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Kim Petrone
FASB Senior Project Manager
Financial Accounting Standards Board
krpetrone@fasb.org

Regenia Cafini
FASB Project Manager
Financial Accounting Standards Board
rdcafini@fasb.org

Jennifer Wilson
IASB Outreach Coordinator
International Accounting Standards Board
jwilson@iasb.org

Comments on Staff Draft of an Exposure Draft on Financial Statement Presentation

Dear FASB Project Manager, IASB Outreach Coordinator, Board Members, and Staff:

My comments on the Staff Draft of an Exposure Draft on Financial Statement Presentation dated July 1, 2010 are described in this memorandum.

In general, I support the Staff Draft and I believe that the July 1, 2010 document is an improvement on the original FASB / IASB Discussion Paper *Preliminary Views on Financial Statement Presentation* (hereafter "Discussion Paper"). My comments in this memo address the following topics:

	Topics	Applicable paragraphs in Proposed Guidance	Applicable paragraphs in Basis for Conclusions (BC)
1.	Nonpublic companies	5	40-45
2.	Overall objectives	8, 43	46-50
3.	Core principles	44	72-73
4.	Classification of equity method investments	73;82	99-102
5.	Classification of leases	76	104-108
6.	Dividends payable	94	95
7.	Income tax disclosures	97; 155	111-112
8.	Reporting receivables	119	120
9.	Current versus noncurrent	122	131-133
10.	Effective date of new cash flow disclosures	168	173;179-181
11.	Disclosure of remeasurement information	233	218-229

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1. Application of new requirements to nonpublic companies

Unlike the Discussion Paper, the Staff Draft states that the proposed guidance will generally apply to all entities. Paragraph 5 provides an exception, stating that nonpublic entities will not be not required to apply paragraphs 243-254 (relating to disclosure of analyses of changes between beginning and ending balances of asset or liability line items that management regards as important for understanding the current period change in financial position).

I heartily agree that the new format disclosures should apply to both public and nonpublic entities. Common formats standardize and simplify the calculation of ratios and performance measures across all entities. If we allowed nonpublic companies to use a different format, then all business students would need to learn to analyze two different types of financial reports. This would have required additional time and resources to teach all undergraduate and graduate accounting students – what a potential mess!

However, in addition to the exceptions allowed in paragraphs 243-254, I recommend that nonpublic entities should not be required to (1) apply paragraphs 140-149 (relating to disaggregating income and expense items by function and nature; (2) use the direct method in applying paragraphs 170-192 (relating to the cash flow statement) or (3) apply paragraphs 233-242 (relating to the presentation of the remeasurements component of items of income and expense presented in the statement of comprehensive income) for the following reasons:

a. Unlike public companies, nonpublic companies have relatively few equity owners and rely on nonpublic debt. In these circumstances, information about expenses, cash flows, and remeasurements can be easily communicated, if needed, directly to the equity owners and creditors. If creditors demand this information, nonpublic companies can provide this information in their financial statements. Otherwise, it is unnecessary and a waste of resources for nonpublic companies to prepare this information if it will not be used.

b. Many smaller nonpublic companies do not currently report their income and expenses by function (other than cost of goods sold). Adding this new requirement will be both burdensome and costly, as it will probably require additional allocations and new software and bookkeeping expenses that may not yield material benefits. If the users of nonpublic company financial statements perceive that these new requirements will yield financial information that exceeds the cost of preparing this information, they can easily demand this information from the nonpublic companies.

c. It is well established that the direct method is more costly to apply than the indirect method. While larger public companies may be able to bear this new cost burden, it will probably result in much higher preparation costs for nonpublic companies. This additional cost could be material for smaller nonpublic companies. Note that the primary advocate of the direct method consists of financial analysts who follow public companies, not nonpublic companies.

d. These three new disclosure requirements can be easily excised from the financial statement format requirements for nonpublic companies without affecting the other benefits of the new financial statement format. These three disclosures (along with paragraphs 243-254) are the most costly for nonpublic companies and will be difficult for relatively unsophisticated preparers to develop each reporting period.

e. At the very least, the imposition of the direct method and the remeasurements disclosures should be delayed until public company financial statement preparers, users, and auditors have gained experience in determining and analyzing the direct method format and the remeasurements disclosures.

f. If the Board removes the direct method and remeasurements disclosures for nonpublic companies, it will still retain the option of requiring these disclosures in future years if it is later established that the benefits of these paragraphs will outweigh the costs for nonpublic companies.

