The quest for clarity

Executive summary

- Standard & Poor's Ratings Services has significant concerns about the accounting boards' proposals to change the way in which companies communicate their financial information.

After years of debate, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have published a joint discussion paper on the presentation of financial statements. The paper proposes a revolutionary change to the format of financial statements that, in our opinion, would have equally significant implications for the analysis of financial statement information. We question the need for such a complete replacement of the format of company financial statements when enhancements could be made to the existing format that might better resolve current concerns.

The two accounting boards propose redesigning balance sheets so that all assets and liabilities are categorised as relating to operating, investing, financing, income tax or discontinued operations. Items on the income statement and the statement of cashflows would also be classified using these same categories, thereby cohesively linking classification of items across the three statements.

Their proposal is to replace the use in the cashflow statement of an indirect method derivation of cashflows from operations (showing adjustments to an earnings measure to derive operating cashflows) with one that shows amounts paid and received on a line-by-line basis that coincides with the lines on the income statement.

We welcome the wide debate the discussion paper has instigated. However, we are not convinced the proposal does as much as it could to address issues that are relevant to our credit analysis. We hope our comments here may prove useful to companies that want to improve their disclosure even in advance of any new requirements.

ANALYTICAL DIFFICULTIES The discussion paper is intended, at least in part, to respond to requests for greater transparency of financial information by the investment and analytical community. We believe that for analysts to better estimate how a company may perform in the future, reporting should both explain the past well and provide a basis for understanding how the company responded to existing conditions.

There are many ways that companies can communicate financial statement information to investors and analysts. In our view, the financial statements and footnotes should be considered as a complete package, rather than individual elements. The boards should therefore focus on identifying a package of financial statement information that improves information quality and enables better analysis.

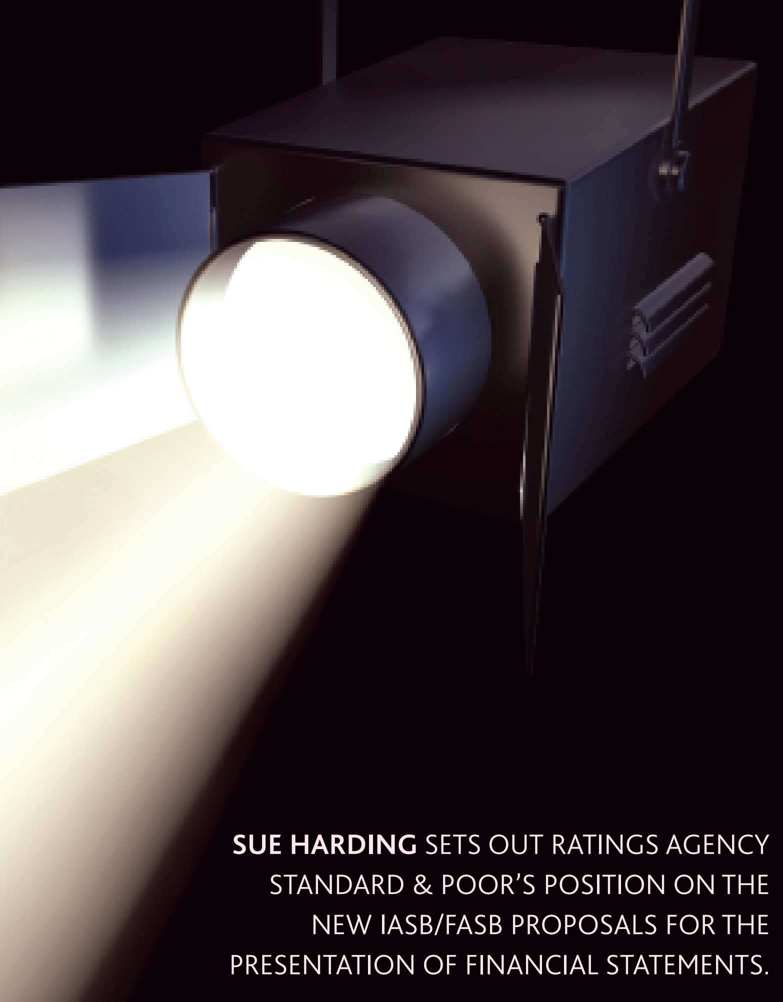
S&P has significant concerns over the current disclosure regime, which for some companies can be ambiguous and disconnected. Our concerns could be addressed by a basic disclosure framework which requires clear explanation of what the company's underlying transactions are, linking this to how they have been accounted for, what the related amounts in the various financial statements are, and information on estimation and sensitivities to future changes.

A prime example of the basic analytical difficulties faced currently is the frequent lack of clear information on derivatives, including the terms of various derivative instruments, their business purpose, the method of hedge accounting applied (or not), and the location of related amounts in assets, liabilities, earnings and cashflows.

