1 INTRODUCTION AND SCOPE OF BOOK

1.1 NATURE OF ACCOUNTING LITERATURE AND PERTINENT PRONOUNCEMENTS

Under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRSs) there is no all inclusive general standard on stockholders' equity. Instead, authoritative literature on this subject consists of concepts from the FASB and the IASB frameworks and standards that apply to specific types of transactions or events or items in financial statements that affect stockholders' equity.

The principal accounting pronouncements, under U.S. GAAP, SEC guidance, and IFRSs respectively, are listed in Worksheet 80, grouped per specific category.

Starting from July 1, 2010, the International Accounting Standards Committee Foundation (IASCF) became the IFRS Foundation. The International Financial Reporting Interpretations Committee (IFRIC) had changed its name into the IFRS Interpretations Committee. The IASB had renamed its website as IFRS.org. The Accounting Standards Executive Committee (AcSEC) recently became the Financial Reporting Executive Committee (FinREC). This Book maintains the above original names for all references.

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1.2 PERSPECTIVES AND MAJOR IMPLICATIONS OF THE CONCEPT OF EQUITY

Accounting for stockholders' equity refers to the recognition, measurement, presentation, and disclosure of equity on a company's financial statements. Along with such meaning, the Book particularly adopts the perspective of a comparative study, by means of criticism and contrast between the U.S. and the IFRSs' pronouncements and practice.

Comment: However, the topic of stockholders' equity is pervasive, well beyond accounting. In fact, according to circumstances, it may be relevant under a number of management, finance, legal, tax, and business viewpoints for several stakeholders, such as company managers, CPAs, financial analysts, and, in general, preparers and users of financial statements. Some of these angles are as follows:

- ***Meaning, and rationale for, equity***: Firstly, equity is an element of the financial statements under the FASB and the IASB conceptual frameworks. Its location within an accounting framework may follow two different approaches: the asset liability (or balance sheet approach) or the revenue expense views. Derivation of income, under the former, is the result of certain changes in net assets during the accounting period, as opposed to the view, under the latter concept, of income producing activities of the enterprise as a major determinant of changes of equity.
- ***Definition and classification of equity***: Finance theory makes a separation between financing activities and an entity's other activities. Within financing activities, accounting has

traditionally developed a dichotomy between financial liabilities and equity. The correspond ing classification of interest versus dividends develops from the concept of income determi nation (net of interest) as opposed to income distribution (to shareholders). The treatment of compound financial instruments, instruments with both characteristics of equity and financial liabilities, and share based payments moves traditional constraints.

- ***Sources of capital, and assessment of "quality of equity"*:** Disclosure of sources of equity firstly discriminates between capital that is contributed and equity that derives from earnings (i.e., retained earnings or other comprehensive income). The use of separate paid in capital accounts offers additional information for analysis of sources of capital and quality of equity. A specific point in this respect is whether or not a gain or loss that relates to distributions to, or contributions from, an entity's owners, should be recognized and, if yes, in which statement.
- ***Rationale for capital and capital disclosures***: The presentation and disclosure of equity also includes the accounting for, and the classification of, specific captions and equity reserves. The definition and segregation of equity "reserves" serve the purpose of appropriation, distributability of earnings, or other forms of defense of capital, and in particular, the guarantee function of capital for an enterprise's creditors, to the extent of means that are statutorily or legally appropriated or restricted. Classification and disclosure of equity sources may also be required for taxation purposes under a specific jurisdiction.
- ***Management of capital*:** From a management viewpoint, an entity has to determine its capital structure optimization policy, the dividend policy, the objectives, policies and processes that it employs for the purpose of managing capital and, depending on the industry, how to cope with externally imposed capital requirements.
- ***Owners' perspective*:** Each one of the owners of a company is interested in understanding whether a certain jurisdiction provides for equality of shareholders' rights for each class of equity securities, which rights are associated with each class of equity securities, minority interest rights, and whether or not such rights are proportional to the equity interest. From an accounting perspective, this also translates into different presentations of minority interests in a partially owned subsidiary in consolidated financial statements, as a result of adopting the entity versus the parent company theory, and how gains or losses that are generated by capital transactions should be accounted for. Furthermore, financial reporting has produced indicators that serve information needs of the controlling interest (such as earnings per share that are attributable to ordinary equity holders of the parent entity) versus those of all owners (e.g., net income).
- ***Definition of financial performance and performance metrics*:** Shareholders are interested in understanding the return on their investment, as well as the performance of the company. A long standing debate exists on the definition of performance: financial versus economic versus nonfinancial performance; net income versus comprehensive income; capital maintenance concepts; short versus long term perspective; GAAP measures versus pro forma earnings. Financial reporting has responded by in computing earnings per share and diluted earnings per share. Financial analysis has developed ROE – Return on Equity, cost of equity, economic value added (EVA), and other models of shareholders' value and financial performance. Many financial ratios involve equity (such as debt to equity ratio), and specific accounting treatments may affect such ratios (such as recognition of a capital versus an operating lease). Furthermore, all this differs from market capitalization of a company, and value of equity from a stock exchange investor's viewpoint.
- ***Business law and regulation*:** Shareholders' contributions are a basic element of their obliga tions as part of the articles of incorporation. Depending on jurisdiction, types and categories of equity instruments differ, as do the related rules and regulations. A certain jurisdiction may require a minimum amount of capital stock for certain company forms, allow the is sue of shares with no par value, and sometimes mandate a minimum par, or stated value, or an integer amount only. Fundamental corporate changes involving capital must follow specific rules.

