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Content:

The article presents processes, which have had strong influence on the current framework for accounting. This forms the background for the assessment of IASB and FASB draft on the new classification scheme and presentation of information in financial statements.

Financial statement in accordance with IASB and FASB model in the light of challenges for modern financial accounting

1. Factors influencing development of financial accounting

Accounting is a system for recording, processing, measuring and presenting impact of economic transactions which is being constantly shaped by the influences of the economic and legal environment. Therefore it must be an elastic tool, open for changes and able to expand, in order to be capable of reflecting new phenomena. Only when these prerequisites are met can accounting fulfill its major task – provide true and fair view of financial position and financial performance.

Evolution of the accounting system is inspired by the following factors:

1) free flow of capital, labor, products and ideas;
2) ever – increasing global competition resulting in higher business risk;
3) technological progress both in production and management activities which results in increased expenditure on research and development;
4) quality and time orientation, meeting needs of individual customers, which shortens product life cycles;
5) significant fluctuations in value of assets and liabilities, especially financial instruments;
6) increased role of information and items which have not been recognized as assets – human capital and internally generated brands;
7) departure from tax regulations for financial accounting purposes.

The answer of modern financial accounting to these processes is best to be seen in harmonization. Initially it was based on expansion and promotion of International Financial Reporting Standards, but in the last years it also began to cover US GAAP. Much of the effort has been spent over the last years on reconciling recognition and measurement criteria for economic transactions between IFRS and US GAAP whereas a lot of freedom was left in terms of presentation.

Second type of response covers revisions of existing standards and publishing completely new ones. Usually they relate to issues where not only deep changes in economic reality take place but nature of transactions tend to be very complex. This relates especially to:

- financial instruments
- investment properties
- impairment of assets
- provisions
- construction contracts

Third crucial attribute of modern financial accounting is the concept of financial capital maintenance followed by broad definition of income and expense. This approach means that Income Statement should reflect all transactions with entities other than owners, including revaluations and remeasurements of assets and liabilities. Consequently, total comprehensive income for the period reflects change in equity for the year. This has got the following consequences for the users of financial statements:

1) increasing number of subjective - carried out by an entity itself - estimates, projections and forecasts;
2) recurring questions: should an item, event find its reflection in accounting records and how should it be valued? (for example deferred tax assets);
3) income and expense items resulting from actual, past transactions (sale, purchase, consumption) are presented along with future and uncertain ones (provisions);
4) subtotal figures are presented, each with different probability and certainty for realization;
5) departure from financial information which is auditable (historic cost convention) and drive towards usefulness (fair value as the basis for measurement);
6) increasing role and scope of accounting policy disclosures.

Based on the above presented processes and influences, on the next pages you shall find an attempt to assess the discussion paper- prepared jointly by IASB and FASB– for presentation of financial statements. It is difficult to understate the importance of this document since final solutions approved by the boards are to determine the scope and contents of financial reporting for external users by all major businesses around the world.

2. Core assumptions for the IASB and FASB financial reporting model (1)

Both boards agreed that a complete set of financial statements covers:

1) statement of financial position (previously called balance sheet);
2) statement of comprehensive income (comprising currently income statement and other comprehensive income statement);
3) statement of cash flows;
4) statement of changes in equity;
5) notes to financial statements.

It has been agreed that the main objective of financial reporting is to provide current and future investors and other capital providers with relevant financial information for decision making purposes.

It is assumed that the above mentioned users are primarily interested in amounts, time horizon and uncertainty of future cash flows as well as how evaluation of entity` s potential to generate future cash flows can impact its share prices and issued debentures. Secondly, information provided is often used to assess the work of management and answer the following question: how effectively has the management carried out its tasks as agent?

The boards suggest that financial statements should therefore meet three conditions:

1) portray a cohesive financial picture of an entity` s activities – meaning that there are relationships between items across financial statements; the boards expect financial statements showing financial position, financial performance (comprehensive income) and cash flows to complement each other as much as possible.

