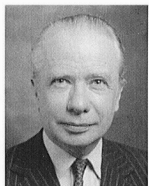


The revolution ahead in financial reporting: a new world -- what the income statement means to financial reporting

David Damant



David Damant is Chairman of the Accounting Advocacy Committee of the United Kingdom Society of Investment Professionals, and a former Board Member of the International Accounting Standards Committee.

Abstract David Damant, one of the leading thinkers in the investment analysis world, shows how the proposed new income statement will change the world of financial reporting, leading to clarification, fair values and a much simpler system by emphasizing cash flow.

Keywords: Financial reporting, Accounting standards, Fair value, Investment appraisal

The proposals for a new format for the income statement represent the greatest revolution in the appearance of financial reporting since the introduction of double entry book-keeping more than five hundred years ago. Indeed the two developments are connected. Double entry book-keeping, with its initial consequence in the form of the trial balance, raises the question: which of the figures in the trial balance represent performance? And the answer now given is that every change is a part of performance, and should be represented in the section of the financial statements which reflect performance – that is, in the income statement (Table I).

In his article in this issue of *Balance Sheet* Richard Barker, Research Fellow at the International Accounting Standards Board (IASB), sets out the arguments for transcending the traditional profit and loss account with a statement of comprehensive income in the form of a matrix[1]. These arguments are individually persuasive, but it is the overall argument which is critical. Everything that happens to a company has some consequence for the future, and to try to make a distinction between items appearing in the traditional profit and loss account and items transferred directly to reserves is a delusion in principle.

no more artificial distinctions

It is also a delusion in practice. It is quite clear from finance theory that share prices take account of a wide information set when pricing shares, and not just the figures in the profit and loss account, and certainly not just the "bottom line" or "earnings". And if this is the case, it is important to display performance in total, that is every change in the shareholders' funds

The greatest revolution in the appearance of financial reporting.

Table I XYZ Company IAS 1 income statement for the period ending 30 September 2002

Revenue	35,999
Operating costs	(33,932)
Operating profit	2,067
Finance costs	(346)
Income from investments	253
Goodwill amortization	(116)
Exceptional items	369
Profit before tax	2,227
Income tax	(636)
Profit after tax	1,591
Income from associates	119
Minority interest	(207)
Net profit for the year	1,503

Source: This example is taken from the published accounts of a real company. The reconciliation of several of the figures in the traditional profit and loss account with those in the new income statement requires more detailed calculations than can be shown here, but the calculations are relatively simple.

(except transactions with shareholders), and not disguise the matter by artificial distinctions such as those employed in the traditional approach. Perhaps this argument began with the realization that there is no such thing as an "extraordinary" or "exceptional" profit – the distinction was impossible in practice, and, since we want to see the whole performance, unsound in principle (Table II).

It has been claimed that this set of proposals for the income statement is modest by comparison with most proposals for new accounting standards: it is to a large extent a proposal only for a change of format. One can perhaps appreciate that point in logic, but in fact the difference in kind or of format is so great as to be a difference in degree. And this difference of degree is also a difference clearly relevant to financial analysis – that is, we can see, at last, a true picture of the performance of a company. The items which the readers of the accounts are trying to comprehend will now be displayed, in the clearest possible manner.

This may not be accepted in many places, including by many analysts, at the moment. But this is to a large extent due to unfamiliarity, since discussions on the IASB's proposals on the new income statement have been limited, and so far the published documentation has also been limited. And it is indeed unfamiliarity which may be the main barrier to an early acceptance of this methodology[2]. It can, however, be forecast with some confidence that the capital markets and the representatives of professional investors and analysts will come out strongly in favor of these proposals, once they are fully promulgated. And as there is a wider constituency – especially the vital constituency of the companies themselves – it is essential that the IASB publishes its proposals, even with some matters open for debate, as soon as possible. Any further delay in the formal promulgation of these ideas will make the problem of unfamiliarity all the more difficult to overcome.