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1.3 THE CONCEPT OF OTHER COMPREHENSIVE INCOME

The concepts of comprehensive income and other comprehensive income interact with the concept of equity. Comprehensive income, under a balance sheet approach, represents all the recognized changes in equity (net assets) of an entity from one reporting period date to the next that result from sources other than changes arising from investment by and distributions to owners. The balance sheet view is discussed in Section 2.1.4 later. Other comprehensive income is a part of comprehensive income. Other comprehensive income is a component of equity. Other comprehensive income is treated in Chapter 7, including its interactions with net income in representing financial performance.

1.4 THE FINANCIAL STATEMENT PRESENTATION PROJECT

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The FASB and the IASB are jointly pursuing a comprehensive and consistent approach to financial statements presentation. Stockholders' equity also comprises presentation issues. Therefore, it is worth considering the development of this project to date and its connections to the topic of this Book.

1.4.1 Project History

The accounting and financial communities have long been discussing presentation models to enhance the relevance, quality, credibility, and usefulness of financial reporting, including whether its scope should extend to business issues, real time disclosures, financial metrics, and even nonfinancial information.[1]

In 1998 the FASB decided to undertake research on business reporting, also covering disclo sures that companies may decide to make even on a voluntary basis.[2]

The IASB and the FASB added independent projects on performance reporting, mainly fo cused on income statement presentation, to their agendas, in September and October 2001 respectively. Since April 2004 they have been conducting a joint project.

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[1] *Among others: Association for Investment Management and Research (AIMR),* Financial Reporting in the 1990s and Beyond *(November 1993); AICPA Special Committee on Financial Reporting,* Improving Business Reporting – A Customer Focus *(December 1994); FASB Invitation to Comment,* Recommendations of the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research *(1996); L. Todd Johnson and Andrew Lennard, January 1998 Special Report, Reporting Financial Performance:* Current Developments and Future Directions*, published by the members of the former G4+1 standard setting organizations (January 1998); Kathryn Cearns, September 1999 Special Report,* Reporting Financial Performance: A Proposed Approach*, published by the members of the former G4+1 standard setting organizations (September 1999); UK's Accounting Standards Board (ASB) Financial Reporting Exposure Draft (FRED 22),* Reporting Financial Performance *(December 2000).*

[2] *Special Committee Report of the Business Reporting Research Project,* Improving Business Reporting: Insights into Enhancing Voluntary Disclosures *(January 2001); GAAP SEC Disclosure* Requirements *(March 2001);* Business and Financial Reporting: Challenges from the New Economy *(April 2001);* Update of Electronic Distribution of Business Reporting Information – Survey of Business Reporting Research Information on Companies' Internet Sites *(May 2002).*

During their joint meeting on March 18, 2006, the FASB and the IASB finally decided to rename the project previously entitled *Performance Reporting* as *Financial Statement Presentation Project* to reflect its expanded scope to cover all financial statements.

The project now continues as part of the Memorandum of Understanding which sets out a Roadmap of Convergence between IFRSs and U.S. GAAP 2006–2008. The MoU called for issuance of one or more due process documents on the full range of topics in the Financial Statement Presentation project by 2008. The IASB and the FASB updated their Memorandum of Understanding. A timeline for convergence of IFRSs and U.S. GAAP by 2011 outlined in the Memorandum of Understanding was endorsed by the G20 Leaders on September 24–25, 2009 in Pittsburgh. In November 2009, the FASB and the IASB reaffirmed their commitment to their 2006 Memorandum of Understanding, as updated in 2008. They issued a joint statement indicating a pathway for completion of the major projects by 2011. In June 2010, they revised their convergence work plan to prioritize the major projects.

A Joint International Group (JIG), composed of experienced financial statements professionals, and a Financial Institutions Advisory Group (FIAG), for reporting issues regarding financial institutions, assist the Boards and their staff.

On March 16, 2006, the IASB issued its Phase A Exposure Draft, *Proposed Amendments to IAS 1 Presentation of Financial Statements: a Revised Presentation*. On September 2007, the IASB issued its revised version of IAS 1, *Presentation of Financial Statements*, which completed this first phase of the project. As to Phase B of the project, on October 16, 2008 the IASB and the FASB published for public comment a discussion paper. In July 2010, the staff of the IASB and the FASB published a Staff Draft. Progress on this project is not expected until later in 2011.[3]

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1.4.2 Scope and Objectives of the Project

The *Financial Statement Presentation Project* limits its scope to presentation standards. Its objective is to improve the ability of financial statements users to assess the financial performance of a business enterprise and the amounts, timing, and uncertainty of the enterprise's future cash flows. Through identification of decision relevant information, in a manner that is sufficient for financial analysis, with appropriate display and consistent classifications of data, users would be assisted in understanding an entity's past and present financial position and changes thereof, and the nature of the activities that caused those changes.