(1) Prepared based on: Discussion Paper- Preliminary Views on Financial Statement Presentation – www.iasb.org

2) guarantee appropriate disaggregation of data, defined as classification of information into reasonably homogenous groups with separate characteristics,

3) provide information about entity` s ability to meet its future obligations as they become due and investing in business opportunities and respond to unexpected needs

Of primary importance for the presented model is the classification scheme based on the management approach. Each of the below shown components of financial statements should have the same sections and categories, which is shown in table 1

Table 1

Classification scheme for financial statements based on IASB and FASB discussion paper

Statement of financial position	Statement of comprehensive income	Statement of cash flows	
Business ●Operating assets and liabilities ●Investing assets and liabilities	**Business** ●Operating income and expenses ●Investment income and expenses	**Business** ●Operating cash flows ●Investing cash flows	value adding activities
Financing ●Financing assets ●Financing liabilities	**Financing** ●Financing asset income ●Financing liability expenses	**Financing** ●Financing asset cash flows ●Financing liability cash flows	financing of value adding activities
Income taxes	**Income taxes** on continuing operations (business and financing)	**Income taxes**	
Discontinued operations	**Discontinued operations**, net of tax	**Discontinued operations**	
	Other comprehensive income, net of tax		
Equity		**Equity**	

Please note that sections names are ***in bold italic type***, required categories within sections are indicated by bullet points

Prepared based on www.iasb.org

Business section covers assets and liabilities as well as income, expense and cash flow items related to value adding processes such as production or rendering of services. Operating category within this section, groups items seen as valuable and crucial from the management perspective in terms of company`s presence in a particular business sector. An entity utilizes its operating assets and liabilities for maintaining its core processes which generate income and expense items. Within its investing activities (section) an entity realizes benefits in the form of interest, dividends, increases in market prices of assets – this however takes place outside the core scope of operations. Financing section should include financial assets and liabilities which meet IFRS and US GAAP definitions criteria and which serve as source of financing. Income taxes section covers assets and liabilities both for current and deferred tax as per IFRS and US GAAP. In discontinued operations section an entity shall disclose assets, liabilities, income, expense and cash flow items related to component of this entity which has been disposed of or is classified as held for sale. Equity section presents transactions with owners.

Following changes are proposed by the two boards regarding components of financial statements.

1) Statement of financial position (previously balance sheet). An entity shall classify its assets and liabilities (with the exception of discontinued operations) based on long term & short term distinction (instead of non-current & current distinction) for operating and investing categories and financing section. Cash shall be presented in one line only, separately from cash equivalents. Similar assets and liabilities shall also be presented separately, if their valuation is based on different models (for example effective interest rate & fair value model).
2) Statement of comprehensive income (comprising currently income statement and other comprehensive income statement). Major change to this component is that it should cover comprehensive financial result, including income and expense items which used to be transferred directly to equity. Under Polish Accounting Act such transactions and events are covered only by Statement of changes in equity. Further disaggregation of income and expense items should follow this logic:
   - business activities (including operating and investing sections);

   - financing activities (with distinction for income and expense items related to financial assets and liabilities);

   - income taxes;

   - discontinued operations;

   - other comprehensive income items.

   Within business section (activities) an entity shall also present separately income and expense items based on functional classification (sale of finished products, rendering of

services, administration, marketing) as well as disclose further information based on natural classification for costs (materials consumed, wages & salaries, depreciation).

3) Statement of cash flows. The boards agreed that this statement should be prepared using direct method only. Secondly, an entity shall reconcile this statement to opening and closing balances of cash (excluding cash equivalents). This change results in the necessity to disclose extra inflows and outflows related to short term investments, currently classified as cash equivalents. Finally, there are going to be changes regarding classification of cash flows between operating, investing and financing activities as these terms found now in IAS 7 are to be redefined. This relates especially to operating & investing distinction.