Revealing Fair Value

There is one aspect of the proposals where the move to a comprehensive income statement would have a positive advantage even in the eyes of those who are unhappy about such a radical change from the familiar. In recent years international accounting standards (now to be called international financial reporting standards) have been moving sharply and with determination towards a fair value balance sheet. There is no doubt that this is the correct solution to the question of measurement, but the move is resisted in some places. There are a number of arguments put forward against fair values and one is the difficulty of reflecting the various changes in fair value in the traditional profit and loss account. Richard Barker mentions the



Table II XYZ Company performance statement for the period ending 30 September 2002

	<i>Total</i>	<i>Income before remeasurements</i>	<i>Remeasurements</i>
Business			
Revenue	35,999	35,999	–
Cost of sales	(28,040)	(27,809)	(231)
Operating expenses	(5,644)	(5,491)	(153)
<i>Operating</i>	<i>2,315</i>	<i>2,699</i>	<i>(384)</i>
Disposal gain/(loss)	254	–	254
Goodwill	(116)	–	(116)
<i>Other business</i>	<i>138</i>	<i>–</i>	<i>138</i>
Income from associates	285	–	285
Equity investments	36	–	36
Debt investments	128	128	–
Operating assets	(195)	–	(195)
Pension plan assets	289	–	289
<i>Financial income</i>	<i>543</i>	<i>128</i>	<i>415</i>
Business profit	2,996	2,827	169
Financing			
Interest	(642)	(628)	(14)
Pension financing	(263)	(263)	–
Financing expense	(905)	(891)	(14)
Tax	(636)	–	–
Discontinuing activities	–	–	–
Forex gain (loss) on net investment	1,359	–	1,359
Cash flow hedges	7	–	7
Total recognized gains and losses	2,821		

question of volatility in his article. There are other problems. And there is no doubt that even for a convinced supporter of fair value the outcomes, as between the traditional profit and loss account and transfers to reserves, and with recycling etc., are complex to handle.

In the proposed matrix this problem is resolved. The separate column for remeasurement immediately clarifies the matter. To take an extreme example, there is considerable opposition to the revaluation of a company's own long-term debt, partly on the grounds that a large "profit" might be seen if a company's credit rating and therefore the market value of its debt should fall. And yet on the other hand, with derivatives such as swaps, how can the derivative be put at fair value (as it must be) but not the underlying debt? With the new income statement, the problem is resolved. The "gain" on the decline in the value of the company's own long-term debt has its own position in the matrix – under "remeasurement", and in the row "financing". No one in looking at the matrix of the new income statement would be in any doubt as to the nature of the change in value concerned.

Furthermore, the central column of the matrix has a certain familiarity – it is to an extent like the historic cost profit and loss account, although drawn up according to much more rigorous principles, and forming a part rather than the whole of the performance reporting for the company. Even the individual investor, or the non-professional observer of the scene, will be able to see the operational flows, separated from remeasurements, and will understand the distinction.

But there is another and powerful line of thought in the argumentation which leads to the separation of the remeasurement column from the column which shows income before remeasurement. A company's operations will generate cash-flows into the future and it is the discounted present value of those future cash-flows which leads to an assessment by the

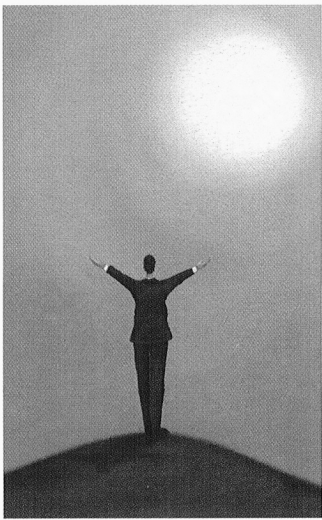
analyst and the capital markets of the value of the company. In addition, a company will have assets and liabilities which will change in value over time. The major part of these revaluations will be fixed by reference to a market – in the case of government securities for example, the stock exchange; in the case of property assets, the real estate market. Discussing fair value in a number of standards, the IASB emphasizes again and again the importance of a market price should one be available. These market prices represent an objective view of what an asset (or indeed a liability) is worth in the market. Thus the cash-flows which value government securities or real estate are those which the parties to the markets in question believe will justify a certain price for the asset, independent of the cash-flows generated on the asset by the company currently holding the asset.