2. Overall objectives

Paragraph 8 describes the purpose of financial statements. However, the purpose described in paragraph 8 does not provide a good description of the overall objectives of financial reporting. Moreover, it does not link to the objective of general purpose financial reporting described in the Statement of Financial Reporting Concepts 8.

The Staff Draft assumes this link exists without explicitly making the connection. I believe that it is important to delineate this connection. I recommend that the exposure draft explicitly links the purpose of financial statements to the objective of financial reporting described in paragraphs OB2-OB11 of Chapter 1 of SFAC No. 8, Conceptual Framework for Financial Reporting, issued in September 2010.

3. Core principles

The Discussion Paper originally included three objectives of financial statement presentation: cohesiveness, disaggregation, and liquidity and financial flexibility. The Staff Draft recharacterized the first two objectives as "core principles of financial statement presentation." I agree with this change – cohesiveness and disaggregation are properly described as principles, not objectives. The third objective, liquidity and financial flexibility, is correctly described as an objective. It is not a principle of financial statement presentation. As such, I agree with the removal of this third objective from the core principles.

However, I wish to point out that the two principles could be better linked to the purpose of financial statements described in paragraph 8 and to the conceptual framework. Moreover, the liquidity and financial flexibility objective should be discussed in connection with the purpose described in paragraph 8 and linked to the conceptual framework.

4. Classification of equity method investments

Paragraph 73 states that operating activities generate revenue through a process that requires the interrelated use of the entity's resources. It also states that the process also requires the application of employee and management expertise. By contrast, paragraph 81 states that the investing category includes assets that an entity uses to generate a return. It further states that no significant synergies are created for the entity by combining assets in the investing category with other resources of the entity.

The Staff Draft classifies equity method investments as investing activities (paragraph 82). It does not include equity method investments as possible operating activities (paragraph 73).

In many cases, equity method investments are strategic investments that perform critical operating functions and interact with other firm activities (e.g., several of Coca Cola Company's equity method investments bottle and sell Coca Cola for the parent entity). Other equity investments are often joint ventures that further the company core business activities. It is often the case that companies have operating contracts with their equity method investments regarding sales of inventory or research activities. When companies make significant equity investments that are accounted for under the equity method, it generally means that the company is investing in the activity as part of their operating strategy, not to merely earn a return on excess cash through dividends and capital gains.

While most equity method investments should be regarded as operating activities, some investments may be properly classified as investing activities. These investing equity method investments are relatively rare, but might exist, for company investments outside their core areas.

Therefore, I recommend that companies should classify equity investments as investing activities only if the investments are not in the same line of business, are not considered a part of the companies' operating strategy, or do not interact with any of the companies' other operating activities, like sales, research and development, etc. Otherwise the equity method investment should be classified as an operating activity section.

5. Classification of leases

Paragraph 83 states that the financial section includes items that are part of an entity's activities to obtain or repay capital. Paragraphs 83-85 appear to indicate that the financing section should consist of the liabilities and equity that form an entity's capital structure.

The Staff Draft does not define the term "capital structure." In fact, the term capital structure refers to the way an entity finances its assets through a combination of debt and equity. Though there is no universal agreement on which liabilities should be included in the capital structure, the debt component usually includes short-term borrowings, current and long-term interest-bearing debt, and capital leases.

Paragraph 76 classifies lease obligations in operating activities, in a separate category described as operating finance liabilities. This classification appears arbitrary. For example, in the Basis for

Conclusions, paragraphs BC104-BC108 discuss the rationale for including liabilities such as postemployment benefit or decommissioning liabilities in the operating finance section of the statement of financial position. It is notable, however, that the Staff Draft does not discuss its reasons for include leases in this category. This is a huge omission, given the importance of leasing in modern finance. Liabilities for postemployment benefits or decommissioning liabilities represent payments for services. By contrast, leases usually represent payments for tangible and intangible assets, not services

Capital lease obligations are usually included in debt ratios. Under the Staff Draft classification, debt ratios will not ordinarily include lease obligations. This is inappropriate, given the current importance of leasing. For example, many airline companies finance their airplane fleet primarily through leasing, not through straight debt. Moreover, the interest on leasing obligations should be considered a financing expense, not an operating expense. Classifying lease interest costs as operating expenses distorts the operating activity section of the statement of comprehensive income and incorrectly reduces operating cash flows. It also misrepresents financing costs in the cash flow statement and the income statement.

