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LETTER OF COMMENT NO. 48

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Mr. Russell Golden Technical Director File Reference No. 1630-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Preliminary Views on Financial Statement Presentation

Dear Mr. Golden,

I am writing in response to the FASB's request for comments regarding its Discussion Paper "Preliminary Views on Financial Presentation", dated October 16, 2008. My views are based on a very long and diverse background including teaching accounting and finance at some of the top business schools in the world, consulting to a number of major corporations, serving as the CFO of two publicly traded corporations, sitting on the boards of both public and private corporations as well as a private college, chairing several audit committees, and having been widely published. A more detailed summary of my background appears at the end of my letter.

Financial reporting is at a critical point in its history. It has not kept up, well, with changing business characteristics over the past half century, even though the promulgated accounting policies have become increasingly complex. Increased firm size; product, market, and global diversity; shorter product life cycles; heightened marketing expenses; increased reliance on intellectual capital; and methods of financing and complex financial instruments, for example, have made existing financial reporting less understandable and useful. Firms have taken it upon themselves to redefine "earnings" by adding their own definitions and metrics to supplement their GAAP reporting. Balance sheets are often misvalued due to the use of historical cost based valuations and the absence of recognizing such "drivers" of value as R&D, brand expenditures, and intellectual capital. The statement of cash flows, unfortunately, does a poor job of clearly presenting the cash being generated (consumed) by the firm.

The Financial Accounting Standards Board (FASB) in the U.S., in conjunction with the London-based International Accounting Standards Board (IASB) and other accounting governing bodies, initiated a project in 2005 aimed at addressing financial reporting. They are to be complimented for undertaking such an effort.

In July 2006, the FASB issued a set of Preliminary Views on a Conceptual Framework for Financial Reporting: Objectives of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information. In it, the FASB reiterated the objectives of financial reporting:

- The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource decisions.
- To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and shareholders.
- To help present and potential investors and creditors and others in assessing an
 entity's ability to generate net cash inflows, financial reporting should provide
 information about the economic resources of the entity (its assets) and the claims
 to those resources (its liabilities and equity). Information about the effects of
 transactions and other events and circumstances that change resources and
 claims to them is also essential.
- In developing financial reporting standards, standards setters presume that those who use the resulting information will have a reasonable knowledge of business and economic activities and be able to read a financial report. Standard setters also presume that users of financial reporting information will review and analyze the information with reasonable diligence.

Thus, in 2006, the FASB reiterated its own objectives for financial reporting, that it is intended, primarily, for the use of outside creditors, investors, and other interested parties such that they may assess historical entity economic performance, make estimates of future entity economic performance, and make their own rational economic credit, investment, and other decisions. It is assume that users of financial statements have a reasonable understanding of business and economics and that they will study the information provided with reasonable diligence.

Unfortunately, the Discussion Paper does not, in my opinion, improve financial reporting such that the statements better enable outside creditors, investors, and other interested parties to assess historical entity economic performance, make estimates of future economic performance, and make rational economic credit, investment, and other decisions.

Basic Finance 101 would emphasize that "the value of any asset is the net present value of the future stream of cash flows which that asset will generate". The renowned investor Warren Buffett repeatedly focuses on the term "intrinsic value" which he says is the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is "the discounted value of the cash that can be taken out of a business during its remaining life". Estimating intrinsic value at any point

in time is not easy and will frequently have to be reevaluated, but estimates of intrinsic value should drive internal business and external investment decisions. Business performance should be evaluated on the basis of increases in intrinsic value; external investments should be made on the basis of the relationship of intrinsic value to market price. "Intrinsic value is what you buy; market price is what you pay". Cash flows are the underlying determinants of intrinsic value.

Although the FASB's objectives of financial reporting, with the emphasis on cash flow information for the benefit of intelligent and diligent users for rational decision making is laudatory, the prescribed formats in use today and the preliminary proposed statement format examples offered fail to provide the economic perspective needed to permit users to more easily make better decisions. Quite frankly, they do not adequately provide cash flow information, do not reflect many of the assets which drive those cash flows, and combine realized and unrealized earnings even those they are very different in terms of their impact on and timing and uncertainty of cash flows.

