

CHAPTER 2: THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1. Summary of Recent Development of Authoritative Guidance on Financial Statement Presentation: Global Trend towards Convergence of Accounting Standards

2.1.1. Performance Reporting Statement and Earnings Concepts

Financial statements are, indeed, the outcomes of applying the accrual accounting concept¹ to the business transactions occurred during a given accounting period. The objectives of presenting financial statements to investors are to help investors (1) making projections about firm future performance (*predictive*), (2) judging past financial performance (*feedback*), (3) evaluating or adjusting projections on firm performance (*feedback/predictive*) and (4) determining enterprise valuations as well as stock price of a given firm (JIG, 2005).

Among many other things, earnings information presented on the face of financial statements is crucial to investment and credit decisions. Prior literature on information content of earnings numbers suggests that the investors rely on such information when making security trading decisions (see for examples, Ball and Brown, 1968, Beaver, 1968, Atiase, 1985, and Subramanyam, 1996).

¹ **Accrual basis accounting** is defined by Libby et al. (2009) as “records revenues when earned and expensed when incurred, regardless of the timing of cash receipts and payments.” Accruals basis accounting constitutes two important principles, namely revenue principle and matching principle. Revenue principle requires that the revenues are recognized when goods or services are delivered and when the collection is reasonably assured. Matching principle requires that the expenses be recognized when incurred in earnings revenue or when the economic benefits are used up. Accrual accounting aims to assist investors in evaluating the entity-of-interest’s economic performance during the accounting period through the use of proper revenue recognition principle and matching concept (Dechow and Skinner, 2000). More importantly, the use of accrual accounting opens the opportunity for the firm’s management to convey their private information about the firm’s permanent earnings estimation, which helps investors in predicting future profitability (Arya et al., 2003 and see also the positive accounting literature e.g. Watts and Zimmerman, 1978 and 1990). However, some researchers and practitioners argue that applying accrual accounting concepts also opens door to earnings management schemes (see Jones, 1991 and Dechow et al., 1995 for examples).

In today's practice, earnings definition varies remarkably, since there is no agreeable earnings concept outlined by standard setters². In accounting context, earnings number (commonly known as *net income* (FASB) or *profit or loss for the period* (IASB)) is an aggregate measure of income, expenses, gains or losses, which portrays the financial performance of a particular firm during a given period of time. According to *Framework for the Preparation and Presentation of Financial Statements* (IASB, 2001), income is defined as increases in equity or net assets³, other than those resulting from owner-related transactions. Specifically, profit is the inflows of net assets during the accounting period in excess of amounts required to retain a given level of capital. Put it differently, profit is defined as *return on capital*, which is the residual amount of inflows of net assets after the *return of capital* is fulfilled.

The presentation of income and expense line-items also matters in the investors' investment decisions (Burgthaler et al., 2002, Gu and Chen, 2004 and Nichols, 1977). Different income statement classifications and differential placement of line items imply different levels of information content and decision usefulness. Prior literature suggests that the closer the item is to sales, the more permanent or persistent this item tends to be (Lipe, 1986 and Fairfield et al., 1996). The investors understand the distinction and do not consider line items homogeneously. Hence, the importance placed on each line item is different from the other line items presented on statement of comprehensive income or income statement. Being aware of this given fact, the management exerts effort to manipulate the classification and presentation of the line items on the income statement (McVay, 2006, Barnea et al., 1976, Min and Nyeen, 1998, and Beattie et al., 1994). The standard setters are aware of such behavior and try to amend the performance reporting statement to enhance the transparency of financial information presented.

² Hicks (1946) (cited in Bauwenberge and Beedle, 2007) define income as "*the maximum value which a man can consume during a week and still be expected to be as well off at the end of the week as he was in the beginning*". The reported earnings determined by a given firm usually exclude certain items that are *non-operating, non-recurring, or beyond management's control* (Barker, 2004). However, these exclusions cannot objectively and agreeably be defined.

³ The increases in economic benefits can be in the form of asset enhancements or decreases of liabilities; while the opposite is true for an expense. In determining the profit or loss for the period of a given firm, the capital maintenance concept is at work. That is, in financial performance measurement, the capital that an entity seeks to maintain is employed as a reference point to determine the profit.