The project is divided into three segments, with the following scope:

- ***Phase A*** – Decision on which primary statements shall form a complete set of financial statements; the number of years and configuration of comparative information; and the use of a single statement of comprehensive income and its appropriate subtotals;
- ***Phase B*** – Definition of principles for disaggregating and totalizing financial information; whether to maintain the notion and mechanics of "recycling" of other

[3] *Discussion Paper,* Preliminary Views on Financial Statement Presentation *(October 2008); FASB and IASB,* Staff Draft of an Exposure Draft on Financial Statement Presentation *(July 2010);* FASB Technical Plan and Project Updates (last visited August 25, 2011) *www.fasb.org;* IASB Work Plan *as of July 26, 2011*.

comprehensive income items to net income; and whether the statement of cash flows should follow the direct or indirect method of presentation;

- ***Phase C (FASB only)*** – Decision on interim reporting, including which financial statements shall be involved; whether and how to use condensed formats; what periods are relevant for comparative information; and whether guidance should differentiate private versus public companies.

The project does not include recognition and measurement, presentation or disclosure of nonfinancial metrics, financial reporting other than financial statements (such as management discussion and analysis), and pro forma earnings.

Although discussed during the project, the Discussion Paper scoped out the accounting for other comprehensive income and its recycling to net income or reclassification to profit or loss.[4] To benefit from the shorter term improvements made through the *Financial Statement Presentation Project* and other projects, the Boards enucleated the aspects of presentation of other comprehensive income, resulting in June 2011 in Amendments to IAS 1 and in an Accounting Standards Update.[5]

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1.4.3 Working Principles

The *Financial Statement Presentation Project* has been proceeding deductively from a num ber of working principles. Those working principles address the manner in which financial statements should present information. A short explanation of those principles follows. The Discussion Paper and then the Staff Paper revised them in number, definition, and priority.

1.4.3.1 Cohesiveness The first, and initially the governing, working principle states that financial statements should portray a cohesive financial picture of an entity. This principle initially included subprinciples on comparativeness and consistency. These subprinciples were subsequently removed, because they were already part of the overarching qualitative characteristics of financial reporting.[6] Qualitative characteristics make accounting or financial statements information helpful to users.[7] The *Financial Statement Presentation Project* instead translates general qualitative characteristics into working principles of financial statement presentation.[8] The Staff Draft gives a special relevance to cohesiveness as one of the core prin ciples. Cohesiveness structures financial statements similarly, by using sections, categories, and subcategories that make the interrelations of financial statements transparent. Depending

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[4] *Discussion Paper,* Preliminary Views on Financial Statement Presentation, *¶ 1.22 (October 2008).*

[5] *FASB Accounting Standards Update No. 2011 05,* Comprehensive Income (Topic 220) – Presentation of Comprehensive Income*; Amendments to IAS 1,* Presentation of Items of Other Comprehensive Income.

[6] *CON 8,* Conceptual Framework for Financial Reporting, Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information*, ¶¶ QC21, QC22; CON 2 (superseded), ¶¶ 111, 120;* The Conceptual Framework for Financial Reporting 2010*, ¶ QC21, QC22; IASB Framework, ¶ 39 (superseded).*

[7] *CON 8, ¶ QC1; CON 2 (superseded), ¶ 1;* The Conceptual Framework for Financial Reporting 2010*, ¶ QC1; IASB Framework, ¶ 24 (superseded).*

[8] *IASB Meeting, September 19, 2006, Agenda Paper 9,* Application of Working Principles*, ¶ 122 (September 2006).*

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on the granularity of the changes in assets or liabilities, financial statements may align at various levels, from category to line items.[9]

1.4.3.2 Categorization The working principle of categorization requires that financial statements should separate an entity's financing activities from its business and other activities and further separate financing activities between transactions with owners in their capacity as owners and all other financing activities. The terminology used for the working principle has changed to specify *value creating activities* as *business and other activities* (e.g., business, investing, and others) and, symmetrically, to replace *financing activities* (i.e., financing of those business and other activities) to *capital activities*. Finally, the point on segregation between transactions with owners in their capacity as owners from all other financing activities, which was previously independent, was added to this working principle, to underline equity financing as one of the types of financing activities. This principle did not survive the Staff Draft and was embedded in other principles.

1.4.3.3 Liquidity Under the working principle of liquidity, financial statements should present information in a manner that helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash or time to conversion to cash). This working principle previously included an explanation of the importance of liquidity to predict future cash flows, and has subsequently incorporated a definition of liquidity as nearness to cash or time to maturity. Moreover, the Boards have been considering whether the notion of solvency should be included in this working principle. The Discussion Paper finally subsumed this working principle in that of "liquidity and financial flexibility."[10] The Staff Draft has eliminated the principle of liquidity and financial flexibility, as subsumed in the Conceptual Framework.[11]

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1.4.3.4 Measurement The working principle of measurement dictates that financial statements help a user understand the following aspects concerning the measurement of assets and liabilities:

1. The basis on which assets and liabilities are measured (measurement basis);
2. The uncertainty in measurements of individual assets and liabilities (measurement uncertainty);
3. What causes a change in reported amounts of individual assets and liabilities (causes of asset and liability changes).

