trans-national oversight bodies responsible for global market

and financial stability publicly proposed that more attention be given to the analysis and reporting of liquidity risks embedded in assets and liabilities of financial institutions.

However, as is well understood, the operations of most if not all of the largest companies, e.g., General Motors and General Electric, are driven as much or more by their own financial operations as they are by their manufacturing activities. Thus, a liquidity criterion would seem to be as appropriate for them as for any traditional financial institution.

As a practical matter, for those firms with little or no complex or structured finance, the concepts are likely to converge, presenting few if any new challenges to the financial managers of the companies who are responsible for financial reporting. Thus, we would encourage the Boards to require that statements of financial position be ordered and classified by order of liquidity.

12. *Paragraph 3.14 proposes that **cash equivalents** should be presented and classified in a manner similar to other short-term investments, not as part of cash. Do you agree? Why or why not?*

We agree that cash equivalents should be presented and classified in a manner similar to other short-term investments, and not as part of cash. One of the more disturbing revelations to emerge from the current crisis is that many structured instruments were marketed as cash equivalents when in fact they possessed substantial but undisclosed liquidity risk, a matter we've touched on above. Thus, at a minimum, we believe that cash should be separated from all non-cash instruments. Such a separation would be consistent with a classification by liquidity for all reporting companies.

13. *Paragraph 3.19 proposes that an entity should present its similar **assets and liabilities that are measured on different bases** on separate lines in the statement of financial position. Would this disaggregation provide information that is more decision useful than a presentation that permits line items to include similar assets and liabilities measured on different bases? Why or why not?*

We agree that similar assets and liabilities that are measured on different bases should be presented on separate lines in the statement of financial position. The DP model proposes many highly beneficial changes, but this one is among a

handful of the most important proposals and we commend the Boards and staff for bringing it forward.

As part of their assessments of the financial statements issued by companies, and the quality of the information reported therein, investors and other capital providers must evaluate the measurement of reported items, and the objectivity and reliability of that measurement. Based upon these assessments, investors will typically employ different multipliers to items measured using different measurement methods, e.g., (amortized) historic cost, manager estimates, and market-derived (fair value) measures. It is reasonable to assume that investors would apply the highest (positive or negative) valuation multiplier to those items measured with the highest degree of objectivity and least bias. In contrast, the greater the subjectivity and/or bias associated with a particular measure, the greater the degree of skepticism an investor would likely have for the measure reflecting the assessed greater likelihood of unpleasant surprises later.

Put simply, this proposal will, if enacted, bring much greater transparency to the measurement processes impounded in the financial statements and the quality of the information to be found in the statements.

A particular benefit of this proposal is that it will reduce the overall complexity of financial reporting by eliminating the need for many of the voluminous schedules and note disclosures, disclosures which are likely to increase substantially in the future in the absence of such reporting. Instead, the note disclosures could be devoted to methods used to prepare the various measures.

14. *Should an entity present comprehensive income and its components in a **single statement of comprehensive income** as proposed (see paragraphs 3.24-3.33)? Why or why not? If not, how should they be presented?*

Yes, we agree with the Boards that **all** revenues and expenses, gains and losses, i.e., components of comprehensive income should be presented in a **single** statement of comprehensive income. Allowing preparers to sequester certain inconvenient gains and losses outside of the primary income (profit and loss) statement, and outside of the primary focus of investors, thus requiring them to search the notes for core earnings information, resulted from political compromise rather than objective, high quality accounting principles or sound economic logic. The time has come for such obscuring of important information to end.

We also agree with the Boards' conclusions:

...[A] single statement of comprehensive income will improve the comparability of financial statements because all entities will present the components of comprehensive income in a similar manner in the same financial statement. [paragraph 3.29]

All items of other comprehensive income should be presented in the same manner as all other nonowner changes in assets and liabilities. In other words, the existing requirements to recognize and present other comprehensive income items outside profit or loss or net income should be eliminated as well as the need to reclassify those items subsequently into profit or loss or net income. [paragraph 3.32a] [Emphasis added]

Above all, no items should be permitted to circumvent net income (profit and loss) and permanently remain in other comprehensive income (OCI), as has been occasionally proposed.

