

Financial Accounting Standards Board

Reporting Financial Performance: The Key to Resolving Many Vexatious Accounting Standard Setting Issues?

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Unresolved Standard Setting Issues

- During my time on the FASB, the IASB and FASB have suspended work on the following joint projects due to inherent complexities in identifying workable solutions
 - Financial statement presentation
 - Measurement phase of the conceptual framework
 - Financial instruments with characteristics of equity
- I believe that a key to resolving these issues **may** be
 - Determining what financial statement users seek in the reporting of financial performance (income) AND
 - Revising financial performance reporting to meet these needs
- The purpose of this lecture is to propose a revised financial performance reporting model and to explore what it might mean for the three projects above



Key Issues in Reporting Financial Performance

- Other comprehensive income (OCI) and recycling
- Earnings per share (EPS)
- Non-GAAP measures

OCI & Recycling

- In considering the reporting of financial performance, the primary focus of our constituents has been on determining
 - Which components of income should be reported in OCI
 - Whether and in what circumstances OCI items should be recycled to net income (NI)
- Solutions to these issues require
 - Developing a definition of OCI items that differentiates them from items in NI
 - Identifying what we are trying to achieve with the reporting of NI that suggests OCI items should be reported twice within different measures of financial performance by recycling OCI amounts to NI



Current Definitions

- Comprehensive Income (CI):

“...is the change in equity of a business during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.”

- Concept Statement No. 6, paragraph 70

Current Definitions

- Earnings:

“...is a measure of performance for a period...”

- Concept Statement No. 5, paragraph 34

“...focuses on what the entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices to produce and distribute that output (expenses). Earnings also includes results of the entity’s incidental or peripheral transactions and some events and circumstances stemming from the environment (gains and losses).”

- Concept Statement No. 5, paragraph 38



Current Definitions

- Other Comprehensive Income:

“...certain classes of gains and losses are included in comprehensive income but are excluded from earnings.”

- Concept Statement No. 5, paragraph 42

- Conclusion: Current Conceptual Framework definitions are not useful in

- Differentiating OCI items from NI items

- Indicating why items should be reported twice in CI and NI

Potential Characteristics that Differentiate OCI from NI Items

- Degree of Persistence
- Core / Non-core
- Management Control (Stewardship)
- Remeasurements
- Degree of Measurement Uncertainty
- Time horizon until realization
- Operating v. Investing & Financing
- Other?

Can we Define OCI by Identifying Unique Characteristics of Current OCI Items?

- FASB and the IASB co-sponsored a conference last December entitled, “Other comprehensive income and the presentation of earnings”
- The conference is attended annually by members of the FASB and IASB and our staffs and about sixty individuals from our key constituents, including academics, regulators, users, auditors, and preparers
- The first case used at the conference asked participants to identify the key characteristics of every OCI item required to be reported under US GAAP or IFRS
- Once those characteristics were identified, the case then asked conference participants whether they could identify items with the same characteristics reported in NI



Can we Define OCI by Identifying Unique Characteristics of Current OCI Items?

- For every OCI item examined, conference participants identified at least one income component with the same economic characteristics within NI
- Conclusion: There is no differentiating set of characteristics to define what items are included in OCI rather than NI other than that standards setters decided for political reasons to present those items below the line net income
 - This also means we have no basis for identifying what we are trying to achieve with the separate reporting of NI
- Query: Is this approach working in serving financial statement users needs relating to the reporting of financial performance?

EPS

- The effort to differentiate OCI items from items in NI has the primary outcome of defining the earnings amount reflected in numerator of the single most important income statistic derived from US GAAP reports: EPS
- Financial statement users pay significant attention to EPS
- However, some users also pay even more attention to non-GAAP measures provided by management and the numbers and types of these measures is proliferating
 - This suggests EPS (and NI reporting) increasingly may not be serving all users' needs
- Query: Could examining the primary types of non-GAAP measures provide insights into what users primarily are seeking from reporting financial performance?