This is no longer a basic principle. Measurement is a dimension of the disaggregation principle.

1.4.3.5 Disaggregation Financial statements should disaggregate line items, under the disaggregation working principle, if that disaggregation enhances the usefulness of the information in predicting future cash flows. This working principle lost the previous component of the notion of totalization. Totalization is important as it consists in the aggregation on the face of the financial statements of line items into subtotals and totals that are considered

[9] *FASB and IASB,* Staff Draft of an Exposure Draft on Financial Statement Presentation, *¶¶ 44–45, 57–58, 61 (July 2010).*

[10] *Discussion Paper,* Preliminary Views on Financial Statement Presentation, *¶¶ 2.12–2.13 (October 2008).*

[11] *FASB and IASB,* Staff Draft of an Exposure Draft on Financial Statement Presentation, *¶¶ BC72–BC73 (July 2010).*

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relevant. However, excessive totalization makes cluttered financial statements. Finally, the Discussion Paper proposes the presentation of meaningful subtotals for each section and category within a section of the financial statements.[12] The Staff Draft gives a special relevance to disaggregation as one of the core principles. The keys of disaggregation are the functions, nature, and measurement basis of items. Disaggregation, by enucleating activities, cash flows, and relationships between assets or liabilities and the effects of their changes, makes financial statements clear and ready for financial analysis for appraisal of performance and prediction of future cash flows. The correct level of disaggregation depends on the interaction of materiality and understandability.[13]

1.4.3.6 Cash Flow Assessment This working principle was introduced in December 2006. It requires all financial statements, not just the statement of cash flows, to apply the objectives of the statement of cash flows under Subtopic 230 10 (FASB Statement No. 95, *Statement of Cash Flows*) and International Accounting Standard No. 7, *Cash Flow Statements*. Specifically, under this working principle, financial statements should be prepared in a manner that helps investors, creditors, and others to assess an entity's ability to generate future cash inflows, meet its obligations, and establish what transactions do not involve cash and their impact on an entity's financial position.[14]

The Discussion Paper finally subsumed this working principle within that of "liquidity and financial flexibility."[15]

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1.4.3.7 Selection of Working Principles in the Financial Statement Presentation Project Among these working principles, the Discussion Paper of the *Financial Statement Presentation Project* selected cohesiveness, disaggregation, and liquidity and financial flexibility as the objectives of financial statement presentation and renamed them as objectives of financial statement presentation.[16] The objective of "liquidity and financial flexibility" included the former working principle of liquidity and that of cash flow assessment that were previously separate ones. Under the Staff Draft, disaggregation and cohesiveness remain the two core principles.[17]

1.4.4 Interrelationships and Conflicts among Working Principles

Some interrelationships (and conflicts) arguably arise from the working principles. Worksheet 1 illustrates those relationships.

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[12] *Discussion Paper,* Preliminary Views on Financial Statement Presentation*, ¶ 2.23 (October 2008).*

[13] *FASB and IASB,* Staff Draft of an Exposure Draft on Financial Statement Presentation*, ¶¶ 44–46, 51, BC66, BC70–BC71 (July 2010).*

[14] *Financial Accounting Standards Advisory Council,* March 20, 2007 Agenda*, Attachment F – Exhibit 1, ¶ 3.*

[15] *Discussion Paper,* Preliminary Views on Financial Statement Presentation*, ¶¶ 2.12–2.13 (October 2008).*

[16] *Discussion Paper,* Preliminary Views on Financial Statement Presentation*, ¶ 2.4 (October 2008).*

[17] *FASB and IASB,* Staff Draft of an Exposure Draft on Financial Statement Presentation*, ¶¶ 44, 45 (July 2010).*

1.4.5 Link to the Topic of This Book

The *Financial Statement Presentation Project* has raised some issues that have a connection to the topic of equity. The main aspects are illustrated in Worksheet 2 along with paragraph references in this Book.

1.5 MAIN INTERRELATIONSHIPS WITH OTHER PROJECTS

The FASB and the IASB are conducting several projects independently, or in conjunction as a result of the convergence effort. Some of these projects have points of contact with the topic of equity, as follows.

Within the context of deliberations on the elements of financial statements and on recognition as part of Phase B of the *Conceptual Framework Project*, the discussions compare alternative views on equity. Part of the debate regards an effort to define equity, as opposed to leaving it as a residual classification. Additionally, an approach to identifying a single element of *claims* is an alternative to a more traditional classification of equity versus liabilities. A Discussion Paper from the IASB and from the FASB on Phase B is not expected until after June 2011 and December 2011, respectively. Phase A was completed by publishing in September 2010 the Objectives and Qualitative Characteristics chapters.[18]

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Debate on the adoption of the entity versus proprietary concepts is included as part of Phase D of the project, with a Discussion Paper issued on May 2008. Continuation of this Phase by the IASB and the FASB is not expected before June 2011 and December 2011, respectively.[19] This issue is treated extensively in Section 4.3.2 later.

