

LETTER OF COMMENT NO. 198

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April 13, 2009

To: **FASB**

Technical Director

File Reference No. 1630-100

From: John Kostolansky, Associate Professor of Accounting, Loyola University Chicago

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Re: Preliminary Views on Financial Statement Presentation

We appreciate the opportunity to comment on the discussion paper regarding financial statement presentation and we hope that our insights are useful in improving the value of the statements. Here are our thoughts and observations.

Discussion Question 1: Would the objectives of financial statement presentation described 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?

We believe the answer to this question is "yes," and that the views in this discussion paper generally are aligned with these objectives. However, we believe that certain views run counter to the objectives that have been laid out. We detail these exceptions later in our comments.

Discussion Question 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? Why or why not?

We think the answer is "probably yes." If the separation of activities does not diminish the relevance and reliability of the information across firms, then we feel that the additional information and insight will clearly improve financial reporting. However, if one firm is able to include specific information in the business category while its competitor is able to include the same information in the financing category, then the separation reduces decision usefulness. It will be more difficult to predict future business and financing cash flows, as well as to compare such projections across firms. Likewise,

assessing relative liquidity and financial flexibility will be hampered if firms are able locate similar assets and liabilities in different categories.

Discussion Question 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? Why or why not?

We believe that a separate equity section makes the most sense in the proposed presentation framework primarily because this allows the articulation of net assets and equity in the proposed balance sheet. We were not swayed by the discussion in paragraph 2.54 that the cohesiveness object would not be satisfied since "only the statements of financial position and cash flows would include an equity category." The statement of comprehensive income will not include an equity section under any format and it does not make sense to us to organize information in a less intuitive format simply to meet the cohesiveness objective. Decision usefulness overrides the cohesiveness objective.

Discussion Question 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 there is usefulness in uniformly showing discontinued operations in a separate section of the statements. To identify the nature of the discontinuation, the relevant category could be provided within the discontinued operation section.

Discussion Question 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.

- 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?

As we indicated in our response to Discussion Question 2, we find it most useful if financial statement information is comparable across firms. Having to undo a management approach to compare competitive firms is inefficient and difficult.

In our view, one of the main attractions of the proposed presentation model is the opportunity to aid in comparative analysis. We would not find it "most useful" if one firm could categorize a lease obligation as an operating liability while a similar firm could

categorize the lease obligation as a financing liability. In our view, lease obligations are financing liabilities and we cannot envision an acceptable justification for the operating liability category. Thus, we believe that limits on the management approach may be required.

We agree with the observations in paragraph 1.13 that "increased globalization of capital markets and investment opportunities leads to a need for a common set of principles for presenting information in financial statements used by capital providers around the world. Even if the underlying recognition and measurement principles are the same, different presentation of the resulting information makes it difficult for users to compare financial statements of different entities." We believe that this extends to not only the presentation format but also to the way in which information is categorized within the format.

We do, however, agree that management should be able to categorize assets and liabilities in line with the nature of the overall business as was illustrated for a financial services entity in paragraph 2.79.

Discussion Question 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?

We think that the proposed business and financing categories may make the computation of certain ratios easier, but we would again raise our concerns of relevance and reliability. The content of these sections should be similarly determined across similar firms. We do not see a major benefit of providing categories if the categorization of the management approach must be redone in order to compute comparable ratios across firms.

Discussion Question 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.

We believe that the statements would be most useful if firms classify their assets and liabilities at the reportable segment level as proposed. On the surface, this would enhance comparability across firms and be consistent with the firm's organizational structure.

We again note here our concern about "management perspective" that arises from the example in paragraph 2.40. That example supposes: "In the financial services segment, the main operation consists of earning a higher return on financial assets than is paid on financial liabilities and, therefore, the financial instruments are classified in the operating category."

We can imagine a long-term financial liability whose main purpose was to fund operations (either the operations of financial services segment or the operations of a manufacturing firm). In our view, such a liability should be a financing liability and not an operating liability. We do not believe that management should have an option in such a case and the Board's example in paragraph 2.40 seemingly opened that possibility.

Finally, we acknowledge our inability to make a cost/benefit calculation for such a requirement.

Discussion Question 9: Are the business section and the operating and investing categories within that section defined appropriately? Why or why not? Discussion Question 10: Are the financing section and the financing assets and financing liabilities categories within that section defined appropriately? 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?

Our main concerns with the definitions in Questions 9 and 10 are related to the classification of liabilities and with the Board's limitation in paragraph 2.69 regarding the classification of cash

Under the definitions, operating liabilities are those "that management views as related to the central purpose(s) for which the entity is in business. Investing liabilities are those "that management views as unrelated to the central purpose for which the entity is in business. Financing liabilities are "financial liabilities... that management views as part of the financing of the entity's business and other activities."

Suppose a firm obtains a long-term bank loan to acquire machinery to produce inventory. This liability clearly falls within the financing liability category. Does it not also fall within the operating liability category? A similar loan obtained for the purpose of making investment seemingly falls within either the financing or investing categories. This is problematic in our view. We identify both loans as "financing" the acquisition of operating assets or investing assets.