Primary Types of Non-GAAP Measures

- Seven reports by preparers, users and auditors at our October 2012 FASAC meeting indicate non-GAAP measures generally serve the purpose of reporting financial performance through the eyes of management
- Overall the reports indicate that there primarily are two types of non-GAAP measures
 - Non-financial measures that most often provide volume information (# of clicks, # of tweets, # of barrels of oil etc.)
 - Financial measures that exclude from net income
 - Items that are distortive of operations and/or
 - One-time, non-recurring items
- These latter financial measures primarily present the results of core, recurring operations and suggest what is the primary number of interest to users



Observations about Current Income Statement Reporting

- Most income statements are quite abbreviated, presenting less than 10 line items, including 2-3 totals and subtotals
- This abbreviated reporting causes the user to focus primarily on the one single bottom line number - NI
- Standard setting efforts in the US, therefore, primarily have taken a bottom up approach that concentrates on getting the bottom line summary number right by
 - Excluding certain purportedly irrelevant OCI items from NI and
 - Recycling items reported in OCI to NI
 - If reporting financial performance is about getting one number right, clean surplus accounting requires that all changes in equity be reported in NI, except those resulting from investments by owners and distributions to owners



Does the Current Approach to Reporting Financial Performance Serve Users Well?

- The proliferation of the Non-GAAP measures suggests the answer is no
 - To understand why, I think about the primary reasons I invest in certain entities and not others
 - I primarily invest in an entity because I believe its core business activities have the potential to provide a persistent, recurring positive return that compensates for the risk taken
 - This view suggests that the primary income number in which I am interested is operating income
 - In addition, to determine whether that number will recur it also suggests that recurring operating items should be presented separately from one-time, non-recurring operating items
 - Note this top down approach to highlighting operating income and separately presenting recurring and non-recurring operating items is perfectly consistent with financial non-GAAP measures provided to and/or demanded by users



Is Operating Income the Only Income Information Needed by Users?

- In examining my investment decisions, the answer again is no because the additional changes in equity for the period (exclusive of transactions with owners) also affect the total amount of net assets available for dividends
- This suggests that I also am interested in the outcomes for the period of the investing, financing, tax and discontinued operations activities of the entity
- In addition, it suggests that I am most interested in two key subtotals: operating income (my primary interest) and comprehensive income with separate reporting of recurring and non-recurring items within each subtotal
- Finally, because non-operating items never become operating, I am not interested in recycling between the categories



Potential Issues with Proposed New Financial Performance Reporting Model

- The model proposed on the prior slide might be operationalized by requiring presentation of one statement of comprehensive income with one required intermediate operating income subtotal
- There may be two key concerns with such presentation
 - The most important subtotal is buried in the middle of the statement, which might cause users to focus more on the bottom line CI number rather than operating income
 - On which number(s) should EPS be defined?
- Potential solutions
 - Require two statements (the Statement of Operating Income and Statement of CI) presented consecutively
 - Require an EPS number for both operating income and CI OR provide the user with the EPS denominator only



Applying the Proposed Model to the Financial Statement Presentation Project

- In July 2010, the FASB and IASB staffs posted a staff draft of a final standard on both organizations' websites
- The staff draft was not issued as final standard, in part, because after redeliberating all issues raised by constituents in response to the original exposure draft the boards were still hearing that the final model was too ambitious, causing major changes in presentation that many constituents stated were not cost-beneficial
- A primary objection also raised was that the project failed to differentiate OCI items from NI items, which many said was the primary issue relating to performance reporting
- In spring 2011, the boards officially stopped work on this project to concentrate efforts on 4 higher priority projects



Why a Project on Financial Statement Presentation (FSP)?

- Goal: Improve the usefulness of financial statements
- Today:
 - No common format for financial statements
 - Relationships between individual statements unclear
 - Dissimilar items are aggregated into highly simplified, condensed amounts
- Proposals in Staff Draft:
 - Provide a common organization and presentation of information in financial statements
 - Clear relationship between the individual statements
 - Provide detail on the nature of, and changes in, assets and liabilities, revenue and expenses, and cash flows



Key Features of the Proposed FSP Model

- **Separation** of operating, investing, financing, tax, and discontinued operations across all of statements
- **More detailed reporting**
 - By function (Sales, COGS, G&A)
 - By nature (Materials, Labor, Advertising, Pension)
 - By measurement bases (Fair Value, Amortized Cost)
- **Direct method** for presenting operating cash flows and a reconciliation of operating income to operating cash flows
- **Analysis of changes** in balance sheet line items
- **Remeasurement** information in a single note