The *Financial Instruments with Characteristics of Equity Project – former Financial Instruments: Liabilities and Equity Project* – (Phase 1 of which resulted in FASB Statement No. 150[20]), is intended to produce a comprehensive standard for all financial instruments, including those with characteristics of equity, liabilities, or both. As part of this project, three different approaches to equity – ownership, ownership settlement, and reassessed expected outcomes (REO) approaches – have been under discussion. Progress on this project is not expected until later in 2011.[21]

The *Financial Instruments Project* has the long term objective of adopting fair value measurement and simplification of accounting for financial instruments, including overcoming the current dichotomy between net income and other comprehensive income. In November 2009 the IASB issued IFRS 9, *Financial Instruments*, and in October 2010 revised it. In May 2010,

[18] The Conceptual Framework for Financial Reporting *2010; CON 8,* Conceptual Framework for Financial Reporting*, Chapter 1,* The Objective of General Purpose Financial Reporting*, and Chapter 3,* Qualitative Characteristics of Useful Financial Information*; FASB* Technical Plan and Project Updates *(last visited August 25, 2011) www.fasb.org;* IASB Work Plan *as of July 26, 2011.*

[19] *Discussion Paper,* Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity*; FASB Technical Plan and Project Updates (last visited August 25, 2011) www.fasb.org; IASB Work Plan as of July 26, 2011.*

[20] *FASB Statement No. 150,* Accounting for Certain Financial Instructions with Characteristics of Both Liabilities and Equity *(May 2003).*

[21] FASB Technical Plan and Project Updates *(last visited August 25, 2011) www.fasb.org;* IASB Work Plan *as of July 26, 2011.*

P1: .../... P2: ...
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the FASB published a proposed Accounting Standards Update. A Final Document is planned by 2011.[22]

The *Business Combination Project* in its Phase II also included the accounting for, and reporting of, noncontrolling (minority) interests. Phase I of the project resulted in IFRS 3, and revised versions of International Accounting Standard No. 36[23] and International Accounting Standard No. 38.[24] Phase II resulted in IFRS 3 (Revised January 2008) and FASB Statement of Financial Accounting Standards No. 141 (Revised 2007),[25] as well as International Accounting Standards No. 27 (Revised January 2008)[26] and FASB Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. The topic of noncontrolling (minority) interests is discussed in Section 4.3 later.

Both Phase 2 of the FASB's *Postretirement Benefit Obligations including Pensions Project* and Phase 1 of the IASB's *Post Employment Benefits (including Pensions) Project* aim at a comprehensive reconsideration of pension and postretirement benefit accounting. A first step was the issuance of FASB Statement No. 158 in September 2006. The implications on equity are analyzed in Section 7.18 later. In June 2011, the IASB issue a revision of IAS 19. However, this is not a comprehensive reconsideration of postemployment benefits. The FASB placed this project in a not active status.

The IASB's *Intangible Assets Project* was intended to address the accounting for intangible assets, resulting in the amendment of IAS 38. In December 2007, the IASB decided not to add this project to its active agenda. The effect of the revaluation model to equity is explained in Section 6.6 later and Section 7.16 later.

The *Income Tax Short Term Convergence Project* addresses selected differences between U.S. GAAP and IFRSs on income taxes, including those directly affecting other comprehensive income and equity. The IASB issued an Exposure Draft on March 2009. However, in October 2009, the IASB decided not to go forward with the Exposure Draft and to re introduce some of its proposals. It also resolved to address specific issues concerning income taxes in the short term and conduct a fundamental review with the FASB in a longer period.[27] Certain requirements proposed in the Exposure Draft are illustrated in Chapter 8 later.

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1.6 SIGNIFICANCE OF EQUITY

Stockholders' equity has at all times been considered a significant item in financial statements for several reasons. Firstly, most transactions and events that involve assets and liabilities result, directly or indirectly, in changes in equity. Secondly, contributions from, and distributions to,

[22] *FASB, Proposed Accounting Standards Update,* Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815) *(May 2010)*. FASB Technical Plan and Project Updates *(last visited August 25, 2011) www.fasb.org*.

[23] *International Accounting Standard No. 36,* Impairment of Assets.

[24] *International Accounting Standard No. 38,* Intangible Assets.

[25] *FASB Statement No. 141(R),* Business Combinations.

[26] *International Accounting Standards No. 27,* Consolidated and Separate Financial Statements.

[27] *Exposure Draft,* Income Tax *(March 2009); Amendments to IAS 12,* Deferred Tax: Recovery of Underlying Assets, *¶ BC3; IASB Update, November 2009; IASB Update, March 2010*.

shareholders also affect equity. Additionally, transactions and events that determine income (or expenses), or gains (or losses), increase (decrease) stockholders' equity, through either net income (loss) or other comprehensive income (loss), although the percentage impact of income or expense (nature of flow) is alleviated by the cumulative nature of equity (nature of stock). Finally, changes in accounting principles and correction of errors generally impact equity, under FASB Statement No. 154 and IAS 8, mostly through retroactive restatement of retained earnings.