In this regard, we would observe that OCI has neither a conceptual definition nor a compelling economic rationale. Rather, it has arisen from a series of standard setting compromises, and served as an out-of-earnings receptacle for items that encountered opposition in either recognition or measurement. However, as a means of easing forward improved financial reporting standards we believe it has long outlived its usefulness and should be eliminated as expeditiously as possible, ideally with this project.

The method of addressing the OCI items is not challenging: It simply requires that the items in OCI be reclassified into the relevant and related sections of the income statement. It is a presentation issue, not a recognition or measurement question.

Above all, we believe that no new items should be classified in this section. Those assets, liabilities, or adjustments to accounts that have been contentious in the past such as market gains and losses on securities, will in the new FSP model be separated into distinct columns. This should alleviate the concerns of some that investors and other users may not be able to adequately assess the items if they are mixed with items measured on other bases.

15. *Paragraph 3.25 proposes that an entity should indicate the category to which items of **other comprehensive income** relate (except some foreign currency*

translation adjustments) (see paragraphs 3.37-3.41). Would that information be decision useful? Why or why not?

Yes, we believe that this will assist investors and other capital providers to make needed adjustments more quickly and efficiently. That is, until such time as OCI elements are eliminated and required to be presented in net income with related items, this information will assist investors in reclassifying the items.

16. *Paragraphs 3.42-3.48 propose that an entity should further **disaggregate** within each section and category in the statement of comprehensive income its revenues, expenses, gains, and losses **by their function, by their nature, or both** if doing so will enhance the usefulness of the information in predicting the entity's future cash flows. Would this level of disaggregation provide information that is decision useful to users in their capacity as capital providers? Why or why not?*

We believe that **disaggregation by nature** provides the most relevant information for financial decision-making. As the DP itself recognizes, disaggregation by nature better reflects the economic drivers and provides information investors need to evaluate risks and trends and to better assess the amounts, timing, and riskiness of a company's future cash flows.

It is worth noting that the statement of financial position has historically been organized largely by liquidity or maturity, and within those categories, by the nature of the item, e.g., by cash, marketable securities, receivables, inventories, etc. This notion is still retained to a degree in the income (profit and loss) statements of some jurisdictions. The distinction was lost when extreme degrees of aggregation of information in the income statement, accompanied by a loss of much of the information content in the aggregation process, became the unfortunate norm in **external** financial reporting. So, in a sense, the proposal to disaggregate items by nature would simply restore information lost in transition from general ledger to the income statement.

Unfortunately, it is not at all clear from the DP what sort of information investors could expect to receive because the decision of whether or not to present information by (1) function, (2) nature, (3) both, or (4) neither is left as an exercise for managers and would be at their full discretion. That is, managers would be permitted to decide "*if [disaggregating] will enhance the usefulness of the information in predicting the entity's future cash flows.*" Given that not all managers regard full and complete transparency for investors as a basic necessity of their fiduciary responsibility to capital providers, we doubt that presentation of

items within the statements will necessarily change much if at all as a result of this proposal. Thus, **the vagueness in reporting requirements would not only work at cross-purposes with cohesiveness, the core goal put forward in this DP for improving our antiquated financial reporting model, and likely defeat the second goal, disaggregation, but it is unlikely that either would be routinely achieved in practice if it is observed at all.**

We believe it is essential if this DP is to provide a basis for meaningful improvement to financial reporting that, at a minimum, information should be required to be presented in the financial statements by nature. In addition, if managers desire to do so, items may be clustered by functional categories if the categories provide meaningful information, e.g., cost of goods sold in a mercantile company. As we have stated on other occasions, we believe that for functional disclosure to be economically meaningful, it should be provided by economic segments, such as we have discussed above. For example, in the pharmaceutical example we have used, cost of goods sold aggregated across the segments, which have widely varying margins and totally different economic drivers, would be of very little use. However, providing such categories within segment disclosures would be helpful.