Although the stated purpose of financial statements is to provide creditors, investors, and others will useful cash flow information, the current cash flow statement (which is, in effect, a reconciliation statement to the balance sheet) fails to do so. Furthermore, although it contends to differentiate between operating, investing, and financing cash flows, it, in fact, includes financing flows (interest expense/income) in operating cash flows and financing flows (purchase/sale of securities) in investing cash flows. Given that creditors, investors, and managers are primarily concerned with whether the firm is "creating value" or not, and that the value of any asset (business) is the net present value of its future cash flows, recasting the statement of cash flows would be a good place to begin. I believe a format which focuses on the (unlevered) free cash flows available to creditors and shareholders would be a good place to start, such as the following:

Net Operating Profit after Tax (NOPAT) +/-Non-Cash Adjustments to NOPAT

- 1. Cash Earnings
- 2. +/- Changes in Working Capital
- 3. Capex, net and Other Operating Investments

"Unlevered Operating Free Cash Flows Available for Creditors and Shareholders"

- +/- Non-Operating Income/Expense (after tax)
- +/- Discontinued Operations (after tax)

"Unlevered Free Cash Flows Available for Creditors and Shareholders"

These UFCFs are a critical measure of the business' ability to generate cash. It is what investors look at when considering whether to invest in a business. It is also a key

internal measure of a business' cash generation performance. If a business has negative UFCFs, it must raise more capital; if it has positive UFCFs, it has cash to service debt, return cash to shareholders, and/or reinvest in the business. UFCFs may be, then, reconciled to the changes in cash and cash equivalents by dealing with creditor related cash flows, other financing flows, equity related flows, and reinvestment flows, as follows:

Debt Service

- -/+ Interest Expense/Income (after tax)
- +/- Changes in Debt

Other Financings

-/+ Purchases/Sales of Securities

"Levered Free Cash Flows Available for Shareholders"

Equity Transactions

- + Sale of Stock
- Repurchase of Stock
- Dividends
- + Tax Benefits of Options

Acquisitions/Divestitures

Effects of Forex

"Change in Cash and Cash Equivalents"

It should be clear from this proposed format that I believe the "indirect" cash flow format is far superior to the proposed "direct" method. Businesses generate cash earnings through the relationship of their revenues and (ultimately) cash expenses. When a business is growing, it typically must reinvest in the business in the form of working capital (receivables, inventory, offset by payables, etc.) and fixed and other assets. The indirect cash flow method captures these relationships well; the direct method does not. The relationship of working capital/revenues is very important to understand. As a business grows (or contracts) one can easily track whether the working capital and fixed and other asset levels are maintaining the expected relationships, improving, or getting worse. It is also very important to note that although the direct method is a reporting option, today, for firms, few report on the direct method. In my experience, few companies use the direct method for internal management purposes.

I would propose a framework for the revised balance sheet which is consistent with the proposed cash flow statement and which, more importantly, establishes the parity equation as "financing" = "investing". Businesses raise money from several sources.

Initially, they raise funds from investors; subsequently, if the business is deemed creditor worthy, they raise funds from creditors. It can also be argued that deferred taxes and long term pension and other benefit liabilities are a source of capital, although they are rarely considered so and typically not included when calculating leverage ratios and the weighted average cost of capital. Financing is raised for the purpose of investing in the business. Businesses invest in two categories of investments, working capital and fixed and other operating investments. Thus, the balance sheet should be thought of as follows:

"Investing"	=	"Financing"
Working Capital		<u>Debt</u>
Current Assets:		S.T. Debt
Accounts Receivable		L.T. Debt
Inventory		-Cash
Other C/A		Other L.T. Liabilities
		Deferred Taxes
- Current Liabilities:		Pensions
Accounts Payable		
Accruals		Shareholders Equity
Other C/L		Preferred Stock
		C/S Paid in Capital
Fixed and Other Assets		-Treasury Stock
Tangible Assets		Retained Earnings
Intangible Assets		_
-		Other Comprehensive Income
Total Investing		Total Financing