Proposed FSP Model

| Statement of Financial Position (Balance Sheet) | Statement of Comprehensive Income (Income Statement) | Statement of Cash Flows |
|--|--|---------------------------------------|
| Business section | Business section | Business section |
| Operating category | Operating category | Operating category |
| Operating finance subcategory | Operating finance subcategory | |
| Investing category | Investing category | Investing category |
| Financing section | Financing section | Financing section |
| Debt + other | Debt + other | Debt + other and Equity |
| Equity | | |
| | Multicategory transactions | Multicategory transactions |
| Income tax section | Income tax section | Income tax section |
| Discontinued operation section | Discontinued operation section, net of tax | Discontinued operation section |
| | Other comprehensive income, net of tax | |

Overall Structure of Statements

- **Business** section includes operating (core) and investing (non-core)
 - Subcategory: operating finance activities (leases, pensions, vendor financing)
 - Capital expenditures for operating assets are an operating cash flow (no longer “Investing”)
- **Financing** section includes debt and equity
- **Income tax** section
- **Discontinued operation** section

Constituents complained that the break down into so many sections complicated the statements too much



Expected Benefits of Overall Statement Structure

- Relationship between activities across statements is more transparent
- Easier to calculate “activity based” metrics – e.g., return on operating assets, cash collections as % of operating income



Statement of Comprehensive Income (SCI)

- Statement of comprehensive income in two parts
 - Profit or loss/Net income – subtotal
 - Other comprehensive income
- Separate classification of OCI items
 - Identify whether operating, investing or financing
- Disaggregate by nature information in a note, grouped by function
 - FASB: Present breakdown by segment in segment note



Remeasurement Note

- Present separately the remeasurement component of income and expense items recognized in the SCI
- A *remeasurement* is an increase or decrease in the carrying amount of an asset or a liability that is the result of:
 - A change in (or transaction at) a current price or value (e.g., fair value change in a security, loss on sale of receivable)
 - A change in an estimate of a current price or value (e.g., impairment of goodwill)
 - A change in any estimate or method used to measure the carrying amount of an asset or liability (e.g., change in litigation accrual)



Remeasurement Note

| | <u>20X1</u> | <u>20X0</u> |
|---|-------------|-------------|
| Operating | | |
| Gain on disposal of property, plant, and equipment | 22,650 | - |
| Gain on futures contracts (a) | 5,821 | 5,390 |
| Loss on sale of receivables | (4,987) | (2,025) |
| Change in estimate for bad debt expense | - | 2,707 |
| Loss on inventory | (29,000) | (9,500) |
| Impairment of goodwill | - | (35,033) |
| Change in estimated share-based compensation liability | (6,250) | (5,000) |
| Change in litigation accrual | (1,998) | (1,850) |
| Investing | | |
| Fair value change of securities (b) | 98,700 | 81,000 |
| Fair value change of investment in company | 7,500 | 3,250 |
| Foreign currency translation adjustment on equity method investment | (2,160) | (2,000) |
| Other | | |
| Foreign currency translation adjustment - consolidated subsidiary | 3,222 | (2,295) |



Applying the Proposed Model to the Financial Statement Presentation Project

- The proposed performance reporting model
 - Suggests the most important items that the financial statement presentation project should focus on
 - Focusing the section breakdown in all of the statements on separating operating activities from all other items, simplifying the complexity of the statements while still facilitating analysis across statements
 - Requiring a breakdown in the performance report of recurring and non-recurring items in the operating and CI sections either on the face or the notes and limiting remeasurement items identified to one-time, non-recurring amounts
 - Eliminating the need in performance reporting for defining other comprehensive income items and recycling, addressing the primary issues raised by constituents about the performance reporting model
 - Only operating items (activities) need to be defined

Applying the Proposed Model to the Financial Statement Presentation Project

- The proposed performance reporting model
 - Raises questions about whether other aspects of the project are needed to serve primary users needs, including
 - More detailed reporting by function and nature
 - Whether remeasurements should include recurring items
 - Direct method for presenting operating cash flows and a reconciliation of operating income to operating cash flows
 - Perhaps instead requiring footnote presentation of only cash collections from customers and cash paid to suppliers
 - Analysis of changes in balance sheet line items
- Query: Would this more streamlined version of the project change constituents views about whether the project is cost-beneficial while still providing better information to meet users needs?