Finally, we would note that in the DP discussion regarding development of the proposed direct method cash flow statement (paragraphs 3.78 (a,b,c), 3.79, and 3.80) it will be essential to have information disaggregated by nature to construct such a meaningful statement. That is, cash receipts and payments will provide useful information to investors only if it is disaggregated by nature of the items, which we believe is the clear intent of the Boards. Similarly, for the proposed Reconciliation Schedule (paragraphs 4.19 ff) to provide useful information, it must be organized by nature of item, although we would not object to clustering of such items by function.

17. *Paragraph 3.55 proposes that an entity should allocate and present **income taxes** within the statement of comprehensive income in accordance with existing requirements (see paragraphs 3.56-3.62). To which sections and categories, if any, should an entity allocate income taxes in order to provide information that is decision useful to users? Please explain.*

We do not believe that intraperiod tax allocation will provide useful information to users of the financial statements. Although schedules of income taxes, both payable and deferred, are initially built up from individual line items and their tax effects, complexities of the tax codes mean that top level adjustments to the

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aggregate taxes render the final tax total a less than meaningful number at the operating, investing, and financing level. That is, to reallocate the total tax to the individual sections, highly arbitrary decisions regarding the allocation must be made. Therefore, in general, we do not believe that useful information can be obtained by investors from the necessarily arbitrary allocation that would be required to “attribute” portions of the total to individual sections in the financial statements.

Consequently, we would prefer to see a single line item for taxes, supported by a sufficiently detailed schedule in the notes to permit investors to evaluate the various components of the reported taxes and their implications for the future taxes of the company. That said, in the case of discontinued operations by definition recognition of such items requires that the accounts of the items be separable from those of the continuing operations of the parent. Thus, if such is indeed the case, we would not object to continuing this disclosure of separate tax information.

18. *Paragraph 3.63 proposes that an entity should present **foreign currency transaction gains and losses**, including the components of any net gain or loss arising on remeasurement into its functional currency, in the same section and category as the assets and liabilities that gave rise to the gains or losses.*
- a. *Would this provide decision-useful information to users in their capacity as capital providers? Please explain why or why not and discuss any alternative methods of presenting this information.*
 - b. *What costs should the Boards consider related to presenting the components of net foreign currency transaction gains or losses for presentation in different sections and categories?*

We agree that companies should present foreign currency **transaction** gains and losses in the same section and category as the assets and liabilities that gave rise to them. Foreign currency transaction gains and losses represent a major risk exposure for many large, internationally diversified companies and investors must be able to assess the effects of these exposures on a company’s operating, investing, and financing activities, including the extent and effects of any hedging activities.

19. *Paragraph 3.75 proposes that an entity should use a **direct method of presenting cash flows** in the statement of cash flows.*
- a. *Would a direct method of presenting operating cash flows provide information that is decision useful?*
 - b. *Is a direct method more consistent with the proposed cohesiveness and disaggregation objectives (see paragraphs 3.75-3.80) than an indirect method? Why or why not?*
 - c. *Would the information currently provided using an indirect method to present operating cash flows be provided in the proposed reconciliation schedule (see paragraphs 4.19 and 4.45)? Why or why not?*

We strongly support the required use of a direct method cash flow statement. Although both U.S. GAAP and IFRS allow the use of either the direct or the indirect method, the overwhelming choice of reporting companies has been the indirect method, which provides **no actual cash flow information within the operating section, the single most important section of the cash flow statement**. In fairness, we must observe that a handful of U.S. companies to their merit have voluntarily chosen to produce a direct method cash flow statement.⁴

The indirect method for the operating section is not really a cash flow statement at all. Rather it is a centuries-old approximation method used by those, largely investors, without access to detailed general ledger information, but who needed to approximate or estimate a single total cash flow number, “operating cash flow,” as a part of their evaluations. Because of its historical widespread use and familiarity, it managed to be carried forward as an acceptable approach when a required cash flow statement was first adopted. In an excellent discussion, the DP recognizes the major infirmities of this approach explicitly:

...Thus, the details presented in the statement of cash flows when an indirect method is used consist of noncash operating items included in profit or loss or net income rather than operating cash receipts or payments. [paragraph 3.76]

That description of an indirect method of presenting net operating cash flows indicates its major deficiency: it derives the net cash

⁴ We would also observe that a majority of public companies in Australia currently provide a direct method statement, although the method of developing the statement varies from that envisioned in this DP.