NEW PROPOSALS The discussion paper proposes a very detailed direct basis cashflow statement that enables a proposed reconciliation of cashflows to earnings. This particular aspect of the proposal has caused some controversy among preparers because of

Table 1: S&P's proposed structure for reconciliation of changes in a

A	B	C
Amount included in the statement of financial position at the beginning of the accounting period, making the respective line on that statement clear.	Amounts included in profit or loss. These should be in sufficient detail to distinguish accruals based on business transaction activity versus adjustments to valuation (such as fair value adjustments or currency translation) and reversals of provisions, and where these are included in the statement of comprehensive income.	Amounts included in other comprehensive income (OCI). These should be in sufficient detail to distinguish movements based on activity versus valuation adjustments and where these are included in the statement of comprehensive income.



SUE HARDING SETS OUT RATINGS AGENCY STANDARD & POOR'S POSITION ON THE NEW IASB/FASB PROPOSALS FOR THE PRESENTATION OF FINANCIAL STATEMENTS.

the perceived significant costs in generating detailed levels of cash information, and a lack of consensus among users of the need for information to be gathered in this manner.

Indeed, much of the information that we believe would be useful for analysis could be provided through alternative means. In our view, the main drawback with the current presentation of operating cashflows is not that it is indirect, but that the descriptions of differences between the earnings amount used and operating cashflows are often unclear.

We recommend that the cashflow statement begins with operating income (not net income or another earnings measure). This would ensure a more consistent start point and limit the distance between the start and end point by beginning with a more directly related earnings amount. Adjustments to operating income should be described clearly and in a manner that relates them to specific assets and liabilities. Discontinued operations should also be presented clearly on the statement itself or in the footnotes.

Comprehensive tables – such as the one proposed in the discussion paper to reconcile all cash and earnings amounts – are useful if the totals shown are meaningful and/or the line-by-line detail is helpful. However, the boards' proposals fall short on both these counts.

Even with the proposed reconciliation of earnings to cashflows, the information provided would still not explain fully the changes in balance sheet amounts, such as accounts receivable. In our view, more comprehensive information should be presented on the relationships between amounts on the financial statements. Reconciling the asset or liability amount from beginning to end of year could provide this link.

Many such reconciliations are already required by international financial reporting standards (IFRS), including reconciliations of property, plant and equipment, intangibles, the net post-retirement benefit position, and provisions. Additional reconciliations could include debt (or assets and liabilities classified as financing), working capital items, investments, derivatives and taxes. The effects of business acquisitions, disposals and foreign exchange translation on asset and liability values are very often not apparent, but should, in our view, be identified in such reconciliations.

Table 1 shows a sample structure for such a reconciliation table. Columns B to D could be split into subcolumns to facilitate understanding of what the different components of change represent, and where they appear in the respective financial statements.

In our opinion, such reconciliation information is best presented in the footnotes, as this allows for a more meaningful description of the applicable changes than can be accommodated in a single table that includes all assets and liabilities. Related assets and liabilities could be shown together in a single table, for example, with one table listing various income tax assets and liabilities, one listing debt and interest components for related obligations, or one on derivatives and related assets and liabilities to help present the relationship between such items. Differences between cash and earnings amounts would be apparent as the difference between column B and column D in Table 1.

This package would provide clear information to support analysis, including the cash conversion cycle and the accounting cycle for underlying business activities, tracking through the statements of financial position, and cash and earnings flows.

If the current indirect cashflow statement were removed, it would not generally result in the presentation of enough information to allow users to work out the changes in working capital attributable to differences between related earnings and cash amounts. The IASB/FASB's proposed cohesiveness approach does not sufficiently extend to a reconciliation of a company's assets and liabilities. We believe that an improved indirect statement of cashflows would better provide this information, which is particularly useful in our corporate ratings analysis.

NEXT STEPS We understand that the accounting boards are considering a range of approaches, including steps we have advocated to retain and improve the indirect derivation of operating cashflows and to add certain supplemental reconciliations of asset and liability balances. The current project plan calls for an exposure draft to be issued in April 2010 and a final standard published in June 2011. In the meantime, we continue to monitor the progress of this important project and participate in the ongoing discussion with the boards, issuers, investors and other interested parties.

n assets and liabilities

D	E	F
Amounts attributable to cash amounts paid or received. These should be in sufficient detail to show where they are included in the statement of cashflows.	Other amounts. Also in sufficient detail to show the effects of acquisitions, disposals, non-cash transactions and transfers, and foreign currency translation (not in comprehensive income).	Amounts included in the statement of financial position at the end of the accounting period, making the respective line on that statement clear.

Sue Harding is European chief accountant for Standard & Poor's Ratings Services.

The themes explored in this article are covered in greater depth in a report accessible at: http://tinyurl.com/mgy9fe