Consequently, I recommend that lease obligations should be classified in debt category of the financing section.

6. *Dividends payable*

Paragraph 94 states that the debt category will include liabilities that arise from transactions involving an entity's own equity that are part of the entity's capital-raising activities. Specifically, paragraph 94 classifies dividends payable and certain other options in this category.

I disagree with the classification of common dividends payable as a liability. Common dividends payable, which represents an amount payable to the common equity owners, should be classified in the equity category. Common shareholders cannot owe dividends to themselves. Common dividends payable are part of the equity that common shareholders have in the firm. Common stock subscriptions receivable from shareholders are reported as offsets to equity; similarly, dividends payable should be reported in the equity section.

7. *Income tax disclosures*

Paragraph 97 states that all income tax assets and liabilities should be reported in the income tax section of the statement of financial position while paragraph 98 states that income tax expenses (other than those related to discontinued operations and other comprehensive income) should be reported in the income tax section of the comprehensive income statement. The Staff Draft does not require additional income tax disclosures allocating the income tax expense among other categories (e.g., operating versus financing). Paragraph BC 112 states that allocating the income tax provision at the category level would require complex and arbitrary allocations that would be unlikely to provide useful information.

In April 2010, I published an article in *Tax Notes* that describes why income tax allocations are not necessarily arbitrary or complex, and are likely to provide useful information. I will not restate my analyses in this letter. On this point, however, I wish to point out that the Staff Draft does not address these issues and instead relies on the same unsupported statements as in the original Discussion Paper.

The *Tax Notes* article also describes how the financial statement format could benefit from allocating income taxes across the various categories of assets, liabilities, income, and expense. Such an allocation, however, would clutter up the statement of financial position and the comprehensive income statement, reducing the benefits of a compact statement. Thus, I do not advocate allocating the income tax provision between operating and financing activities on the face of the financial statements.

Instead, as an alternative, I recommend that entities should be required to disclose, in the notes to the financial statements, the following information:

Relating to the statement of comprehensive income

a. The portion of the income tax provision that is allocable to debt financing activities;

b. The portion of the income tax provision that is allocable to operating financing activities;

c. The portion of the income tax provision that is allocable to investing activities;

d. The portion of the income tax provision that is allocable to operating activities;

e. The portion of the income tax provision that is allocable to unusual or infrequent items reported in the income statement;

Relating to the statement of financial position

f. The amount of income tax that is allocable to additional paid-in capital;

g. The amount of income tax that is allocable to goodwill or other nontax assets;

h. The portion of the income tax provision that is allocable to prior year earnings and had not been previously accrued as part of the tax provision;

i. The portion of the components of deferred tax assets that is allocable to discontinued operations and OCI items;

j. The portion of the components of deferred tax liabilities that is allocable to discontinued operations and OCI items; and

k. The amount of income taxes receivable and income taxes payable

These tax allocations are easier for preparers to calculate than for users to estimate (especially for companies operating in multiple jurisdictions).

With this information, users can better understand the after-tax return and after-tax cost of various types of financial statement items. Users will also be better able to calculate ratios like Return on Net Operating Assets and NOPAT because the financial statements will separately disclose the tax costs associated with operating and financing activities. This will enable users to better assess future cash flows and future earnings.

It is also important for users to understand a company's actual tax costs. It is often the case that significant tax costs and benefits are allocated to goodwill or additional paid-in capital. Detailing these costs will allow users to use the tax costs necessary to make intelligent forecasts.

Furthermore, there is some recent research by Jana Smith Raedy, Jeri Seidman, and Douglas Shackelford which indicates that the deferred tax disclosures provide little useful information to capital markets.[1] One reason for their lack of results is that current income tax disclosures lump deferred tax assets relating to continuing operations, discontinued operations, extraordinary items, and other comprehensive income (OCI) items together in the tax footnote. Companies can easily separately disclose this information, making it easier to forecast future deferred taxes and to analyze current changes in deferred tax assets and liabilities.

8. Reporting receivables

Paragraph 119 states that an entity should disaggregate assets and liabilities and present them separately in the statement of financial position when the function, nature, or measurement basis of an item or an aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position.

As part of this disclosure, I recommend that companies should be required to separately disclose the portion of their receivables that are due from customers from the portion of their receivables due from suppliers, governmental jurisdictions, employees, etc.