*flow from operating activities without separately presenting any of the operating cash receipts and payments. **The effect is much the same as if the income statement began with the change in shareholders' equity for the period and then reversed any changes in equity that did not affect profit or loss or net income (for example, dividend payments and share issues or repurchases) to derive profit or loss or net income. That sort of indirect income statement presentation would not provide the relative amounts of classes of income and expenses that investors, lenders, and other creditors find helpful in making decisions in their capacity as capital providers. Many users have said that they attempt to construct a direct method cash flow statement from other information available in the financial statements.*** [Emphasis added] [paragraph 3.77]

We could not have said it better and **strongly commend** the Boards for their analysis of the issues and forthright statements about the importance of this specific proposal. Indeed, we believe it to be a bedrock component of the proposed financial reporting model for today's complex business organization. Paragraphs 3.78-3.80 provide arguments for why the direct method cash flow statement is essential to achieve the cohesiveness, disaggregation, liquidity and flexibility reporting goals of the proposed financial statement presentation model and we concur fully with the observations there.

We must clarify, however, that when we refer to such a statement, we do not mean the highly aggregated and summarized statement with approximately five line items that we typically receive from the companies that currently provide them. Highly summarized information is of limited analytical value. Rather, the type of statement we are requesting would provide disaggregated information with sufficient detail that it could form the cash flow statement column in a balance-sheet-to-balance-sheet reconciliation.

Our position is based on the fundamental principal of cohesiveness, upon which this DP explicitly relies as a core objective, and with which we strongly concur. It is very common for investors conducting financial analyses to reach analytical dead ends. They may believe that they understand the effect of a particular line item on one statement, but find that it is difficult or impossible to trace that effect through the other primary financial statements. Such disjoint presentation is common for even the most highly material items. As a result, investors must try to overcome the inadequacies by extending their analyses, efforts that are inefficient of investor time and resources, unnecessary, and very costly. If these

efforts fail, the only alternative is to attempt to estimate the missing information using whatever limited disclosure is provided, an error-prone exercise subject to substantial modeling risk. These risks inevitably result in lower-quality forecasts. Lower-quality forecasts lead to poor investment decisions, misallocation of capital and a greater probability of wealth destruction. We have seen the effects of a lack of transparency in the current crisis. When the risks are sufficiently high, investors will choose to increase the cost of capital, perhaps prohibitively. This state of affairs serves no one well, not companies and their business constituents, nor their managers or their investors.

The proposed new Reconciliation will provide information that is far superior to that currently provided in the indirect method cash flow statement because the reconciling items will be directly linked to the assets and liabilities that gave rise to the adjustments. Therefore, we believe that the proposed changes, direct method cash flow statement **combined with** a full reconciliation schedule will provide much greater transparency, i.e., clarity, completeness, and understandability in external financial reporting.

Finally, as we have indicated, we must emphasize that our position on the direct method cash flow statement is solidly linked to our position on balance-sheet-to-balance-sheet reconciliation. Both Boards have indicated that they wish to understand what level of detail in a direct method cash flow statement would best satisfy investors' needs. Supporters of the balance-sheet-to-balance-sheet reconciliation hold a principles-based position on this issue. If company activity is material enough to justify disclosure in any one of the financial statements, it is material enough to require disaggregation across all the statements embedded in the balance-sheet-to-balance-sheet reconciliation.

20. *What costs should the Boards consider related to using a direct method to present operating cash flows (see paragraphs 3.81-3.83)? Please distinguish between one-off or one-time implementation costs and ongoing application costs. How might those costs be reduced without reducing the benefits of presenting operating cash receipts and payments?*

Investors will answer readily that the relevant costs to consider are those borne by investors who need but do not have direct method cash flow information provided by companies, must expend substantial time and effort to try to generate it from the very limited information available to them, and who at the end of the exercise are invariably disappointed to find that major pieces of information needed to

generate the cash flow items are not available at all, resulting in highly material estimation error.