At the moment, there are still discrepancies in terms of which items must be included in the net income or profit and loss and which items must be recognized outside net income. Since there is no clear earnings concept, standardizing the presentation of earnings can be quite difficult. The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (hereafter, “*the Boards*”) are aware of these discrepancies. As a result, the Boards add the performance reporting project as one of the active agenda in their joint projects (Munter, 2003). Prior to 2004, each board, FASB and IASB, separately, pursue and propose the amendments to the accounting standards related to performance reporting statement. The Boards, later, extend the scope of the project to cover the presentation of financial statements, not just performance reporting statement. Next, the recent development of authoritative guidance on financial statement presentation is summarized.

2.1.2. Financial Statement Presentation Project⁴

In 2002, the Norwalk Agreement jointly issued by the U.S. Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) (collectively, “*the Boards*”) stated they are committed to develop *high quality*, compatible accounting standards for domestic used as well as cross-border financial reporting. To be exact, the convergence or harmonization of accounting standards is an ultimate goal and long-term strategic priority for the Boards. By 2009, the needs for the reconciliation requirements for non-US companies that applied international financial reporting standards (IFRSs) in financial statement preparation should be removed.

Prior to 2004, FASB and IASB independently conduct performance reporting project⁵. In late 2003, the Boards reconsider their positions with regards to the

⁴ Financial statement presentation project is initiated as performance reporting project (see History of the Performance Reporting Project (Agenda Paper No. 2) by Joint International Group (JIG) dated January 2005 for more details.)

performance reporting standards. To avoid the divergence of authoritative guidance to be issued, the Boards decided to devote their efforts to achieve a highly convergent standard on performance reporting⁶. Performance reporting project is part of financial statement presentation (in short, FSP) project undertaken jointly by the Boards⁷. The objectives of this project are to enhance the usefulness of the financial statements (individually and collectively) in ways that improve the ability of the interested parties (a) to understand an entity's present and past financial position, (b) to understand past operating, investing, and financing activities, which causes changes in financial position, and (c) to assess the amount, timing and uncertainty of future cash flows.

The focus of this FSP project is on the issues of form and content, of classification and aggregation (including totals and subtotals), and of display or presentation of certain items on the face of financial statements⁸. Note that the recognition issue is not part of the project. Also, this project will not address (a) management discussion and analysis (MD&A), (b) pro forma measures, (c) segment reporting, (d) financial ratios (except for earnings per share or EPS), (e) forecasted information, (f) nonfinancial measures, (g) specific-industry financial statements.

⁵See (1) Minutes of the October 23, 2003 IASB/FASB Joint Board Meeting on Financial Performance Reporting by Business Entities (FASB Performance Reporting Summary Paper), (2) Minutes of the March 31, 2004 FASB Meeting on Performance Reporting Joint Working Group (Staff Memorandums dated March 4, 2004 and March 29, 2004, and (3) Minutes of the April 22, 2004 FASB Meeting on Performance Reporting Joint Working Group (Staff Memorandum dated April 15, 2004), for more details on the early development stages of the financial statement presentation project.

⁶ The FASB and IASB dedicate their staff resources and research facility on this joint project and try to synchronize their deliberations and timeline in issuing the public discussion documents if possible; however, they deliberate and vote on each issue individually and separately. Thus, at any given point in time, there might be some discrepancies in the Board decisions.

⁷See Project Updates of Financial Statement Presentation—Joint Project of the IASB and FASB dated September 23, 2008 for more details. The FSP project is one of the topics that are already on an active agenda. The progress expected to be achieved by 2008 is to have issued one or more due process documents on the full range of topics discussed in this project. However, the public pronouncement and standard are expected to be issued by 2011.

⁸ See (1) Minutes of the October 24, 2006 FASB/IASB Meeting on Financial Statement Presentation (FASB Memoranda No. 44A-F and IASB Agenda Papers No. 6A-F), (2) Minutes of the October 31, 2007 FASB Meeting on Financial Statement Presentation (FASB Memoranda No. 56A-B), (3) Minutes of the November 14, 2007 FASB Meeting on Financial Statement Presentation (FASB Memoranda No. 56A-C), (4) Minutes of the March 14, 2008 FASB Meeting on Financial Statement Presentation (FASB Memorandum No. 58), and (5) Minutes of the June 26, 2008 FASB Meeting on Financial Statement Presentation (FASB Memorandums No. 59A-D), for details on the financial statement presentation project.