Operating liabilities arise in the "normal" course of conducting the entity's central business purpose and are exemplified by such items as accounts payable, advances from customers, and wages payable (to borrow three items from Illustration 1A's statement of financial position). But the same illustration includes a lease liability in the operating category and long-term borrowings in the financing category. How does one make the determination that these two liabilities are fundamentally different?

We believe that the category definitions for liabilities require change. Although the Board considered various definitions for financing liabilities, it has missed one. We believe that all short-term and long-term debt that arises outside the normal course of conducting the entity's central business should be categorized as financing liabilities. The purpose of such debt is to "finance" either operating or investing activities. This revised definition would include such items as bank debt, commercial paper, accounts payable with an

abnormal due date, and lease liabilities. In the alternative, the revised definition allows a long-term pension liability to remain in the operating category. Without a definitional change, firms will inevitably use all three categories for the same type of borrowing, and that will not help users to assess an entity's liquidity and financial flexibility.

Turning to the classification of cash, there is a inconsistency in the Board's views in paragraph 2.67 that "management knows how assets and liabilities are deployed in its business activities" and the Board's view in paragraph 2.44 that "it might be difficult, if not impossible, for an entity to identify a specific amount of cash as having one function and another amount of cash as having another function. The firm must be able to determine its cash requirements for various activities such as operations, capital expenditures, investments in other companies, etc. Thus, the Board's basis for its view on the classification of cash in paragraph 2.44 is not convincing to us.

Requiring a single classification of cash (unless segment reporting results in multiple categories) runs counter to the objectives for the statements to be "useful in assessing the amount, timing, and uncertainty of an entity's future cash flows and to help users to assess an entity's ability to meet its financial commitments and to invest in business opportunities. If the new structure is help readers of financial statements, simple concepts such as the current ratio should be easy to calculate and evident from reported subtotals. In Illustration 1A of the ToolCo example, how would a reader approach something as simple as the current ratio when all of the firm's cash is identified as a financing asset?

For example, Microsoft's FY 2008 balance sheet reports cash and equivalents of \$10,339 billion as a current asset (total current assets of \$43,242 billion). Would we be better served if that cash were listed as a financing asset? (Admittedly, the existing practice of including all cash and equivalents as a current asset is not perfect, either.) But surely the firm is best able to indicate the purpose of holding so much cash in terms of operating, investing, and financing plans. The proposed financial statement format would provide us the opportunity to get that information routinely from management rather than providing our own guess. Having the firm allocate its cash would also provide a better measure of the firm's ability to pay its short-term debt, to finance an acquisition, or to buy back more stock.

Discussion Question 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 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?

Given the objective to help users assess an entity's liquidity and financial flexibility, we believe that the Board should require all firms to report a classified statement of financial position. Within the classifications, firms would present the assets and liabilities in order of liquidity. We do not see any benefit to allowing an option on this matter.

Discussion Question

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 with the comment letter No. 49 from our Loyola colleague, Aaron Cunningham, which suggests that a middle ground for reporting cash equivalents would provide a clearer picture of a firm's liquidity than the approach proposed by the Board. We like Aaron's proposal to continue to group extremely liquid cash equivalents with cash and to segregate the other cash equivalents as the Board has proposed.

Discussion Questions 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 believe this practice should be continued, subject to the following comments.

Paragraph 3.57 notes that "[A]n entity also is required to follow the guidance in IAS 1 or Statement 130 that permits an entity to present the components of other comprehensive income either (a) net of their related tax effects or (b) before related tax effects with one amount shown for the aggregate income tax amount related to the total of other comprehensive income items." We would prefer to remove the option and require entities to report components of other comprehensive income net of their related tax effects, but with the amount of the tax effect parenthetically noted, as in for example,

Foreign currency translation (net of \$200 tax benefit) \$(460)

We believe that the requirement to disclose both the income and the related tax amount should be required for line items where an income tax allocation is required. This would add to consistency and help users understand the after-tax contribution or cost of the various components of comprehensive income

Discussion Question 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?

We believe that the Board should require an alternative reconciliation format similar to the statement of comprehensive income matrix described in Appendix B. First, we think that this format mirrors the way in which creditors and investors approach their analysis, looking at income and then determining the cash flow behind the earnings number. The proposed format, which moves from cash flow to income, reverses a very common analytical process, and as a practical matter, results in a large, visual separation of the two most important numbers on each line; income and cash flow.

The alternative format presented in Appendix B is incomplete, as it omits some cash flow transactions contained in the proposed reconciliation format, and therefore provides different totals for important metrics such as cash flow from operations. Clearly we do not want to alter the items that comprise operating cash flow. Therefore, we propose the modification contained in the attached Appendix

Thank you for the opportunity to comment on this important project.