For preparers, the answer to the question will depend directly upon the extent to which their companies have continuously reviewed, updated and modernized their general and subsidiary ledger and related record-keeping systems to keep apace with developments and improvements in software, hardware, banking, and cash management systems. Some of these companies will maintain that they don't manage or monitor cash receipts and payments (which raises a serious question in investors' minds about their efforts to effectively maximize cash, a nonearning asset), but the fact is that they can't with their antiquated systems. One cannot automatically assume that even a very large company in a high-tech industry will have modernized its own internal financial reporting, control, and cash management systems.

Again, the DP explicitly recognizes this sad state of affairs:

...An indirect method may have seemed the obvious choice when IAS 7 and Statement No. 95 were first adopted because entities were familiar with that method and it could be implemented using information easily available from an entity's accounting system. Many entities told the Boards that their accounting systems do not collect information about gross operating cash receipts and payments and that it could be expensive to modify their systems to do that.

Because a large, internationally diversified company operating in the 21st century prefers to rely on 19th century methods developed when ledgers and records were maintained in pen-and-ink, and the accounting was designed to minimize human recording, accrual estimation and other computational effort, cannot be a satisfactory reason for objecting to updating their systems and adopting currently available technologies to provide the information that will better serve both managers and their capital providers. The tradeoff in the 19th century as well as now is reduced human effort at the cost of high quality, up-to-date information. A global company would be prudent to have its financial reporting capabilities keep pace with the growing complexity of the business rather than striving to maintain the status quo most notably in the reporting and monitoring of cash flows. A failure to modernize has immediate implications for the quality of managers' decision-making as well as their control and management of risk exposures. We would repeat an earlier observation at this juncture that a major contributing factor identified by regulators who have examined the causes of the

current financial crisis is outdated, incomplete or irrelevant financial reporting and risk management systems.

So, for companies that have failed to modernize, we can expect substantial one time costs as they bring their systems up to 20th century standards, possibly even 21st century ones. The good news is that many mid-sized, even small companies may have minimal costs of implementation because their high and sustained growth rates have required them to update and modernize frequently to effectively manage their operations. However, in the end, it is the enormous benefits investors will derive from having the information that should drive the Boards' decision on this critical issue.

We strongly object to the proposition some have put forward that because many companies' financial reporting systems are out-of-date and cannot directly produce cash flow information, that they should be permitted to approximate the information, i.e., indirectly estimate the cash flows, using extant general ledger line items for, for example, revenues, receivables, and the like. Given the state of these companies' information collection and reporting systems, and their claims that they do not collect or use cash flow information in managing their operations, investors would be able to place no faith whatsoever in the reliability or representational faithfulness of the numbers. Indeed, the accounts they would need to make the estimations are likely to be rife with estimates, guesses, and other approximations, which is one among many of the reasons that investors require cash flow information: as a check on the quality of the reported income statement information. So, this suggestion should be rejected on its face.

Some large companies with extensive international operations have argued that direct cash flow statements cannot be prepared in a meaningful manner. We discount these claims. Part of the problem is that many companies have chosen to create their cash flow statements at the end of the financial statement consolidation process, an expedient response to the issuance of SFAS No. 95 in the U.S., and more recently IAS No. 7 for those countries that have adopted IFRS. In these cases, the problem can be addressed effectively and efficiently if companies prepare direct method cash flow statements at the subsidiary level prior to consolidation. An obvious benefit resulting from this relatively minor change is that companies would begin to treat cash flow statements with the same level of importance as the balance sheets and income statements. Further, this would address many of the complications, including audit challenges, related to foreign currency translation.

In the end, investors both supply the capital that funds companies' operations and pay for any improvements in financial systems. While we will likely incur some costs across our investment portfolios if such improvements are made, we do not believe that the costs will be material in most cases, and a large portion will be one-time implementation costs that investors tend to accept. In any event, investors will balance any costs they must bear for individual company accounting system updates against the savings all investors in the aggregate will realize. These savings will result from reduced analytical time and effort, elimination of cash flow estimation errors, investors' enhanced ability to make better, more informed investment decisions, and a lower cost of capital. Finally, if managers, with the benefit of these upgrades are able to make more informed decisions, all investors, managers, employees, customers, and suppliers alike, will benefit.