The scope of this FSP project⁹ is as follows:

1. To develop a principle-based standard on financial statement presentation applying to all business entities (public and nonpublic), but not applying to nonbusiness entities.
2. To address the organization and presentation of financial information on the face of financial statements.
3. To address all financial statements that constitute a complete set of financial statements, including interim financial statements.
4. To address the needs for totals and subtotals in the financial statements.
5. To amend the requirements on note disclosure resulting from the consequential amendments of financial statement presentation standard.

The FSP project is undertaken in phases¹⁰ as follows:

Phase A: The Boards completed deliberations in this phase in December 2005¹¹. The main focuses of this phase are the composition of a complete set of financial statements and the requirements in presenting comparative financial statements.

FASB chose not to publish separate Exposure Draft on Phase A; however, it will publicize its decisions together with Phase B decisions. The tentative decisions of the FASB are summarized here.

A complete set of financial statements comprise (a) a statement of financial position at the beginning of the period, (b) a statement of financial position at the end of the period, (c) a statement of comprehensive income, (d) a statement of changes in equity, and (e) a statement of cash flows¹². Each financial statement must be

⁹ See (1) Minutes of the April 18, 2007 FASB Meeting on Financial Statement Presentation – Discontinued Operations: Potential Acceleration of Timing of Project (FASB Memorandum No. 1), (2) Minutes of the August 31, 2005 FASB Meeting on Interim Financial Reporting (FASB Memorandum dated August 10, 2005), (3) Information for Observers for the October 22, 2007 IASB Meeting on Content of Initial Discussion Document and Project Plan (IASB Agenda Paper No. 2), (4) Information for Observers for the June 19, 2008 IASB Meeting on Implications of Scope Change (IASB Agenda Paper No. 9A), (5) Information for Observers for the June 19, 2008 IASB Meeting on Disclosures and Other Potential Issues to be Excluded from the Project Scope (IASB Agenda Paper No. 9D), for more details on the scope of the project.

¹⁰ The Boards meeting dates and the issues discussed are listed in Appendix A.

¹¹ See Minutes of the December 7, 2005 FASB Meeting on Segment A: Issues (FASB Memorandum No. 1 dated November 21, 2005) for more details on Segment A decisions.

¹² See (1) Minutes of the April 21, 2005 IASB Meeting on Required Financial Statements & Comparative Financial Statements (IASB Agenda Papers No. 2, 2A, and 2B), and (2) Summary of the September 15, 2006 Financial

presented with equal prominence. Moreover, a single statement of earnings and comprehensive income is required to present all changes in financial position from nonowner transactions during the period. FASB allows the voluntary presentation of financial information. The presentation of basic and diluted EPS on the face of the statement of comprehensive income is required. The disclosure of basic and diluted EPS in the notes is permitted, but not required. However, the disclosure of weighted average number of shares used to determine EPS measures in the notes is required.

IASB, nonetheless, published Phase A Exposure Draft on Proposed Amendments to International Accounting Standard No. 1 -- Presentation of Financial Statements: A Revised Presentation on March 16, 2006¹³. Finally, on September 6, 2007, IASB issued a revised version of IAS 1 Presentation of Financial Statements, which will be effective in 2009. The revised IAS 1 reconciles the current divergent financial statement presentation standards of the two Boards and harmonizes IAS 1 to SFAS 130: Reporting Comprehensive Income. The IAS 1 (revised 2007, effective 2009) has the following main features. IASB proposes the amendments in statement title of certain financial statements to better reflect their functions is encouraged, but not mandated.

A statement of changes in equity presents all owner changes in equity, but does not include non-owner changes in equity. All non-owner changes in equity are presented either in one statement of comprehensive income or in two statements (an income statement followed by a statement of comprehensive income starting from profit or loss for the period.) Nevertheless, the IASB expresses the preferred view over a single statement of comprehensive income. A disclosure of reclassification adjustments and income tax related to other comprehensive income items is required in the notes. Moreover, dividend distributed to owners together with related per-share amounts must be presented in the statement of changes in equity or in the notes.

Statement Presentation Joint International Group Meeting on Presentation and Display of Information on the Financial Statements (IASB Agenda Papers No. 1-9) for more details on a complete set of financial statements and the display of information on the financial statements.

¹³See Information for Observers for the December 14, 2006 IASB Meeting on Comment Letter Analysis ED IAS 1 (Agenda Paper No. 14) for public comments on the exposure draft of IAS 1 on Financial Statement Presentation.