4) Statement of changes in equity. The role of this component is to be reduced since many transactions are to be disclosed in the statement of comprehensive income. This statement is to be constrained to transactions with owners and allocation of total comprehensive income between equity items.

The boards have also proposed that an entity should present a schedule in the notes to financial statement that disaggregates total comprehensive income into cash and accrual items. This is presented in diagram 1.

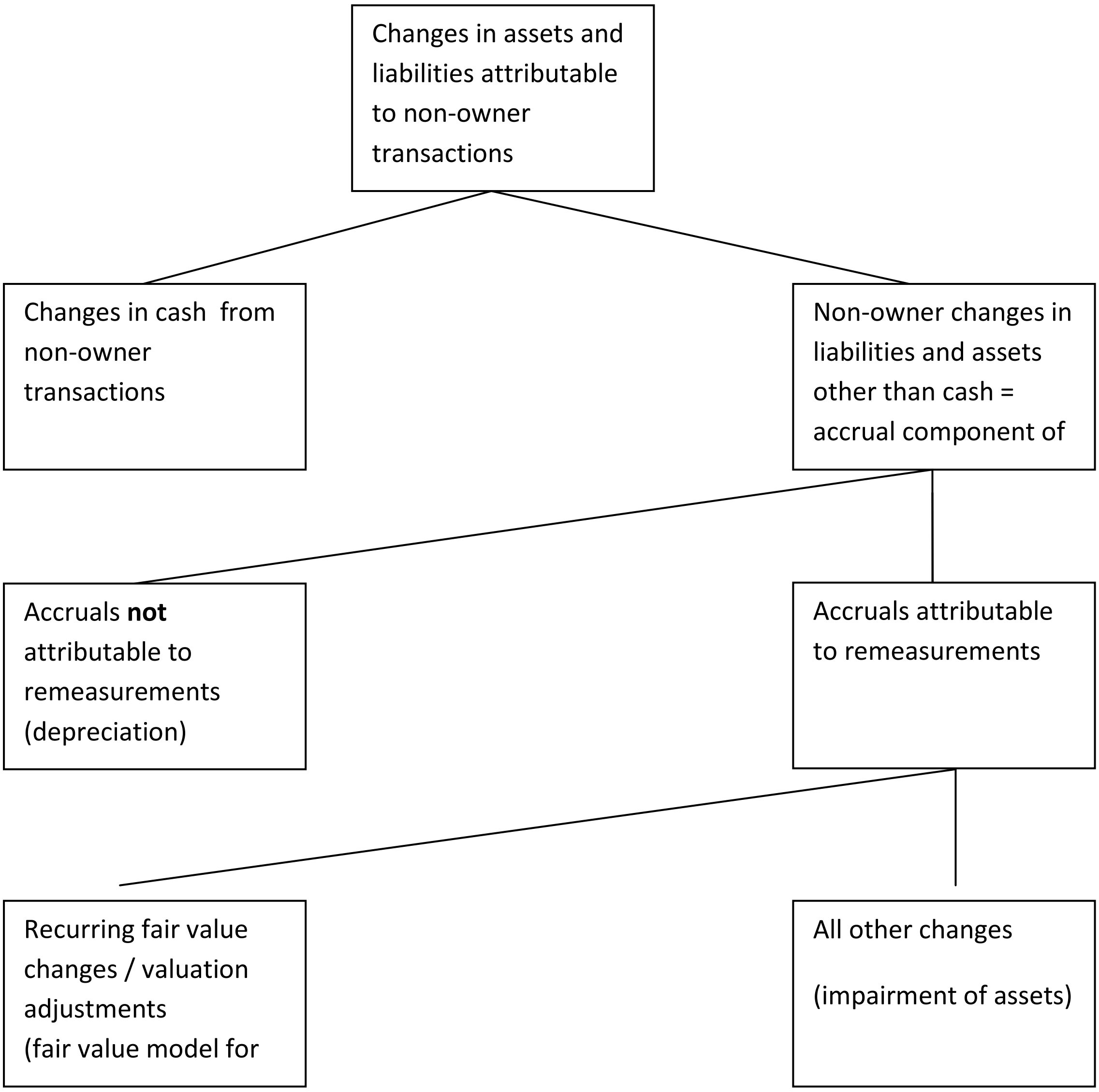

Diagram1. Diagram of disaggregation process based on IASB and FASB discussion paper