There are three important messages that may be taken from this format. First, if a business does not manage its investing tightly, that requires additional financing, at a cost to the firm. Second, if the investing categories are inaccurately valued, for example inventories carried at LIFO or tangible fixed assets at historical cost, then the shareholders equity is inaccurately valued and any metrics calculated on such inaccurate values are similarly inaccurate. Finally, if there are categories of investments which are

missing completely, then, again, equity and measurement metrics are invalid.

It would seem that one of the FASB's current directions is to revalue assets such that the balance sheet more closely reflects economic value. "Fair value" accounting has this purpose, although it may be argued that basing value on market prices, when market prices may not accurately reflect underlying "intrinsic" value, has significant short term risk. It has been said that "price is what you pay; value is what you get." Using the market as the basis of valuing investments may not, then, accurate reflect real value.

A major deficiency of current balance sheets, and not reflected in the proposed changes, is the absence of internally generated intangible investments. Until this deficiency is corrected, the relationship of market values to book equity values will not be closed and

considering balance sheet values as a reflection of firm value will be misguided, even after all the investments carried on the balance sheet have been revalued. Pharmaceutical, high technology, and software companies spend 10-20% of revenues on development costs; consumer product companies spend major resources on brand positioning costs; and professional service firms spend a major portion of resources on intellectual capital. Inasmuch as intangibles can be valued in the context of an acquisition, it would seem that now is the time to revisit internally generated intangibles. The failure to do so makes all other efforts to revalue balance sheets, in many cases (except for financial firms), pale by comparison.

I would make one additional comment regarding mark to market accounting. The distinction between "available for sale" and "held to maturity" has merit both in a financial and tangible/intangible investment context. Certainly, if a firm has every intention to hold a financial instrument to maturity, to require that instrument to be valued to current market values makes little sense. Similarly, if a firm intends to hold a tangible investment, such as a manufacturing plant or retail location, to maturity, adjusting values to market similarly makes little sense.

Throughout the FASB's revised statements, there has been the attempt to sustain the operating, investing, and financing distinction. In my opinion, this distinction has been flawed in current practice and really has little fundamental usefulness. I say it has been flawed in current practice, for several reasons. As indicated earlier, the current cash flow statement combines both financing and what is currently considered operating activities under the operating category and financing and investing in the investing category. I would go a step further and argue that classifying working capital accounts as operating activities is inappropriate. As far as I am concern, firms raise capital via financing and invest capital for the purpose of generating a return on that investment. A dollar invested in inventories, for example, is just as much of an investment as a dollar invested in fixed assets. To attempt to sustain these three categories of activities and apply them to each of the three primary statements in an attempt to achieve some sort of bridge between the statements is, at best, a forced fit.

The idea that realized and unrealized gains/losses should be combined into a single income statement is very troubling. Realized and unrealized gains/losses have very different impact on and timing and uncertainty of cash flows, the ultimate determinant of value creation. To combine them into a single stream would suggest otherwise. I have no problem with adding a reconciliation schedule, which bridges realized income to comprehensive income, to the set of primary financial statements. To explicitly tie realized and unrealized information into one statement is at least misleading.

As I have suggested above, distinguishing between operating, investing, and financing activities on the income statement is "contrived", in an effort to have a similar construct across all three primary statements. I do believe that distinguishing between operating income and non-operating, discontinued, and financing transactions does have merit. I believe that taxes are just as much of an operating expense as other expenses and the

separation of taxes into a separate category is inappropriate. I would propose the following:

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Revenue

-Operating Expenses
Operating Profit

-Taxes (based on Operating Profit)
Net Operating Profit after Taxes (NOPAT)

+/-Non-Operating Profit/Loss (A.T.)