Phase B: The Boards finished the deliberation on the issues in this phase by the end of 2008. The Preliminary Views or a Discussion Paper is published at the end of 2008. The topics discussed are (1) level of aggregation of line items presented in each financial statement, (2) totals and subtotals to be reported in each financial statement, (3) the use of direct method versus indirect method in presenting the statement of cash flows, and (4) the presentation of other comprehensive income (hereafter, *OCI*) and the recycling mechanism (if any).

The preliminary views are discussed in detail in Appendix A. The summary of decisions reached so far is summarized in the next section.

Phase C: This phase started at the beginning of 2009 and is currently deliberating on the issues of Phase C. The issues in Phase C include (1) a composition of the interim financial statements, (2) the needs for a condense format of the interim financial statements, (3) requirements in presenting comparative interim financial statements, and (4) the needs for different sets of guidance for public and nonpublic companies.

2.1.3. Tentative Preliminary Views on Financial Statement Presentation

Resulting from Phase B deliberations, the working principles of financial statement presentation¹⁴ suggest that financial statements should have the following characteristics:

- a. Financial statement items must depict a cohesive financial picture of an entity. The cohesive principle¹⁵ should be applied at a line-item level when applicable.

¹⁴ See (1) Minutes of the April 5, 2006 FASB Meeting on Performance Reporting Project – Scope, Objectives, and Principles (FASB Memorandum No. 41), (2) Minutes of the July 19, 2006 FASB Meeting on Financial Statement Presentation – Application of Working Principles (FASB Memorandum No. 42), (3) Information for Observers for the July 21, 2006 IASB Meeting on Application of Working Principles (IASB Agenda Paper No. 17), (4) Information for Observers for the September 19, 2006 IASB Meeting on Application of Working Principles (IASB Agenda Paper No. 9), (5) Minutes of the September 20, 2006 FASB Meeting on Financial Statement Presentation – Application of Working Principles (continued) (FASB Memorandum No. 43), (6) Information for Observers for the October 24, 2006 IASB/FASB Meeting on Application of Working Principles (IASB Agenda Paper No. 6 and FASB Memorandum No. 44), (7) Minutes of the December 13, 2006 FASB/IASB Meeting on Financial Statement Presentation – Application of Working Principles (continued) (FASB Memoranda No. 45A-D and IASB Agenda Papers No. 15A-D), and (8) Information for Observers for the July 21, 2006 IASB Meeting on Application of Working Principles (IASB Agenda Paper No. 17), for more details on working principles.

- b. Different activities should be presented separately; that is, entity should present financing activities independently from its business and other activities¹⁶.
- c. The line items should be disaggregated if doing so improve the usefulness of financial information in forecasting future cash flows. Under the disaggregation principle, the financial information should be disaggregated by functions and by nature.
- d. The financial statements should enhance the financial statement user's ability to assess whether the entity has the ability to fulfill financial commitments and obligations and identify plausible investment opportunities.
- e. The financial statements should also help users understanding (a) measurement basis applied, (b) uncertainty associated with the measurement basis, (c) source of changes in financial position, (d) difference between cash-based and accrual-based accounting, and (e) significant non-cash activities.

From the abovementioned working principles, the Boards have initiatives as to how the financial statement should be presented¹⁷. The main categories in three main financial statements embrace (1) Business (operating and investing), (2) Financing, (3) Income taxes¹⁸, (4) Discontinued Operations¹⁹, and (4) Equity (if applicable). Consistent with the cohesiveness principle, the line items presented in each and every the financial statement are linked together, as depicted in following table. Users of financial statement should be able to easily notice the financial statement articulations

¹⁵ See Information for Observers for the October 17, 2007 IASB Meeting on Issues Related to Application of the Cohesiveness Principle (IASB Agenda Paper No. 8B) for more details on the application of cohesiveness principle to financial statement presentation.

¹⁶ See (1) Minutes of the October 24, 2005 IASB Meeting on Segment B: Financing (IASB Agenda Paper No. 2), and (2) Information for Observers for the October 24, 2006 IASB/FASB Meeting on Financing Section and Investing Category (IASB Agenda Paper No. 6A and FASB Memorandum 44A), for more details on presentation of financing information.

¹⁷ See (1) Information for Observers for the October 17, 2007 IASB Meeting on Miscellaneous Issues, and (2) Information for Observers for the June 19, 2008 IASB Meeting on Sweep Issues (IASB Agenda Paper No. 9B), for details on other issues on financial statement presentation.