Prepared based on www.iasb.org

3. Assessment of the proposed model

The proposed model appears to have many advantages – the most important ones are:

1) The very fact that IASB and FASB – accounting bodies which seem to have competed with each other - have produced a joint document is a big success. It is a proof for the convergence process of European and American accounting regulations for presentation of financial statements. The boards referred to the agreements from the second joint project – on one coherent conceptual framework for financial accounting

(see: exposure draft "An improved Conceptual Framework for Financial Accounting")

2) The boards have identified and tackled inconsistency between harmonisation on recognition and measurement level and lack of precise regulation for presentation and disclosure. Although IAS 1 includes minimum disclosure requirements whereas US GAAP provide some guidelines (for example how items should be classified for the cash flow purposes), it seems however that the number of options available literally eliminates comparability of financial statements between entities, comprising benchmarking within sectors of national economy.

3) Scope of financial statements has been correctly defined. The concept of total comprehensive income is especially worth underlining. It allows to clearly distinguish this component of financial statement from changes in equity. Logic of it is based on the following criterium – transactions with non-owners (statement of total comprehensive income) , transactions with owners (statement of changes in equity).

4) Entity `s ability to generate future cash flows has been given priority in terms of layout and design of financial statements. This is the reason why the boards suggested to allow only direct method of preparation for operating cash flows as well as to include the diagram of disaggregation process which clearly distinguishes cash and accruals elements of comprehensive income. This approach is consistent with the concern for information needs of capital providers who are primarily interested in return on their investment.

5) The concept of consistency on section and category level for three components of financial statements: statement of financial position, statement of comprehensive income and statement of cash flows. It should enable users to assess quality of financial results, which will be enhanced by the possibility to compare profit /loss on business activities with the genareted cash flows. New ratios could also be developed which should allow to evaluate effectiveness of assets employed in operating and investing activities.

6) The model is also to undergo thorough testing. Numerous entities will be involved in filed tests during the comment period for the document. Participating business units are to prepare financial statements for two years, based on initial views and guidelines of the two boards regarding presentation issues. Furthermore, Financial Accounting Standards Research Initiative (FASRI) is to carry out a research among investors to verify usefulness of information available thanks to the new model.

It must be clearly stated that the radicality of the proposed solution must give rise to doubts and queries.

1) The management approach for classification of items in financial statements appears to be reasonable from directors perspective , but it does not provide data which is crucial for investors, namely clear distinction of subtotals for comprehensive income with various certainty degree.

2) There are bound to be major difficulties with allocating assets, liabilities, income, expense and cash flow items to various categories and sections. Numerous dilemmas will have to be dealt with on the business unit

level which is to impair comparability between entities.

3) The document leaves many issues open, this relates to accounting for basket transactions (when an entire company is purchased or sold), where (which section and category) to present cash, how to disclose assets and liabilities which primary use changed, how to classify assets and liabilities which simultaneously serve different purposes.

4) In Polish reality it may be especially time-consuming to allocate income taxes between three sections: continuing operations (business and financing sections), discontinued operations and other comprehensive income.

5) Implementation cost of the analysed model may be significant. It will include among others: software adjustments, revisiting accounting policies (new chart of accounts), education expenses.

Summing up, it must be stated that the two boards have made the first, important step towards harmonization of the contents and scope of financial statements. There is however still long way to achive uniform, widely accepted solutions.

Literature:

1. The International Accounting Standards Board website : www.iasb.org