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Appendix (highlighted rows have been added)

MODIFIED STATEMENT OF COMPREHENSIVE INCOME MATRIX (Adjusted to articulate with Statement of Cash Flow totals)							
For the year ende	31 December						
<u>A</u>	B	С	D	E	F		
		Changes in Assets and Liabilities, Excluding Transactions with Owners					
Statement of Comprehensive Income		Not from Remeasurement From Remeasurement					
	Comprehensive Income (C+D+E+F)	Cash Flows	Accruals, Allocations, and Other	Recurring Valuation Adjustments	All Other		
BUSINESS							
Operating							
Sales—wholesale	2,790,080	2,108,754	681,326				
Sales—retail	697,520	703,988	(6,467)				
Total revenue	3,487,600	2,812,742	674,859				
Cost of goods sold:	· [.				
Materials	(1,043,100)	(935,544)	(107,556)				
Labour	(405,000)	(418,966)	13,966				
Overhead—depreciation	(219,300)		(219,300)				
Overhead—transport	(128,640)	(128,640)					
Overhead—other	(32,160)	(32,160)					
Change in inventory	(60,250)		(60,250)				
Pension	(51,975)	(170,100)	109,125	9,000			
Loss on obsolete and damaged inventory	(29,000)				_(29,000		
Total cost of goods sold	(1,969,425)	(1,685,409)	(264,016)	9,000	(29,000		
Gross profit	1,518,175	1,127,333	410,843	9,000	(29,000		
Selling expenses:					`		
Advertising	(60,000)	(65,000)	5,000	'	}		
Wages, salaries and benefits	(56,700)	(58,655)	1,955				
Bad debt	(23,068)		(23,068)				
Other	(13,500)	(13,500)					
Total selling expenses	(153,268)	(137,155)	(16,112)				
General and administrative expenses:							
Wages, salaries and benefits	(321,300)	(332,379)	11,079				
Depreciation	(59,820)	,	(59,820)				
Pension	(51,975)	(170,100)	109,125	9,000			
Share-based remuneration	(22,023)	(3,602)	(12,171)	(6,250)	ĺ		
Interest on lease liability	(14,825)	(50,000)	35,175				
Research and development	(8,478)	(8,478)	ļ		1		
Other	(15,768)	(12,960)	(2,808)				
From SCF: capital expenditures		(54,000)	54,000		<u></u>		
Total general and administrative expenses	(494,189)	(631,519)	134,580	2,750			
Income before other operating items	870,718	358,659	529,311	11,750	(29,000		
Other operating income (expense):]		
Share of profit of associate A	23,760		}		23,76		
Gain on disposal of property, plant and equipment	22,650	37,650	(15,000)				
Realized gain on cash flow hedge	3,996	3,402	(594)	1,188			
Loss on sale of receivables	(4,987)	8,000	(8,000)		(4,987		
Total other operating income	45,419	49,052	(23,594)	1,188	18,773		
Total operating income	916,137	407,711	505,717	12,938	(10,227		

MODIFIED STATEMENT OF COMPREHENSIVE INCOME MATRIX (continued)

A	В	С	D	£ _	F	
Statement of Comprehensive Income		Changes in Assets and Liabilities, Excluding Transactions with Owners				
		Not from Remeasurement		From Remeasurement		
	Comprehensive Income (C+D+E+F)	Cash Flows	Accruals, Allocations, and Other	Recurring Valuation Adjustments	All Other	
Investing						
Dividend income	54,000	54,000				
Realized gain on available-for-sale securities	18,250	56,100	(37,850)			
Share of profit of associate B	7,500				7,500	
Total investing income	79,750	110,100	(37,850)		7,500	
TOTAL BUSINESS INCOME	995,887	517,809	467,867	12,938	(2,727)	
FINANCING						
Interest income on cash	8,619	8,619				
Total financing asset income	8,619	8,619				
Interest expense	(111,352)	(83,514)	(27,838)			
From SCF: Proceeds of issuance of short-term debt		162,000	(162,000)			
From SCF: Dividends paid		(86,400)	86,400			
Total financing liability expense	(111,352)	(7,914)	(103,438)			
TOTAL NET FINANCING EXPENSE	(102,733)	705	(103,438)			
Profit from continuing operations before taxes and other comprehensive income INCOME TAXES	893,154	518,514	364,429	12,938	(2,727)	
Income tax expense	(333,625)	(281,221)	(52,404)			
Net profit from continuing operations DISCONTINUED OPERATIONS	559,529	237,293	312,025	12,938	(2,727)	
Loss on discontinued operations	(32,400)	(12,582)	ļ		(19,818)	
Tax benefit	11,340	, , ,	11,340		` ' '	
NET LOSS FROM DISCONTINUED OPERATIONS	(21,060)	(12,582)	11,340		(19,818)	
NET PROFIT	538,469	224,711	323,365	12,938	(22,545)	
OTHER COMPREHENSIVE INCOME (after tax)						
Unrealized gain on available-for-sale securities (investing)	17,193			17,193		
Unrealized gain on cash flow hedge (operating)	1,825		Ì	1,825		
Foreign currency translation adjust—consolidated subsidiary	2,094				2,094	
Foreign currency translation adjust—associate A (operating)	(1,404)				(1,404)	
Revaluation surplus (operating)	3,653			3,653	` ′	
TOTAL OTHER COMPREHENSIVE INCOME	23,361		1	22,671	690	
TOTAL COMPREHENSIVE INCOME	561,830	224,711	323,365	35,609	(21,855)	