¹⁸ See Information for Observers for the March 11, 2008 IASB Meeting on Presentation of Income Tax Information (IASB Agenda Paper No. 3), for details on presentation of income tax information.

¹⁹ See Information for Observers for the January 25, 2007 IASB Meeting on Definition of Discontinued Operations (IASB Agenda Paper No. 13A) for the details on discontinued operations.

or linkage among the items presented across the financial statements. To be exact, under this cohesiveness principle, the entity should clearly classify its assets, liabilities, and equity into the categories that it sees fit in its statement of financial position and present the changes in its financial position accordingly (in the same categories) in the statement of comprehensive income and statement of cash flows. The similar label for the line item should be used when it is applicable.

The classification of items on the financial statements depends on the management's views²⁰. The entity would decide on the classification that best reflect its view of what constitutes its main business and financing activities and apply the classification scheme at the reportable segment level. As indicated by the Boards, business section would include the line items that result from continuing business activities, which are those activities carried out to create business value.

Note that the business activities can be further disaggregated into (1) operating, and (2) investing activities. Also, note that operating category includes items that management regards as the items related to the central purpose(s) for which the entity is in business, whereas investing category includes items that firm uses to generate return, not directly related to the central purpose(s) of the business. Financing section includes the items related to the financing of the entity's business activities. From the abovementioned working format, the Boards also address the tentative totals and subtotals in each financial statement as depicted in Table 2.1 below.

²⁰ See (1) Minutes of the January 24, 2006 FASB/IASB Meeting on Financial Statement Presentation – Discontinued Operations, Hybrid Entities, and Equity-Related Issues (FASB Memoranda No. 46A-C and IASB Agenda Paper No. 13A, C, and D), (2) Information for Observers for the May 17, 2007 IASB Meeting on Classification by Diversified Entities (IASB Agenda Paper No. 6B), and (3) Information for Observers for the January 25, 2007 IASB Meeting on Hybrid Entity Consideration (IASB Agenda Paper No. 13C), for more details on the application of classification principle.

Table 2.1: Tentative Totals and Subtotals of Financial Statements

| Statement of Financial Position (also known as Balance Sheet) | Statement of Cash Flows | Statement of Comprehensive income |
|--|---|---|
| <i>Business</i> | <i>Business</i> | <i>Business</i> |
| Operating assets and liabilities | Cash flows from operating activities | Operating income and expense |
| Subtotal (A1) | Subtotal (A1) | Subtotal (A1) |
| Investing assets and liabilities | Cash flows from investing activities | Investment income and expense |
| Subtotal (A2) | Subtotal (A2) | Subtotal (A2) |
| Total (A) = Subtotals (A1) + (A2) | Total (A) = Subtotals (A1) + (A2) | Total (A) = Subtotals (A1) + (A2) |
| <i>Financing</i> | <i>Financing</i> | <i>Financing</i> |
| Financing assets | Cash flows from financing assets | Financing asset income/expense |
| Subtotal (B1) | Subtotal (B1) | Subtotal (B1) |
| Financing liabilities | Cash flows from financing liabilities | Financing liability income/expense |
| Subtotal (B2) | Subtotal (B2) | Subtotal (B2) |
| Total (B) = Subtotals (B1) + (B2) | Total (B) = Subtotals (B1) + (B2) | Total (B) = Subtotals (B1) + (B2) |
| <i>Income taxes</i> | <i>Income taxes</i> | <i>Income taxes</i> |
| Income tax assets | | |
| Income tax liabilities | | |
| Total (C) -- ΣIncome tax | Total (C) -- ΣCash flows from income | Total (C) -- ΣIncome tax |
| <i>Discontinued operations</i> | <i>Discontinued operations</i> | <i>Discontinued operations</i> , net of tax |
| Assets held for sale (disposal group) | | |
| Liabilities (disposal group) | | |
| Total (D) -- ΣNet assets of discontinued operations | Total (D) -- ΣCash flows from discontinued operations | Total (D) -- ΣIncome/expense of discontinued operations |
| <i>Equity</i> | <i>Equity</i> | <i>Other comprehensive income</i> , net of |
| Total (E) -- ΣEquity | Total (E) -- ΣEquity | Total (E) -- Σequity |
| Total Assts and Total Liabilities will be presented in the notes | Bottom line = ΣTotals A + B + C + D + D + E (Net change in cash) | Bottom line = ΣTotals A + B + C + D + D + E (Total comprehensive income) |

Note: The bold italics are section names and bullet points depict required categories within sections. The statement of changes in equity is not included in the abovementioned table because it has different section names and categories. The labels and sequences are modified in response to more updated decisions of the Boards.