Some surveys on first time adoption of IFRSs illustrate the pervasive nature of accounting impacts on stockholders' equity. The percentage change in stockholders' equity due to 2005 first time adoption of IFRSs for 24 largest European banks was positive in France up to over 20% in one case, Belgium from over 5% up to 15%, generally decreasing in the United Kingdom up to less than –10% in one instance, and with mixed results in other countries with a range from +10% to less than –15%.[28] An analysis by Ernst & Young of the impact of 2005 first time adoption of IFRSs for six companies in the building materials sector (BPB, CRH, Hanson, Italcementi, Lafarge, and St Gobain)[29] showed a prevailing downward change, ranging from –4% to –10%, in total equity (only one player presenting a positive increase). An analysis of 35 listed companies that were part of the S&P/MIB index in Italy[30] showed that the first time adoption of IFRSs as of January 1, 2005 affected stockholders equity by 2.7% on average, and +15.8% for the insurance sector, +5.5% for industrial companies, +4.5% for media and telecom, –4.9% for energy and utilities, –3.5% for banking, and +51.9% for other trade and services. A survey on 2005 IFRSs' first time adoption by Italian listed companies showed that the change in stockholders' equity relative to previous local GAAP exceeded a +/–10% range for 29% out of 193 consolidated financial statements as of the beginning of 2004 (32% as of the end of 2004) and 35% out of 50 entity financial statements (25% as of the end of 2004).[31]

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1.7 SCOPE OF BOOK

This Book analyzes the accounting for stockholders' equity and other comprehensive income from the point of view of an equity issuer, as well as the related accounting requirements, from the angle of a comparative study, by means of a critical appraisal of and comparison between the U.S. GAAP and the IFRSs pronouncements and practice.

This operational view is taken from a dual reporting approach. In fact, from a practical perspective, Chief Financial Officers, Financial Directors, and controllers of companies that plan to or are required to adopt IFRSs for the first time may need to implement dual reporting systems and processes. This would also apply to European companies that operate both in Europe and in the United States, or U.S. multinational companies that are present in countries where IFRSs are effective. Therefore, they must understand the similarities and differences

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[28] *Ernst & Young,* The Impact or IFRS on European Banks – 2005 Reporting *(October 2006) (last visited October 2006) www.ey.com/ifrs.*

[29] *Ernst & Young, IFRS,* The Implications for the Building Materials Sector *(December 2005) (last visited December 2005) www.ey.com/ifrs.*

[30] *Protiviti,* Insight No. 6 2005 *(December 2005) www.protiviti.it (last visited January 2006)*

[31] *Osservatorio Bilanci Sezione di Ragioneria – Dipartimento di Economia Aziendale Universita degli Studi di Torino,* Summit 2005, Rapporto sui bilanci 2005 delle societa quotate*, Summa (October 16, 2006), (last visited August 5, 2007) www.m2a.unito.it.*

between U.S. GAAP and IFRSs. Furthermore, EC Regulation 1606/2002 permits EU Member States to defer the first time adoption of IFRSs to the financial year starting on or after January 2007 for companies, inter alia, that are listed in an EU non member State and report under U.S. GAAP.

As a result of those changes, the complexity for multinational companies has increased twofold. Firstly, migrating to IFRSs as the primary basis of accounting may be necessary in the relevant jurisdictions. Secondly, the accounting systems, processes, and corporate culture must initially change to allow reporting in (at least) two comprehensive bases of accounting, as opposed to just a one off exercise for reconciliation to U.S. GAAP, as some companies have been required to do.

This often involves transition costs and implementation difficulties, for which companies may seek external support. In this respect, the accounting industry also faces the challenge of digesting new accounting principles and confronting them with other sets of standards.

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Planning Point: Transition processes may result in expensive professional charges to clients, unless better time and result for money are achieved through a multidisciplinary and multi chartered accounting environment that capitalizes on a dual reporting practice, as opposed to the traditional and costly approach of mobilizing staff from the U.S. and European practices of a professional firm.

Certain events reaffirm the need for an understanding of the similarities and differences between the two different sets of accounting principles.

Firstly, as is well known, the IASB and the FASB are committed to a joint work program as described in their Memorandum of Understanding. The Memorandum of Understanding establishes a Roadmap of Convergence between IFRSs and U.S. GAAP 2006–2008. The MoU called for issuance of one or more due process documents by 2008. In 2008, the FASB and the IASB updated the Memorandum of Understanding. On September 24–25, 2009 in Pittsburgh, the G20 Leaders endorsed a timeline for convergence of IFRSs and U.S. GAAP by 2011 outlined in the update of the Memorandum of Understanding. In November 2009, the FASB and the IASB reaffirmed their commitment to their Memorandum of Understanding. They issued a joint statement indicating a pathway for completion of the major projects by 2011. In June 2010, they revised their convergence Work plan to prioritize the major projects. As a consequence of this trend to convergence, economic players, such as academics, accountants, and financial analysts, received a notice to be ready for the changing requirements. Corporate executives must be even more on the alert, in order to plan for easier and more cost conscious migrations.