The result is a valuation of the asset which already takes account of the future cash-flows relevant to the remeasurement. Thus a financial analyst, in forecasting the future cash-flows which a company will generate, will deal separately with those assets (and liabilities) which are already valued on future cash-flows – otherwise the process would be carried out twice. Or, looking at it from another point of view, the valuation of the company will depend upon the discounted present value of the operational cash-flows plus the valuation of certain of the assets (less liabilities) in the balance sheet. To take an extreme example, an investment trust investing in shares, or an investment property company investing in real estate, will generate very little cash-flow by itself. The real success or failure of the company will be measured by the valuation of the assets in the balance sheet and by their changes (which will appear in the remeasurement column). In the case of a general trading company, if it has significant investment or real estate assets, the outcome for each year – the performance which is reported – will have two parts: the changes in the valuation of the assets in the remeasurement column, and the flows of cash arising from items which are first recognized in the second column of the matrix. To mix these two outcomes would be like mixing apples and pears. The new matrix perfectly delineates these two types of performance outcome.

THE FUTURE CASH FLOWS

Over the years, a company generates incomes and expenditures – the future-cash flows which the market is attempting to estimate. The analyst will forecast these cash-flows – such as the sales, the cost of raw materials etc. – by extrapolation and modification. This is part of the day-to-day job of the markets in a changing economic climate which will affect both the future cash-flow estimates and the discount rate which will reflect changing risks. It would be reasonable to take a price/“earnings” ratio to reflect the cash-flow generating power of the company as compared with its market price. How many years cash-flows does the price represent? It would be illogical to strike a price/“earnings” ratio by using items from the remeasurement column as all or part of the “earnings”. Changes in valuation reflect changes in markets, not the company’s operational earning power. It is on the same basis that the case that a price/“earnings” ratio cannot be struck using the total figure in the total column – “Total recognized gains and losses”. Such a figure, containing as it does many items from the remeasurement column, is inappropriately handled in this way. Thus, however useful this total figure may be in certain ways, it is not something which can be handled in the same way as the traditional earnings number.

Richard Barker in his article produces a draft matrix for the new income statement and attached to the present article is an example worked out for a real company, called here the XYZ Company. The new format displays extremely clearly what the outcomes have been for XYZ. Thus, for this international company, some note must be taken of the remeasurement gain on the foreign exchange; otherwise it looks as though the remeasurements for this company are not particularly significant as opposed to the income from operations. For another company the picture might be different. A retail stores group might have very significant real estate assets, used, almost completely, for trading purposes. Changes in the valuation of these real estate assets will appear in the remeasurement column, whereas retail trading outcomes will be shown in the middle column. If the stores become very unprofitable, and real estate values rise, the question of the opportunity costs of the assets held will come more into



the picture. In all cases for all companies, even a mere **survey** of the matrix will show at once the nature of the company and how its various activities move and relate to each other.

Some criticism has been made that a comparison of the matrix figures with the previous years figures will cause a very complicated page to appear. Perhaps the more appropriate approach would be to show each year's matrix separately, one year after the other or on succeeding pages, so that reading through the matrices for the successive years will give the user an understanding of the pattern of performance in each year and of the trends over time, a pattern which is disguised in the traditional system. This surveying of the performance, and the way in which both quantitative and qualitative aspects of performance are so clearly displayed and understandable, is yet another example of how the correct principles have given rise to an outcome which is of extreme practical value.

At the moment some aspects of the matrix are still under discussion and will no doubt continue to be under discussion after the publication of an exposure draft on this subject. Some of these are worth discussing as examples of the process, although the details of the process are less important than the overall and vital principle involved in the move to comprehensive income.

Example by example:

As a first example of the questions under discussion, are the operating expenses of a company to be shown by function or by nature? The example of the XYZ Company shows expenses by function, that is a "cost of sales" figure (following the company); and many analysts prefer this approach. It could be argued that one of the principles of the new income statement is the clarity with which discrete items are separated out. On this argument it would be best if the matrix were to show items by nature – for example, the cost of raw materials, or salaries. Any analysis by function can be shown as a note, or in the segment reporting, which could be the case for many large companies.