Source: Excerpts from the meeting materials in Financial Statement Presentation Meeting of Joint International Group and Financial Institutions Advisory Group on September 14, 2007 with modification made by author in response to Summary of Tentative Preliminary Views as of June 30, 2008.

Except for the statement of changes in equity, the Boards tentatively require that the totals required in each of the financial statements are the totals for the main categories specified in the working format (i.e. Business, Financing, Income Taxes, Discontinued Operations, and Equity)²¹. Nonetheless, the order of presentation is subject to change in subsequent Boards' deliberation process. The grand totals derived from the aforementioned totals are not required. The Boards might allow the presentation of the subtotals that are important for the financial analysis of a specific industry in certain financial statements.

²¹ I discuss only the application of working format to non-financial institutions (see Information for Observers for the December 14, 2006 IASB Meeting on Application of the Working Format to Financial Institutions (IASB Agenda Paper No. 15C)).

The following sub-sections discussed the summary of proposed changes reached by the Boards for each financial statement²². The subtotals unique for each and every financial statement would be discussed in each section. A more detailed discussion is presented in Appendix A.

2.1.3.1. Statement of Comprehensive Income

Statement of comprehensive income (for FASB) or statement of profit and other recognized income and expenses (for IASB) presents the changes in net assets during the accounting period resulting from non-owner transactions (i.e. overall financial performance). The major components presented on the face of statement of comprehensive income are (a) net income or profit or loss for the period and (b) other comprehensive income items or other recognized income and expenses.

The proposed changes related to statement of comprehensive income focus on three issues: (1) classification of revenues and expenses, (2) disaggregation of items by function and by nature, and (3) presentation of other comprehensive income items²³.

First, aiming to portray cohesive financial representation of a firm, statement of comprehensive income items are categorized into 4 major sections: (1) business, (2) financing, (2) discontinued operations, and (4) income taxes. The subtotals unique to this statement are gross profit, operating income, investing income, business

²² There is no discussion on foreign currency transactions in this study (See (1) Information for Observers for the June 19, 2007 IASB Meeting on Basket Transactions and Foreign Currency Transactions Adjustments (IASB Agenda Paper No. 3A), and (2) Foreign Currency and Basket Transactions (IASB Agenda Paper No. 9C) for the details related to foreign currency transactions.)

²³ See (1) Minutes of the January 30, 2006 FASB/IASB Meeting on Financial Statement Presentation – Disaggregation on the Statement of Comprehensive Income (FASB Memorandum No. 47 and IASB Agenda Paper No. 13B), (2) Minutes of the March 21, 2007 FASB Meeting on Financial Statement Presentation – Disaggregating Changes in Assets and Liabilities, Presentation of Other Comprehensive Income Items, and Cash Equivalents, (3) Minutes of the May 25, 2005 FASB/IASB Meeting on Earnings Per Share and Comprehensive Income Per Share (FASB Memorandum dated May 5, 2005 and IASB Agenda Paper No. 6), (4) Information for Observers for the October 24, 2006 IASB/FASB Meeting on Measurement; OCI and Recycling; the Statement of Comprehensive Income (IASB Agenda Paper No. 6C and FASB Memorandum No. 44C), (5) Information for Observers for the March 22, 2007 IASB Meeting on Other Comprehensive Income Presentation (IASB Agenda Paper No. 9B), (6) Information for Observers for the January 25, 2007 IASB Meeting on Disaggregation on the Statement of Comprehensive Income (IASB Agenda Paper No. 13B), (7) Information for Observers for the December 14, 2006 IASB Meeting on Other Comprehensive Income (IASB Agenda Paper No. 15A), and (8) Information for Observers for the July 24, 2008 IASB Meeting on Paragraph Describing the Boards' Long Term View on Other Comprehensive Income (IASB Agenda Paper No. 16), for more details on the proposed changes on the Statement of Comprehensive Income.

income, financing income, income from discontinued operations, income taxes, and comprehensive income. The subtotals presented are influenced by alternative presentations of the other comprehensive income, which is discussed below.