While savings related to enhanced investor efficiency; better, more timely, and informed decision-making; and value creation by providing companies with lower costs of capital are not as easily quantified as are gross costs related to accounting system upgrades, the intangible nature of many of these benefits should not lead to them being ignored. The reality is that we can only provide theoretical evidence at this point because the high-quality disclosures we are requesting simply do not exist.

21. *On the basis of the discussion in paragraphs 3.88-3.95, should the effects of basket transactions be allocated to the related sections and categories in the statement of comprehensive income and the statement of cash flows to achieve cohesiveness? If not, in which section or category should those effects be presented?*

We agree with the conclusion of the Boards (paragraph 3.89) that the assets and liabilities acquired in a basket transaction should be distributed to the various categories and sections appropriate to the individual assets and liabilities. We also believe that the income and cash flow statement effects of these transactions should be allocated to the relevant sections and categories. As the DP states in paragraph 3.91, this allocation is necessary to achieve the cohesiveness objective, just as it is with the previously discussed foreign exchange transaction gains and loss allocation. In addition, investors should be able to fully evaluate the effects of acquisitions and disposals on a company's operating, investing, and financing activities.

We recognize that this may involve some degree of arbitrary allocation, but the concern in this case is not with continuing material transactions, but with highly material acquisitions or disposals, and thus the effects would be nonrecurring in nature. Sufficient disclosure of the nature of the transactions, the amounts and types of assets and liabilities acquired (or disposed of), and the income statement and cash flow amounts in the notes should mitigate to a degree the adverse or potentially misleading effects of the allocation on capital providers' assessments.

Chapter 4: Notes to Financial Statements

22. *Should an entity that presents assets and liabilities in order of liquidity in its statement of financial position disclose information about the **maturities of its short-term contractual assets and liabilities** in the notes to financial statements as proposed in paragraph 4.7? Should all entities present this information? Why or why not?*

Yes, we believe that schedules of short-and long-term maturities of contractual assets and liabilities will provide useful information for users. This information could complement the liquidity and fair value information by providing insight on the required amounts and timing of cash inflows and should be disclosed in the notes. However, this disclosure cannot substitute for either liquidity or fair value recognition and measurement.

As we have discussed in the section on liquidity organization of the balance sheet, we believe that liquidity information is essential for evaluating the health and risk exposures of a company, and for enabling investors to assess a company's ability to generate the resources needed to survive adverse conditions over both the short-and long-term. However, a complete understanding of the contractual maturities of assets and liabilities will provide additional information about the constraints and risks imposed on the company's operations by its contractual commitments. For example, a company with relatively low levels of liquidity, poor cash flow generation from a slowing economy, and substantial short-term maturities of obligations could face dire near-term consequences, as we have seen in the current crisis.

Note: We will respond to questions 23-25 jointly.

23. *Paragraph 4.19 proposes that an entity should 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.

- a. *Would the proposed **reconciliation schedule** increase users' understanding of the amount, timing, and uncertainty of an entity's future cash flows? Why or why not? Please include a discussion of the costs and benefits of providing the reconciliation schedule.*
 - b. *Should changes in assets and liabilities be disaggregated into the components described in paragraph 4.19? Please explain your rationale for any component you would either add or omit.*
 - c. *Is the guidance provided in paragraphs 4.31, 4.41, and 4.44-4.46 clear and sufficient to prepare the reconciliation schedule? If not, please explain how the guidance should be modified.*
24. *Should the Boards address further disaggregation of **changes in fair value** in a future project (see paragraphs 4.42 and 4.43)? Why or why not?*
25. *Should the Boards consider other **alternative reconciliation formats** for disaggregating information in the financial statements, such as the statement of financial position reconciliation and the statement of comprehensive income matrix described in Appendix B, paragraphs B.10-B.22? For example, should entities that primarily manage assets and liabilities rather than cash flows (for example, entities in the financial services industries) be required to use the statement of financial position reconciliation format rather than the proposed format that reconciles cash flows to comprehensive income? Why or why not?*

In our view, the proposed reconciliation schedule represents the single most important improvement to financial reporting in the entire model. Indeed, we believe that with time this “schedule” should move out of the notes and become the primary financial statement for reporting income and cash flows.