Second, there is the question of how to deal with the items in the section of the balance sheet headed "current assets". A possible approach to a "pure" fair value system would insist that any change in value of, say, inventories should appear in the remeasurement column, and the same point arises if there is some impairment of receivables as a result of bad debts. It is very difficult to see that a bright line can be drawn between items such as this and the sales figure which will appear in the matrix in the center column. Inventories dissolve into sales and sales into receivables. Also these items in the current position may legitimately be part of the total for the bottom line in a price/"earnings" ratio calculation.

There is also the question as to whether a figure for "operating profit" should be shown under the heading "business" in the matrix. In the XYZ example, the heading "operating" is shown, but to enter the word "profit" at this level begins to bring in the concepts of the earlier and traditional methodology. Perhaps it is best just to leave an operating total, without further specification as to whether it can be called a profit at such an early stage in the performance statement. Users will make their own choices in their calculation of profit margins or trends, according to the company or the industry, or on some other basis.

It is worthwhile to comment on the figure for "tax" in the matrix. At the moment the IASB proposal shows the figure for tax only in the total column, on the grounds that an international body can hardly require individual jurisdictions to enable the tax to be broken down between tax on remeasurements and tax on other income. This difficulty may be particularly relevant to large international groups. Nevertheless it is possible to suggest that this matter should be left open for individual jurisdictions to choose to apply a rule that the tax effect on the two types of

performance should be delineated. For the last decade, tax adjustments of this kind have been made for the purposes of calculating price/earnings ratios in the *Financial Times* for UK companies, and for company announcements on the Johannesburg Stock Exchange, as described in the discussions of headline earnings below. The necessary tax adjustments, although presenting some problems from time to time, have not been too difficult in practice.

Financial performance indicators

At this point the reader might well ask whether we are looking at something rather like Shakespeare's play *Hamlet* without any appearance by the Prince of Denmark. Where, it might be asked, is an earnings figure? The answer is that the IASB is at the moment determined not to show an earnings figure. This reflects an appreciation by the IASB that the market takes account of a wider information set when valuing a company – not just the bottom line if one is shown – and that the more steps that can be taken to avoid a concentration on one number the better.

In terms of finance theory, the IASB's position on this question is correct. Also analysts have argued for decades that there is no standard definition of earnings – it should be left to the user of the accounts to make the necessary calculations according to the user's own formula, which could well vary from company to company, from industry to industry, or from one part of the economic cycle to another. Not only the definition of earnings may vary – the way the figure is used may also vary, different "earnings" figures being used for different purposes. There is no single bottom line.

It is however impossible to leave the matter there. Whatever is done by the setters of accounting standards, companies are bound to want to publish an earnings figure. It is likely that such a figure would, according to the rules, have to be reconciled to the figure for total recognized gains and losses. That is satisfactory in principle but it would mean that at the time of an earnings announcement, with such a reconciliation required, it would take some considerable effort to work out how the company's own choice of an earnings number fits into the matrix.

There are further considerations. The world is now full of information systems, transferring information about companies into all sorts of contexts, whether printed or electronic. Something of a standard definition would appear to be necessary since without it all figures produced by intermediaries such as newspapers or computer bureaus would be individually defined and non comparable. This in itself is undesirable.

We are here in the presence of an apparent contradiction. If it is true that there is no standard definition of earnings, because the performance of a company cannot be encapsulated into one figure, how can a standard figure for the purposes mentioned above be calculated? If a figure does not exist, it is impossible to define it.

This is exactly the problem which was faced by the analysts society in the UK in 1993, at the time of the publication of the UK accounting standard concerned with the income statement, FRS3, which represented a significant step towards the current IASB proposals. It was represented to the analysts by various parties that unless some sort of standard definition of earnings was produced, chaos would result. The result was a committee of the UK analysts which produced a definition of "headline earnings" which has been used ever since for the calculation of price/earnings ratios in the *Financial Times*, for UK companies every day, and for certain index calculations. The same definition for headline earnings, modified to take account of the introduction of IAS in South Africa, has been used for company announcements on the Johannesburg Stock Exchange for the last seven years[3].