Second, the statement of comprehensive income items should also be disaggregated by function and by nature. **Functions** are defined as primary activities that an entity engages (e.g. manufacturing, selling, and administrative). Those functions would then be further segregated based on their nature (e.g. materials, labor, transportation). Specifically, **nature** is defined as the inputs or costs required to carry out the aforementioned activities. Level of data disaggregation is bounded by the usefulness of information; that is, the information should be disaggregation until the disaggregation would harm rather than be useful to the users. The Boards require that the by-nature information can either be presented on the face of the statement or be disclosed in the note disclosure.

Third, the Boards have not reached the decisions on the presentation of the “**bypass**” items, which are defined by FASB as *other comprehensive income* (OCI) and by IASB as *other recognized income and expenses*, on the statement of comprehensive income. The other comprehensive income items currently listed by FASB and IASB are summarized in Table 2.2 below.

Table 2.2: List of Other Comprehensive Income Items as Defined by FASB and Other Recognized Income and Expense Items as Defined by IASB

| Item No. | Other comprehensive income items - FASB | Other recognized income and expense items - IASB |
|----------|---|---|
| 1 | Unrealized gains and losses on available-for-sale securities (Statement of Financial Accounting Standards No. 115 - "Accounting for Certain Investments in Debt and Equity Securities") | Unrealized gains and losses on remeasuring available-for-sale financial assets (International Accounting Standard No. 39 - "Financial Instruments: Recognition and Measurement") |
| 2 | Gains and losses on derivatives held as cash flow hedges (Statement of Financial Accounting Standards No. 133 - "Accounting for Derivative Instruments and Hedging Activities") | The effective portion of gains and losses on hedging instruments in a cash flow hedge (International Accounting Standard No. 39 - "Financial Instruments: Recognition and Measurement") |
| 3 | Minimum pension liability adjustments (Statement of Financial Accounting Standards No. 87 - "Employers' Accounting for Pensions") | Actuarial gains and losses on defined benefit plans (International Accounting Standard No. 19 - "Employee Benefits") |
| 4 | Gains and losses resulting from converting foreign currency subsidiaries to the parent currency (Statement of Financial Accounting Standards No. 52 - "Foreign Currency Translation") | Gains and losses arising from translating the financial statements of a foreign operation (International Accounting Standard No. 21 - "The Effects of Changes in Foreign Exchange Rates") |
| 5 | Unrealized gains and losses from a foreign currency hedge of a net investment in a foreign operation (Statement of Financial Accounting Standards No. 133 - "Accounting for Derivative Instruments and Hedging Activities") | N/A |
| | N/A | Changes in revaluation surplus (International Accounting Standard No. 16 - "Property, Plant and Equipment" and International Accounting Standard No. 38 - "Intangible Assets") |

The Boards consider several proposed presentation alternatives of the OCI items both for short-term and long-term time span. Actually, the Boards' long-term goal is to present all changes in assets and liabilities (non-OCI and OCI items) in their corresponding sections, without discriminating non-OCI from OCI items. This would make the recycling mechanism of OCI items²⁴ unnecessary. The OCI items are

²⁴ Net income and other comprehensive income constitute comprehensive income. The other comprehensive income would, at the end, be recognized in net income when realized. This refers to as "recycling" of other comprehensive income items. To avoid double counting the gains or losses, the reclassification adjustments are required.

currently recognized outside net income or profit or loss; thus, later when those items are realized, they will be presented as part of net income or profit or loss. However, to achieve the Boards' long-term goal, the current accounting standards need to be amended. Since the scope of FSP project focuses mainly on form and presentation, not recognition issues, the long-term goal would not be attained at this stage. The summary of four alternative presentations of OCI items are displayed Figure 2.1 below and the detailed discussion on pros and cons of each alternative is presented in Appendix A.