Applying the Proposed Model to the Measurement Phase of the CF

- Work on the measurement phase of the Conceptual Framework project was suspended in May 2011 to concentrate board efforts on higher priority projects
 - In addition, progress was slow because the task is so challenging
- The work so far on the project focused primarily on identifying measurement methods to be used in the Balance Sheet (initial measurement) rather than the Income Statement (subsequent measurement)
- Preliminary decisions were that future financial reporting should incorporate both historical cost (HC) and fair value measures (FV)
 - The challenge was developing a framework for when each should be used



Balance Sheet vs. Income Statement Focus

- According to Concepts Statement No. 8, the objective of financial reporting is to provide decision-useful information to help capital providers assess:
 - The amount, timing and uncertainty of cash flows to be received by them from the entity, which also requires considering management's stewardship over the net assets entrusted to them
- The Income Statement has the potential to provide the most useful information in making that assessment
- Query: Would an income statement focus based on the proposed performance reporting model provide a new perspective that facilitates identification of when fair value vs. historical cost measures should be used?

HC vs. FV: What Income Statement Information can each System Provide?

- HC:
 - Recurring income or expense
 - Impairment losses on assets
 - Realized gains/losses on sales/settlements
- FV:
 - All of the above, if reported separately (but this is not always done)
 - Incremental unrealized gains/losses
- Recurring income and expense amounts often are persistent
 - All changes in FV, therefore, do not follow a random walk
 - The Income Statement need not be redundant in a FV model

Applying the Proposed Model to the Measurement Phase of the CF

- Selection of HC and FV measurements requires evaluation of the relevance and reliability (representational faithfulness) of the alternative measures
- Reliability (representational faithfulness) of measures is questioned when there are significant judgments or estimates required to apply the measure

Is HC always more Reliable than FV?

- Judgment/estimates in HC model
 - Initial measurement – few
 - Subsequent measurement
 - Recurring income and expenses – depends
 - *Financial instruments – few (relates to interest and sometimes dividends)*
 - *Non-financial assets – many (e.g., pattern of benefit, useful life, salvage value)*
 - Impairment – many (e.g., impairment trigger, expected cash flows, discount rate, fair value)
 - Realized gains/losses – few
- Judgment/estimates in FV model
 - Similar to the HC model, if all income components above are presented separately
 - *Only difference with HC model is FV estimates must be made on a recurring basis*

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Assertion: From an income statement perspective, reliability (faithful representation) cannot be the primary issue driving the selection of FV vs. HC



Is FV (always) more Relevant than HC?

- The only additional income information provided by a FV model (with full income component reporting) is the inclusion of unrealized gains/losses (UGLs) in income
- Do UGLs always provide useful information to assess either future cash flow prospects from the entity or management 's stewardship?
 - The answer is definitely yes only if management has the incentive and ability to sell the asset or settle the liability before maturity or the end of its useful life (EoL)
 - *UGLs reverse if assets/liabilities are held to maturity or the EoL and, therefore, provide only limited information to help meet the objective of financial reporting in those circumstances*

[continued on next slide]



Is FV (always) more Relevant than HC?

- *However, UGLs provide more useful information about the potential change in wealth the entity will experience if an asset is sold or liability settled before its maturity or the EoL*
 - This information is useful in assessing both cash flow prospects from the entity and the opportunity cost of management holding vs. selling the asset/settling the liability
 - When the asset/liability is unlikely to be sold/settled before maturity or EoL, UGLs primarily provide relevant information about the opportunity cost of management holding vs. selling the asset/settling the liability
- » *However, this is unlikely to be a justification for providing FV information on the face of the statements*

Is FV (always) more Relevant than HC?

- Thus, whether UGL information is decision-useful primarily depends on whether management has the incentive and ability to sell the asset/settle the liability before its maturity or EoL
- Factors that affect management's incentive and ability to sell an asset before maturity or EoL
 - The asset is being used in a manner that makes it easy to sell
 - *Is it being used alone vs. together with other assets?*
 - There is a market available on which that asset can be exchanged
- Factors that affect management's incentive and ability to settle a liability before maturity
 - There is a market available on which the liability can be transferred

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Assertion: From an income statement perspective, relevance of FV information depends on the nature of the asset or liability and how it is being used or able to be used within the business. Relevance should be the driving factor for voluntary or mandatory selection of FV or HC.