The reconciliation single-handedly overcomes numerous problems associated with the current financial reporting model, including but not limited to:

- The current mixed-attribute model that combines changes (transactions, events, accruals) measured on different bases with

widely varying timeliness, subjectivity, and reliability in single line items;

- The lack of information about the reported measures of value creation, thus obscuring understanding of the value creation process itself;
- The lack of sufficient information to assess the ability of the company to convert reported earnings into cash flows;
- The lack of information regarding predominant sources of cash flows and the major claims (consumers) of cash; and
- The lack of information about the economic drivers of the earnings and cash flow generation processes that reporting by nature of the item and type of measurement will provide.

Indeed, many of the problems of which users have complained for decades will be largely resolved with the implementation of this schedule.

That said, and as we have discussed at length above, we would strongly prefer a schedule that reconciles from balance sheet to balance sheet, as described in Appendix B. This should not be difficult to achieve if the items in the schedule are required to be reported by nature, as we argue they should be. We have already observed that the balance sheet is currently organized, in addition to rough short- and long-term categories, largely by nature of the item. The major advantage of a balance-sheet-to-balance-sheet reconciliation is that it provides a much greater degree of transparency and understanding of the changes (flows) affecting all of the items in the financial statements. It also provides a degree of comfort that all items affecting the balance sheet, income statements, and cash flows have been correctly identified and reported.

We believe that conceptually all of the financial statements should be considered to be of equal importance and should be granted equal prominence. The three statements provide different but essential information that must be evaluated as a cohesive whole if the valuation process is to be carried out in a competent manner. By only requiring a reconciliation between cash flows and earnings the DP strongly suggests that balance sheets are somehow not as relevant or as important the other financial statements, and can be safely relegated to secondary status. While we do not believe that this is the intent, nonetheless, we believe that such an implied bias would not serve future standard setting well.

To those who would argue otherwise, we would note that the severe global crisis confronting the world's economies began primarily with and continues principally as a balance sheet problem. A glut of poor quality assets both on- and off-companies' balance sheets have led to the destruction of trillions of dollars of investor capital and triggered governments to take unprecedented actions. We raise this obvious point because severe balance sheet deterioration will inevitably lead to severe income and cash flow deterioration, just as we have seen in the aftermath. If ever there was a time when it was evident that the relationship between all of the primary financial statements needs to be transparently displayed with each statement being given equal prominence, it is now.

Many of us are of the opinion that many of the problems that characterize this crisis potentially could have been avoided (thus preserving trillions of dollars of investor capital) if we had had this superior form of financial presentation before this business cycle began. For example, a balance-sheet-to-balance-sheet reconciliation could have helped reveal the amount of companies' earnings and cash flows associated with off-balance-sheet activities. Analysts could have created ratios of off-balance-sheet earnings and cash flows to on-balance-sheet earnings and cash flows and identified companies with the most significant exposure. These ratios would have led us to ask important questions of managers that could have helped investors identify problems earlier in the cycle and potentially could have averted some portion of this crisis and wealth destruction and helped markets operate more efficiently.

It is worth observing that such reconciliations are not new to business. Such a balance-sheet-to-balance-sheet reconciliation schedule is sometimes used by auditors in their examinations of companies in which a complete understanding of cash flows and their effects is an essential part of their audit. Similarly, such schedules are employed in forensic analyses when financial statements must be regenerated and their representational faithfulness and reliability demonstrated. However, and more importantly to the current DP, many fundamental investors themselves routinely try to approximate the schedules from the financial statements and notes available to them so that they will gain a clearer and more complete understanding of the operating, investing, and financing activities of companies of interest.

A balance-sheet-to-balance-sheet reconciliation would ensure that the cohesiveness goal has been fully achieved. Because the accrual information, i.e., columns C, D, and E in the schedule in paragraph 4.45 must be generated in order to produce the current income statement and OCI items, and with the requirement

for companies to report a direct method cash flow statement, the information to generate this schedule will be readily available in the general ledger system of companies and should not present additional costs. (We have already discussed the claimed inability of some companies to produce direct method cash flow statements as a result of their outdated accounting systems and will not address it further here.)