In currently issued statements of financial position, it is often difficult to discern the portion of an entity's receivable balance that is due from customers. This classification is important because the receivable turnover ratio is one of the most important ratios used by analysts to assess performance and risk. Unexpected changes in the receivable turnover ratio can be a signal of changes in future performance. While receivables from customers are related to sales revenue, receivables from vendors are related to cost of goods sold. The current practice of reporting all receivables in a single line item distorts the receivable turnover ratio. Therefore, separately disclosing receivables from customers will enable users to calculate the receivable turnover ratio will better precision.

9. Current versus noncurrent

Paragraph 122 states that assets and liabilities shall be classified as short term or long term if either its contractual maturity or its expedited date or realization or settlement is within one year of the reporting date.

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[1] Raedy, J.S., J Seidman, and D.A. Shackelford, Is There Information Content in the Tax Footnote? Working Paper (October 1, 2010).

This is a startling change from the past and could possibly make the financial statements more confusing for companies with inventory that will not ready to be sold within one year. For example, many wines are stored for more than one year before resale. Under this new guideline, inventory will need to be broken out between short-term and long-term in the statement of financial position. This change could have a large negative impact on the current ratio, which is often used in debt covenants. As a result, companies may modify their otherwise optimal investment behavior in reaction to this new guideline.

Moreover, allocating inventory and prepaid expenses between current and noncurrent will increase financial reporting clutter.

The Staff Draft does not mention why this new classification scheme is necessary. It is not clear from the draft whether users in certain industries were complaining about the current method of allocation assets between current and noncurrent. Therefore, my first recommendation is that the Staff Draft should include some rationale for this change, as it will be disruptive for many types of companies.

If this allocation is truly necessary, I recommend that the current and noncurrent portions of inventory are instead disclosed in the notes to the financial statements. This will eliminate the need to revise debt covenants for changes in the current ratio and reduce the anticipated abhorrent preparer behavior that could result from this proposal.

10. Effective date of new cash flow disclosures

Paragraph BC 173 recognizes that the initial costs of preparing direct method cash flow statements will be significant. On the other hand, paragraphs BC 174 through176 indicate that users generally believe that direct method cash flow statements will provide more useful information than the indirect method used by most companies. Though academic research on this topic generally indicates that the direct method provides useful information, it should also be recognized that there is relatively little empirical research on this issue and that the existing research does not engage in any cost-benefit analysis.

Since the Staff Draft's assumption that the benefits of the direct method exceed its preparation costs is merely speculative, I recommend that the Boards consider implementing the direct method in stages:

a. First, the largest and most profitable public companies (based on market value) would be required to use the direct method.

b. Second, after two years, a second group of firms (also based on market value) would be required to use the direct method.

c. Last, after four years, all public companies would be required to use the direct method.

By implementing this section of the Staff Draft in stages, the initial costs of learning how to prepare and disclose the direct method will be borne by the largest companies that are best able to afford its cost. After accounting firms and financial statement users learn how to implement this new method, the second group of public companies would then be required to use the direct method.

After the first or second year of implementation, the financial statement users and academic researchers will also be able to assess the benefits of the new direct method. For example, by comparing earnings forecasts of companies that use the direct method with earnings forecasts for companies that use the indirect method, researchers should be able to estimate the relative benefits of the new method and can compare these benefits to the actual costs incurred by the larger public companies.

After preparers and users have obtained extensive experience with the direct method and we have determined that the benefits exceed the costs, then the direct method can be required for all public companies.

By enacting this costly process in stages, the implementation costs for smaller and less profitable companies will be more reasonable. A staged implementation process will also make this expensive section of the Staff Draft more acceptable to small companies. After all, companies have been using the indirect method while the Boards have been working on the Financial Statement Presentation project for the past decade. The indirect method has been used by companies since APB Opinion No. 3 was issued in 1963 and has been allowed by the Securities and Exchange Commission since it began requiring funds statements in 1969. It surely could not hurt to wait a few years before smaller companies must use the direct method.

11. Disclosure of remeasurement information

Paragraph 233 states that entities must disclose information about remeasurements in a note to the financial statements. I agree with this recommendation and fully support this proposal. This new proposal will make it much easier for users to analyze remeasurements because the remeasurements information will be described in a single footnote. Users will no longer need to hunt for this information. Very good idea and I hope it finds its way into the exposure draft.

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I hope these comments are of some use to you. I look forward to the exposure draft.

Sincerely,

Michael Calegari

Michael Calegari
Associate Professor
Santa Clara University
mcalegari@scu.edu
Office phone: 408.551.1694