Figure 2.1: Alternative Presentation of Other Comprehensive Income Items.

| | |
|--|---|
| <p>Alternative 1</p> <p>BUSINESS</p> <p>Operating <i>OCI - Operating</i></p> <p>Investing <i>OCI - Investing</i></p> <p>DISCONTINUED OPERATIONS</p> <p>FINANCING</p> <p>INCOME TAXES</p> | <p>Alternative 2</p> <p>BUSINESS</p> <p>Operating Investing</p> <p>DISCONTINUED OPERATIONS</p> <p>FINANCING</p> <p>OCI</p> <p><i>OCI - Operating</i> <i>OCI - Investing</i></p> <p>INCOME TAXES</p> |
| <p>Alternative 3</p> <p>SHORT-TERM</p> <p>BUSINESS</p> <p>Operating Investing</p> <p>DISCONTINUED OPERATIONS</p> <p>FINANCING</p> <p>LONG-TERM</p> <p>Operating (<i>including OCI items</i>) Investing (<i>including OCI items</i>)</p> <p>INCOME TAXES</p> | <p>Alternative 4</p> <p>BUSINESS</p> <p>Operating (<i>including OCI items</i>) Investing (<i>including OCI items</i>)</p> <p>DISCONTINUED OPERATIONS</p> <p>FINANCING</p> <p>INCOME TAXES</p> |

Although the focus of this study is on the proposed changes on performance reporting statement, the proposed changes on the other statements that constitute a full set of financial statements are also discussed in the next sub-sections.

2.1.3.2. *Statement of Financial Position*

Statement of Financial Position (formerly known as balance sheet) presents financial position of the firm at a given point in time. The issues discussing by the Boards related to statement of financial position are (1) classification of assets and liabilities, (2) totals and subtotals on the statement of financial position, and (3) disclosure of liquidity information²⁵.

First, the assets and liabilities are required to be categorized in the same manner as in the statement of comprehensive income. The statement of financial position also presents the equity section towards the end of the statement. The financial statement users would be able to easily trace the linkage between the statement of financial position and other financial statements.

Second, in addition to the required totals for main categories stated above, totals and subtotals unique to the statement of financial position are short-term and long-term operating assets and operating liabilities. The Boards currently consider two alternatives, namely “*Net assets/Equity*” format or “*Value creating/Funding*” format, in presenting additional subtotals on the face of statement of financial position.

Particularly, the “*Net assets/Equity*” format presents the sum of total net assets and balances it with total equity, while the “*Value creating/Funding*” format presents the sum of value-creating and balances it with sum of funding sources. Lastly, the Boards encourage the disclosure of liquidity information as a supplemental schedule to the statement of financial position. The three alternative disclosure formats for liquidity information considered by the Boards are summarized in Appendix A.

²⁵ See (1) Minutes of the May 16, 2007 FASB Meeting on Financial Statement Presentation – Presentation of Liquidity Information, Classification Issues Related to Diversified Entities, and Segment Reporting (FASB Memoranda No. 51A-C), (2) Information for Observers for the May 17, 2007 IASB Meeting on Presentation of Liquidity Information (IASB Agenda Paper No. 6A), and (3) Information for Observers for the October 24, 2006 IASB/FASB Meeting on Presenting Information about the Short and Long-term Nature of Assets and Liabilities (IASB Agenda Paper No. 6B and FASB Memorandum No. 44B), for more details on the proposed changes on the Statement of Financial Position.

2.1.3.3. Statement of Changes in Owners' Equity

Statement of changes in owners' equity is required to constitute a complete set of financial statements. The presentation of the statement of changes in equity does not adhere to cohesiveness principle under working principle discussed earlier. The statement of changes in owners' equity presents all owner-related changes during the accounting period, while all other changes resulting from non-owner transactions are presented in statement of comprehensive income. The beginning and ending balances of all equity-related accounts are presented with the detail of changes occurred during the accounting period.

2.1.3.4. Statement of Cash Flows

The statement of cash flows presents the cash inflows and outflows resulting from the business transactions during the accounting period. The Boards address two issues related to the statement of cash flows. The first issue is whether the statement of cash flows should be prepared using direct method as opposed to indirect method. FASB is of the standpoint to require the direct method to determine the operating cash flows. However, IASB encourages, rather than requires, the direct method. The Boards also discuss the methods of preparing direct method of statement of cash flows, namely direct-direct method or indirect-direct method (see Appendix A for more details).

The second matter is on the presentation of the reconciliation schedule accompanying the statement of cash flows. The reconciliation schedule would portray the linkage between the statement of cash flows and other statements; especially, the statement of comprehensive income and statement of financial position. The Boards consider the three proposed presentation alternatives for the reconciliation schedule: (a) *Statement of Financial Position (FP) Reconciliation*, (b) *Statement of Cash Flows to Statement of Comprehensive Income (CF-CI) Reconciliation*, and (c) *Comprehensive Income (CI) Matrix* (see Appendix A for more details.)