Applying the Proposed Model to the Measurement Phase of the CF

- PP&E and intangible assets often
 - Are used synergistically with other assets in the business
 - Are more costly to extract and sell
 - Do not have liquid secondary markets on which they are sold
- Financial liabilities often are
 - Restricted from being transferred and, therefore, do not have secondary markets on which they can be exchanged
- These characteristics make it less likely that management will have the incentive and/or ability to sell these assets or settle these liabilities before the EoL/maturity
 - This suggests FV accounting and reporting of UGLs in income is less likely to provide relevant information; UGLs would merely reverse if held to EoL/maturity

Applying the Proposed Model to the Measurement Phase of the CF

- Financial assets and investment properties often
 - Are not used synergistically with other assets in the business
 - Are not as difficult to sell without hindering other business activities
 - Have secondary markets on which they are sold
- These characteristics make it more likely that management will have the ability and incentive to sell these assets before maturity or the EoL
 - This suggests FV accounting and reporting of UGLs in income is more likely to provide relevant information
 - However, under the proposed performance reporting model UGLs could be reported outside operating income if not expected to be realized in the near-term

Applying the Proposed Model to the FICE Project

- The financial instruments with characteristics of equity (FICE) project was suspended due to complexities introduced in trying to identify whether and when hybrid instruments have characteristics that are more consistent with either plain debt or common stock – a balance sheet focus to classification
- Since hybrid instruments often have characteristics of both debt and common stock, the boards were frustrated in developing a non-complex, consistent classification scheme that did not permit structuring to achieve certain income and leverage targets
 - Hybrid instruments are like equity because there is no obligation to make cash payments but many are settled in stock
 - Hybrid instruments are like debt because any payments have a dilutive effect on dividends available to common



Applying the Proposed Model to the FICE Project

- Query: Could an income statement focus to classification consistent with the proposed performance reporting model provide a non-complex classification scheme, while properly indicating the how income affects the future cash flow prospects of capital providers from the entity?
- From a performance reporting framework, the distinction between liabilities and equity serves to differentiate the items reported in comprehensive income from the items reported as transactions with owners

Applying the Proposed Model to the FICE Project

- EPS is the primary metric derived from income reporting
- One goal of EPS is to report the earnings available to existing common shareholders after all payments have been made to other claimants on the assets of the entity
 - i.e., EPS takes a dilution perspective on income measurement
- From this perspective, comprehensive income should reflect distributions to all claimants that dilute the earnings available to common
- This suggests that in the proposed performance reporting model that all hybrid instruments should be classified as liabilities, which is consistent with the basic ownership approach originally supported by the FASB



Applying the Proposed Model to the FICE Project

- There are two key issues that must be addressed to make this classification work
 - If hybrid instruments do not have required contractual cash payments but rather are settled in stock, will we need to distinguish between those two types of liabilities in the balance sheet?
 - This also may necessitate a change in the definition of a liability in the conceptual framework to define liabilities as instruments with present obligation to settle in cash or stock
 - In this scenario, preferred stock also would be classified as equity
 - Will the separate reporting of the income effects of hybrid instruments outside of operating income with non-recurring changes reported separately from recurring changes, provide the necessary information for users to properly evaluate the effects on future cash flows from the entity?

Closing Remarks

- The current reporting model for net income and comprehensive income is broken
 - Concentrating on separate reporting of OCI items from NI
 - Failing to provide the a clean measure of operating income
 - Failing to separate recurring income items from one-time, non-recurring changes in wealth
- Users of financial statements have indicated that in their analyses they first attempt to separate operating income from other income and then to distinguish in both categories persistent income items from non-recurring items
- These observations have caused me to suggest a new model for reporting financial performance that facilitates such analyses



Closing Remarks

- This model also has the potential to provide new perspectives on resolving some vexatious accounting issues
 - Some may assert that my suggested solutions are too radical
 - However, at minimum, taking an income statement perspective on the issues based on the proposed performance reporting model provides an alternative perspective to consider in considering these issues that may open new dialogue that suggests a more consistent framework for resolving these issues
- Of course, I am interested in your views and reactions

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Questions/Discussion