We believe that, subject to our discussion above regarding the importance of a balance-sheet-to-balance-sheet reconciliation, the disaggregation as proposed, i.e., cash flows (column B), accruals (column C), recurring remeasurements (column D), and nonrecurring remeasurements (column E) will provide a very strong disclosure platform, along with the proposed disaggregation by nature of the item. The objections raised by various constituents over the years about the problematic mixed attribute model are fully addressed by the transparency introduced by this reconciliation. Furthermore, the schedule provides a platform for future standards development by readily accommodating the more challenging presentation problems that have continually arisen in the past, such as presentation of remeasurement components. We believe that the preparation guidance is quite clear.

As new innovations occur, new standards are being developed to address old reporting problems as well as newer ones from the new innovations, the Boards may reconsider additional refinements and no doubt will. As the DP suggests, one particularly helpful columnar disclosure would be the separation of fair value disclosures based on market prices from Level 3 estimates for which one or more significant inputs are unavailable, and which may entail substantial manager judgment. The good news is that the matrix of the schedule is sufficiently robust that changes will not present a major problem.

We do not support the Statement of Comprehensive Income Matrix, which does not include the cash flow column, column B. This reconciliation format provides too little economic information and would merely perpetuate the inadequate reporting that we currently have.

26. *The FASB's preliminary view is that a memo column in the reconciliation schedule could provide a way for management to draw users' attention to **unusual or infrequent events or transactions** that are often presented as special items in earnings reports (see paragraphs 4.48-4.52). As noted in paragraph 4.53, the IASB is not supportive of including information in the reconciliation schedule about unusual or infrequent events or transactions.*

- a. *Would this information be decision useful to users in their capacity as capital providers? Why or why not?*
- b. *APB Opinion No. 30, **Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions**, contains definitions of unusual and infrequent (repeated in paragraph 4.51). Are those definitions too restrictive? If so, what type of restrictions, if any, should be placed on information presented in this column?*
- c. *Should an entity have the option of presenting the information in narrative format only?*

We are somewhat perplexed by the proposal to provide a special column for unusual or infrequent events. Such items are frequently found to be merely “inconvenient” items, and usually only when they have negative effects on the financial statements. Moreover, providing a separate column for such items would seem to be a departure from the rationale for the disaggregation proposed. Unusual or infrequent events affect comprehensive income, assets and liabilities, and the net assets available to equity holders just as any other items do. We would note that it has not been that long since extraordinary item treatment was first constrained and then eliminated from financial reporting altogether for very good reasons, including removing the temptation for abuse and misleading presentation. We would not want to see it creep back in by the back door.

We believe that if managers believe special information needs to be conveyed regarding one or more items in the reconciliation, that this would best be done by flagging the item and providing additional discussion about the item in the notes. This is true in any case and is an option currently available to managers.

Question Specific to the FASB

27. *As noted in paragraph 1.18(c), the FASB has not yet considered the **application of the proposed presentation model to nonpublic entities**. What issues should the FASB consider about the application of the proposed presentation model to nonpublic entities? If you are a user of financial statements for a nonpublic entity, please explain which aspects of the proposed presentation model would and would not be beneficial to you in making decisions in your capacity as a capital provider and why?*

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Our experience as investors is primarily although not exclusively in the public company sector. Although nonpublic entities run a wide gamut, many raise substantial amounts or even all of their capital in the public as well as private **debt** markets. These nonpublic companies include some of the largest and most important companies in the United States and abroad. Thus, the quality of information provided would be of importance to all of those who analyze (e.g., credit rating agencies) or invest (fixed income investors, banks, insurers, etc.) in the debt securities of these companies.

Consequently, our view is that so long as companies choose to rely upon third party capital in support of their operations, those who rely on their reporting should have the same high quality information available for their decision making. Thus, special exceptions should not be made for such companies and they should be required to conform to all of the standards required of public companies in their financial reporting to their constituents.

The ITAC appreciates the opportunity to respond to the Discussion Paper: *Preliminary Views on Financial Statement Presentation*. Should the Board or staff have questions about our views or wish to discuss these matters further, please contact the undersigned or any member of the ITAC.

Respectfully,



Rebecca McEnally
Member, ITAC

cc: Denise Gomez Soto, IASB Project Manager