Secondly, to give preparers a relatively stable period to implement the IFRS platform, the IASB announced that it would not require the application of new standards before January 1, 2009,[32] although in the meantime it has developed new standards. In October 2010, the IASB and the FASB published a Discussion Paper soliciting feedback on the most effective

[32] *IASB Press Release, December 2006*. No new major standards to be effective before 2009. *[Online] IASB. Available at www.iasb.org (last visited February 2007).*

times and transition methods of standards that they are jointly developing.[33] In general, the effective date of major projects planned for completion by 2011 is the beginning of 2013.[34] Therefore, companies yet to adopt IFRSs still have an additional opportunity to get a better understanding of future directions and design their accounting systems according to multi standard compliance.

Thirdly, effective for financial years ending after November 15, 2007 and interim periods within those years contained in filings made after the effective date, the Securities and Exchange Commission recently eliminated the requirement for reconciliation of financial statements prepared in conformity with IFRSs as issued by the IASB to U.S. GAAP in Form 20 F, and allowed annual filings and registration statements without reconciliation to U.S. GAAP.[35]

The SEC also published a Concept Release on allowing U.S. issuers to file financial statements in accordance with IFRSs as issued by the IASB with the Commission.[36]

On August 27, 2008 the SEC also proposed a "roadmap" to IFRSs that would require all U.S. public companies to file their financial statements in IFRSs by 2016 and would also allow certain U.S. companies, based on certain criteria, to use IFRSs for their filings for fiscal years ending on or after December 15, 2009. In 2011 the SEC would evaluate the steps made in the roadmap and decide whether or not to require large accelerated filers (issuers with common equity of at least $700 million) to report under IFRSs starting from fiscal years ending on or after December 15, 2014, accelerated filers to report under IFRSs starting for fiscal years ending on or after December 15, 2015, and all other public companies from fiscal years ending on or after December 15, 2016.

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However, on February 24, 2010, the SEC issued a statement calling for more study of IFRSs and setting 2015 as the earliest possible date for the required use of IFRSs by U.S. public companies. It confirmed year 2011 as the threshold for a decision on whether to move ahead. The SEC withdrew the proposed rules for limited early use of IFRS by certain U.S. issuers, although it did not exclude the possibility of early use or adoption. The statement does not rule out the possibility in the future that issuers may be permitted to choose between the use of IFRSs or U.S. GAAP. The Work plan addresses six specific areas of concern: 1) whether IFRSs are sufficiently developed and consistent in application for use in the U.S. reporting system; 2) the independence of standard setting; 3) investor understanding and education regarding the new standards and comparison with U.S. GAAP; 4) impact on U.S. laws or regulations;

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[33] *FASB, October 2010. Discussion Paper,* Effective Dates and Transition Methods*; IASB, October 2010*. Request for Views on Effective Dates and Transition Methods.

[34] *IASB Update, December 2009*.

[35] *Security and Exchange Commission,* Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP *(March 4, 2008); Security and Exchange Commission, Proposed Rule (Release No. 33 8818),* Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP *(July 2, 2007). Hereinafter Proposed Rule.*

[36] *Securities and Exchange Commission, Release No. 33 8831,* Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards *(August 2007), page 6. Hereinafter Concept Release.*

P1: .../...   P2: ...
JWBK541 c01   JWBK541 Bellandi   February 11, 2012   14:40   Printer Name: Yet to Come

5) impact on both large and small companies; and 6) preparation of auditors. The successful completion of the FASB IASB convergence project is perceived as a critical milestone.

On May 26, 2011, the SEC published an update concerning its Work plan to IFRSs.[37] After analyzing the difference between enforcement and convergence, the SEC's paper addresses the so called "condorsement" approach. This approach intends to lead to IFRS compliance by U.S. issuers that are compliant with U.S. GAAP. At the end of a transitional period, U.S. GAAP would incorporate IFRSs. In this respect, it is similar to an enforcement approach. During a transitional period of five to seven years, differences between IFRS and U.S. GAAP would be addressed. In this respect, it is similar to a convergence approach. The transition period could permit a staged or phased implementation.

Finally, the FASB would also have a role in issuing supplementary or interpretative guidance, adding disclosure requirements, or setting requirements on issues not addressed by IFRSs. Finally, as of May 18, 2008 the IASB has been designated by the Council of the AICPA as the body to establish international financial reporting standards for both private and public entities pursuant to Rule 202 and Rule 203 of the AICPA Code of Professional Conduct. In three to five years, the Council will reassess this decision.[38]

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Planning Point: This should be seen as an opportunity. Adopting high quality, understandable, transparent, and internationally accepted standards (such as IFRSs or U.S. GAAP) for financial reporting should be part of the corporate, marketing, and communication strategy to stakeholders and requires top management commitment.

It may be a unique opportunity to enhance decision usefulness for users of financial statements, aid the raising of foreign finance, and improve corporate image, competitiveness, financial transparency, and international visibility. In addition, it is an opportunity to shift business processes from report generation to streamlined and cost effective data gathering.