+/-Discontinued Operations (A.T.)

-/+ Interest Expense/Income (A.T.)
Net Income
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This format provides the NOPAT information which may be taken to the cash flow statement as the starting point for the calculation of cash earnings. The other three adjustments to NOPAT to get to Net Income provide differentiating information between operating and non-operating and discontinued operations and between operating and financial (interest) activities. This information may also be taken to the cash flow statement and presented in their appropriate places.

I frequently, especially for my students' benefit, will actually show the adjustments to NOPAT to get to cash earnings with the income statement, as follows:

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NOPAT
+/- Non-Cash Adjustments:
    Depreciation and Amortization
    Stock Based Compensation
    Deferred Taxes
    Other
    Cash Earnings
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The proposed income statement continues what I call an outdated traditional manufacturing model:

Revenues
-Cost of Goods Sold
Gross Margin
-Operating Expenses
Operating Profit

I believe that a revised income statement should be reorganized along a "value chain" orientation, such as the following:

Revenues

- -Service and Sales Costs (related to the revenue support and generation)
- -Product Costs
- -Strategic Costs (R&D, Brand, and other long term strategic expenses)
- -Administrative Costs
 Operating Profit

Costs to service customers, acquire or build products, lay the foundation for the future of the business, and to administratively support the business are very different. They should be separated in order that the users of financial statements can get a feel for the relative proportion of the categories of expenses.

I, personally, do not believe separating costs by their "nature" would be very useful. What is the typical user going to do with such granularity? In addition, I doubt many companies could easily provide such information given the way they are organized (groups, divisions, and product lines) and operate along functional activities such as Marketing, R&D, Purchasing, Manufacturing, Distribution, Sales, Service, and Administrative Activities.

In conclusion, I believe that the FASB's proposed revised financial statements fall far short of my expectations and that there are a number of ways they should be improved before re-releasing for review and ultimate promulgation. There needs to be much more explicit focus on cash flows generated and available for creditors and shareholders, a revision to the balance sheet such that the parity equation becomes financing equals investing, and a reordering of the income statement such that it better reflects the business' activities. The balance sheet has to capture the real drivers of value, if it is going to be a meaningful statement. The distinction between realized and unrealized gains/losses must be maintained.

I trust you find my comments useful.

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Best wishes,

Dr. Robert A. Howell

About the author: Dr. Robert A. Howell is the David T. McLaughlin, D'54, T'55 Distinguished Visiting Professor of Business Administration at the Tuck School of Business at Dartmouth. He is also Senior Partner, The Howell Group, through which his consulting services are offered. He has taught Financial and Managerial Accounting, Internal Control Systems, Corporate Financial Management, Financial Statement Analysis, and Business Strategy and Policy to MBA, EMBA, MS in Accounting, and DBA students at the Harvard Business School, New York University, Thunderbird: The

American Graduate School of International Management, IMD: International Institute for Management Development, and the Tuck School of Business at Dartmouth over the past 40 years. His primary teaching responsibility at Tuck over the past eight years has been "financial statement analysis". In that role, he and his students have studied the financial statements of more than 500 companies across various industries and geographies. He has also been the CFO of two publicly traded companies, General Housewares Corporation and Schick, Inc., and has consulted to a number of leading companies over the past 35 years. Dr. Howell has also been a director of public and private companies for more than 20 years and chairman of an audit committee. He is currently a faculty member of the National Association of Corporate Directors' (NACD) Certificate in Director Professionalism program with responsibility for the "Scrutinizing Financial Statements" module. He has been a member of FEI for 35 years, of IMA for 25 years and holds Certificate in Management Accounting # 19, and of AAA for 40 years. His thoughts and writings have appeared in Harvard Business Review, Sloan Management Review, Fortune, The Financial Times, Business Strategy Review, Management Accounting, Financial Executive, and a number of other publications. He holds BSEE, MBA, and DBA degrees from Bucknell University; Wharton, The University of Pennsylvania; and Harvard University, respectively.