The growth of the company's contribution

It will not have escaped the notice of some observers of the proposed matrix that the headings of the various rows bear a close resemblance to the headings in the usual formats for the cash-flow statement, such as those attached to IAS 7. This is by no means a matter of chance. The performance of a company may be said to have two types of outcome – the “profit” however defined, and the cash-flows. If the formats of the income statement and the cash-flow statement become coherent, the relationship between these types of outcome will be made clear and the problem of sorting out the consequences of accruals etc. will disappear.

Financial reporting and the real economy

Financial analysts have for many years looked at a coherent set of financial statements rather than simply individual figures (and certainly not earnings alone). Thus, how the balance sheet, the income statement and the cash-flow statement articulate one with another over time, and over an economic cycle, are at the heart of what a financial analyst does and at the heart of how the capital markets value shares. If this articulation is explicitly demonstrated in the financial statements, so much the better. Then it can be more easily appreciated how the structure of the financial statements – that is, all the financial statements fitting together with each other – articulate with the real economy, an articulation which results in the flows of cash which the analyst is attempting to forecast and which the market will value. It should always be borne in mind that according to the IASB’s Framework of Principles, the aim of financial reporting is to enable the user to make economic decisions on the basis of future cash-flows generated by the enterprise – their size, timing and certainty. It is this view of the company as a cash-flow generating machine, with a financial structure and an interface with the real economy, which should be reflected in the financial statements. The proposed new income statement fits exactly into this requirement.

It is a pity that the time pressure on the IASB prevents work at this stage on the consequences of the new income statement for the format of the balance sheet. Thus, for example, the consequences of a revaluation downwards of a company’s long-term debt is now clearly shown in an appropriate place in the matrix of the income statement, but how it will be shown under the heading “Shareholders funds” in the balance sheet is a matter which is still open. Financial analysts argue that the beginning of the exercise is to difference the balance sheets – all assets and liabilities. Then by certain adjustments the income statement and the cash-flow statement can be derived. This result of the present line of thought at the IASB would be a further major clarification in company reporting. In addition the distinctions between a balance sheet approach and a profit and loss approach to financial reporting disappears.

The new income statement should be welcomed by everyone concerned, the regulators, the companies and the press, as well as the markets and their constituent actors such as investors and analysts. The matrix is correct in principle, extremely valuable in practice, and deals with one of the great trends in financial reporting – the move to fair values – in a way which is obviously correct and understandable. Towards the end of the case of *The Hound of the Baskervilles*, Sherlock Holmes remarks to Dr Watson that as the evidence accumulated “difficulty after difficulty clears away in front of us”. In just the same way many past and present difficulties in financial reporting clear away as soon as the new income statement is adopted. These proposals should be seized upon with approval, with profound relief, and with delight.

Footnote

1. The original name in the USA for the amount for the “total recognized gains and losses” in the matrix shown in Richard Baker’s article was “comprehensive income”. This seems an acceptable phraseology but it is somewhat controversial. The difficulty with most terminology – for example “net profit for the year” is that the phrase has significant implications because of the use of the word “profit” in different contexts in the past. In this article the phrase “comprehensive income” is used.



2. Familiarity may often be confused with understandability. Thus the traditional form of the profit and loss account, because it is familiar, may appear to be understandable. The understanding is misplaced if the true performance is not reflected in the profit and loss account. For example, the bottom line of the profit and loss account will show a profit after the deduction of interest on debt. If the debt is raised in a foreign hard currency the profit and loss account will be hit only by a low rate of interest, ignoring the increase in value of the debt capital. Thus the understandability of the traditional format for the profit and loss account may be a delusion. Only with comprehensive income can this and other types of misleading information be avoided.
3. The document describing the calculation of headline earnings, and the separate document containing the South African Interpretation which takes account of IAS, may be obtained from the office of the UK Society of Investment Professionals (Tel: 020 7796 3000 and e-mail: uksipstaff@uksip.org).
4. This is a mistake very often made. Setting aside the question of the definition of earnings itself, a price/earnings ratio is often referred to as a way of valuing the company. This is not the case. It is a way by which the market **prices** a company, reflecting so many years earnings, having **valued** the company (and therefore setting this price) on a much wider set of information.