The adoption of modern financial reporting is not simply an accounting exercise, but it generates a pervasive change that involves virtually all the departments of a company.

Therefore, this may result in a new competitive tool for Chief Executive Officers, Directors, and Chief Financial Officers who know how to accept this challenge.

Most importantly, some major economies, e.g., Canada, which has announced IFRS convergence by 2011, are migrating to IFRSs by 2010–2012 and beyond.

On July 24, 2007, the Council of the Institute of Chartered Accountants of India announced its IFRS convergence plan for listed entities, other public interest entities such as banks, insurance companies, and large sized entities from the accounting periods commencing on or after April 1, 2011.

[37] *SEC, 2011.* Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers. *[Online] Available at www.sec.gov (last visited May 29, 2011).*

[38] *Amendment to Code of Professional Conduct Appendix A* – Council Resolution Designating Bodies to Promulgate Professional Standards.

On January 28, 2010, the Brazilian Federal Council of Accounting and the Brazilian Accounting Pronouncements Committee signed a MoU with the IASB to converge fully to IFRS by end 2010.

On August 1, 2008, the Financial Reporting Foundation (FRF) and Malaysian Accounting Standards Board (MASB) announced their plan to bring Malaysia to full convergence with IFRSs by January 1, 2012. For the time being, private entities will continue to apply Private Entity Reporting Standards (PERS).

In November 2008, the National Banking and Securities Commission of Mexico together with the Mexican Board for Research and Development of Financial Reporting Standards communicated a plan to adopt IFRSs for listed entities starting for periods ending on December 31, 2012.

Public companies in Argentina will be required to adopt IFRSs starting in 2012, with an option to file financial statements in accordance with IFRSs starting in January 2011.

The South Korean government has approved mandatory adoption of IFRSs by 2011 for all listed companies and unlisted financial institutions in certain sectors. All companies except financial institutions could voluntarily adopt IFRSs from January 1, 2009.

On December 11, 2009, the Japan Financial Services Agency (FSA) announced regulatory changes to allow certain qualifying domestic listed companies to apply IFRSs in consolidated financial statements, starting from the fiscal year ending on or after March 31, 2010. A final decision on the mandatory requirement of IFRSs from 2015 or 2016 will be taken around 2012.

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In such a context, this Book addresses the informational needs of policymakers, Chief Financial Officers, Financial Directors, controllers, financial analysts, CPAs, and academics to compare the U.S. GAAP and IFRS requirements for the presentation on the face of the balance sheet and on the alternative statements for reporting shareholders' equity. It also draws practical implications for IFRS/U.S. GAAP dual reporting.

This Book approaches the subject mainly from the angle of presentation standards for the statement of financial position[39] and other statements for equity reporting. Recognition, measurement, and disclosure are also addressed, although consequentially derived.

The Book also capitalizes on the study of Basis for Conclusions, proposed Exposure Drafts, Discussion Documents, and other convergence project works, in order to analyze the rationale and the practical implications of differences in accounting requirements.

Firstly, the scope of the applicable authoritative pronouncements and respective definitions is analyzed in depth. Importantly, the main difficulty that comparative studies usually encounter is in making an inventory of whether authoritative literature treats the same, similar, partially overlapping, or totally different issues. This is mostly due to the fact that different bodies of standards often move from different angles, scopes, or starting points.

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[39] *In general, this Book uses the expression "statement of financial position" with reference to U.S. GAAP and IFRSs, consistently with IAS 1, unless used differently in a specific pronouncement. It uses the term "balance sheet" with reference to SEC rules and regulations.*

P1: .../... P2: ...
JWBK541 c01 JWBK541 Bellandi February 11, 2012 14:40 Printer Name: Yet to Come

Then, the differences between the two sets of standards are identified as far as possible, based on a study of the literal wording of the texts involved.

This Book follows a pervasive, comprehensive, multidisciplinary and multistandard comparison approach. Thus, the reader will discover how important the implications for managers may be. Presentation is viewed as a cross cutting feature, as opposed to the traditional way of looking at the presentation issue as a residual item. This Book does more than simply comment on IAS 1. Conversely, virtually all authoritative pronouncements may have direct or indirect effects on the display on the face of the financial statements. Additionally, determining the right presentation entails, as a prerequisite, a clear understanding of the scope of standards, the definitions, and the relative frameworks. Sometimes the issue is intrinsically commingled with recognition criteria. Furthermore, under certain circumstances, professional judgment and application of accounting policies by management may be required to decide whether to display or simply disclose a certain item in the notes. Even more importantly, in practice the topic of presentation is the first and most evident issue that a company faces, as the design of the chart of accounts and the formatting of the financial statements will depend on it.

Further, the Book uses an operating approach which is useful to companies, especially for the concept and precise techniques of dual reporting, guidelines for designing the chart of accounts, restating or reconciling financial statements for different GAAP, and first time adoption of IFRS.

This Book does not treat: 1) the aspects of share based compensation other than those related to its presentation in equity; 2) earnings per share; and 3) classification of equity versus financial liability.

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