

REPORTING FINANCIAL PERFORMANCE RESEARCH PROGRAM

PROJECT PROPOSAL

**THE PRESENTATION OF FINANCIAL PERFORMANCE
UNDER THE FUNDS FLOW APPROACH**

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Curriculum Vita of Research Team

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I. Introduction

Recent discussions concerning comprehensive income have become heated, particularly in regard to the most appropriate location for its reporting. The FASB allowed reporting of comprehensive income in three formats: in the income statement (the one statement approach), in a separate statement of comprehensive income (the two statement approach), and in the statement of changes in stockholders' equity (the statement of changes in equity approach) [SFAS No. 130, *Reporting of Comprehensive Income*, para. 22]. It appears that this flexibility has led to failure. Studies examining the presentation of comprehensive income in the United States [e.g., Pandit and Phillips, 2004] show comprehensive income, although reported, tends to be "buried" in the statement of changes in stockholders' equity.

At an international level, the IASB considered a separate statement of comprehensive income that would include "net income from continued operations" or a similar subtotal [G4+1, 1999]. The statement would report the effects of all changes in net assets during the period and would include financing and investing activities. To facilitate efforts toward convergence of international accounting standards, the IASB and the FASB agreed in 2004 to work jointly toward determination of the need for a single statement of comprehensive income as well as agreement on the required primary financial statements [IASB Project Update, 2004].

To date, this problem has been approached mainly from two perspectives: the Asset and Liability view and the Revenue and Expense view. Under such approaches, the discussions tend to be confined to the articulation between the balance sheet and the income statement.

In this proposal, we would like to approach the problem of comprehensive income from a third view, namely the "Funds Flow" view of financial accounting. This view emphasizes the concept of funds or cash flows as the central element of financial accounting. Although the Funds Flow view has appeared in the accounting literature since 1949 [e.g., Carson (1949), Horngren (1956) and AICPA (1973)], it has, in recent years, literally vanished from financial accounting discussions. Its demise can be traced to the FASB's (1976) presentation of three views of financial accounting, which notably excluded the Funds Flow view. The FASB compared, at that time, only the Asset and Liability view, the Revenue and Expense view, and the Non-Articulation view.

Thus, we need to rediscover the Funds Flow view of financial accounting. One of the characteristics of the Funds Flow view is its ability to articulate three primary financial statements. Utilizing this approach may provide a “new” and more successful articulation of the financial statements through a new statement of comprehensive income. We propose to investigate the articulation of financial statements through the Funds Flow view, theoretically, empirically, and historically.

Specifically, we propose to

1. Explore the logical adequacy of the new form of the statement of comprehensive income provided by the funds flow approach in presenting financial information of a business.
2. Investigate the influence of other comprehensive items on the cash generating ability of businesses.
3. Investigate the historical use of funds flow income determination in Asian accounting.

II. The Funds Flow Approach to Income Determination

The concept of the “funds flow approach to income determination” becomes important in the Funds Flow view. This is the reverse form of the usual reconciliation between net income and cash flow from operating activities (CFO). The funds flow approach, implied in the accounting literature [e.g., Carson, 1949; Horngren, 1956; Staubus, 1966], was presented by Satoh [1980, 1995] as an income calculation method.

The statement below provides the link between comprehensive income and net income under the Funds Flow view.

| <u>Proposed Statement of Financial Performance (Comprehensive Income)</u> | |
|--|--------------|
| CFO | <u>2,300</u> |
| Decrease in accounts receivable | (30) |
| Increase in accounts payable | (160) |
| Increase in inventory | 50 |
| Depreciation | (970) |
| Appreciation of trading securities | 20 |
| Loss on impairment | <u>(10)</u> |
| Net income | <u>1,200</u> |
| Foreign currency translation adjustments | (200) |
| Unrealized gain on securities | <u>330</u> |
| Comprehensive income | <u>1,330</u> |

The three primary financial statements would then be presented as follows: (1) Net income would appear as the bottom line of the income statement; (2) the balance sheet would reflect changes in market value (other comprehensive income), and (3) the statement of cash flows would be presented by the direct method. As the balance sheet and income statement do not articulate, this difference should be reconciled by the proposed statement of comprehensive income. This statement would appear in the form as shown above.

The proposed statement above would start from cash flow from operations. To this amount, accruals such as depreciation are added or deducted to determine net income. Then, other comprehensive income items are added or subtracted to calculate comprehensive income. As a whole, it can be said that the comprehensive income is being determined as a calculation of individual items, each with particular financial characteristics.

In comparison, the typical statement of comprehensive income consists of two parts: (1) net income resulting from the conduct of business and (2) other comprehensive income resulting from market value changes. Because the character of these two income items vastly differs, it becomes difficult to explain that it displays financial performance as a whole.

III. Description of Research Activities

a. Logical Interpretation

What we need here is an interpretation, as the hypothesis, that the individual items of the proposed statement have particular financial characteristics in nature. Obviously, CFO is cash provided by operating activities and thus has specific financial characteristics. In order to interpret the financial characteristics of accruals and other comprehensive income, Taggart's [1934] idea of "maintenance of the circulation power of capital" can be applied. The circulation power of capital can be deemed as equal to cash generating ability [AICPA, 1973]. Therefore, it can be interpreted that the calculations made in the proposed statement are the necessary adjustments to reach the distributable amount of funds after the cash generation ability is maintained.

b. Historical Focus on Funds Flow in Asian Culture

Professor Takatera [1993] contrasted the Asian culture and the Western culture as the "culture of mutual trust" versus the "culture of contract." He argued that these differences

resulted in the development of a cash flow-oriented bookkeeping system in Asia. The presence of such systems in Japan and other Asian countries implies a funds flow approach to income determination. Closer examination of Asian bookkeeping systems may confirm the existence of the funds flow approach to income determination and enable detection of the determination of fair values in the closing process.

We will investigate the actual book of accounts of Japanese merchants in the Edo period, which is the era before the Western double-entry bookkeeping system was introduced. Considerable research in this area exists that could be helpful in investigating prior funds flow approaches.

c. Empirical Research

In addition to the logical advantage of the proposed statement, we will be able to consider whether the funds flow approach to income determination can provide useful information. Thus, we have two hypotheses as follows:

H1: Comprehensive information disclosed by the funds flow approach has value-relevance.

H2: Comprehensive information disclosed by the funds flow approach is helpful in predicting future cash flows from operations.

To test these hypotheses, we plan to perform the following:

First, we will test H1 by regressing the cumulative abnormal return (CAR) on changes in each item in the proposed statement. Considering that prior empirical research in Japan has shown little evidence that other comprehensive income has value relevance, we therefore plan to adjust these numbers to reflect earnings quality. We plan to further investigate the relationship between cash flow from operations and other comprehensive income.

Second, we will test H2 by regressing cash flow from operations (CFO_{t+i}) on current levels of the individual comprehensive income components. In doing so, we will be able to assess the usefulness of the information in predicting future cash flows.

To test these hypotheses, we will use data obtained from Japanese firms (Nikkei 225 companies after 2001). According to Japanese GAAP, other comprehensive income items are directly transferred to shareholder's equity. Additionally, we will be able to test these hypotheses using a comparative U.S. data sample.

IV. Information Added to IASB Decision Process

We believe that information provided by the funds flow approach is not only relevant but potentially more useful to investors and other users of the financial statements. Consideration of this approach and the related information available have not yet been considered by the IASB. Provision of this information, therefore, will enable the IASB to make a more fully informed decision regarding performance measurement.

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