

American Accounting Association's Financial Accounting Standards Committee

**Response to FASB Invitation to Comment on the Proposal for a New Agenda Project –
“Reporting Information about the Financial Performance of Business Enterprises:
Focusing on the Form and Content of Financial Statements”**

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The Financial Accounting Standards Committee of the American Accounting Association (hereinafter the Committee) is charged with responding to requests for comments on issues related to financial reporting. The Committee is pleased to respond to the FASB's invitation to comment on the Proposal for a New Agenda Project – Reporting Information about the Financial Performance of Business Enterprises: Focusing on the Form and Content of Financial Statements. This letter reflects the views of the individuals on the Committee and not those of the American Accounting Association.

General Comments

The Committee supports portions but not all of the FASB's proposal for adding a project on Financial Performance to its agenda at this time. We believe that there are separable issues within the proposal that warrant addressing: namely, a re-examination of the reporting requirements for other comprehensive income; a reconsideration of the reporting requirements for components of net income; and a review of the direct versus indirect method of presenting the statement of cash flows. However, we do not consider these issues to be of top priority. Rather, the Committee believes that fundamental measurement and recognition issues such as revenue recognition and liability definition and recognition represent more pressing needs for allocation of the FASB's limited resources.

The FASB's proposal itemizes the six key issues that the project would consider. For purposes of our discussion and analysis, we combine the first three issues and issues four and six, and recommend different treatment for each of the resulting three issues.

1. Key financial measures
2. Display of new financial measures
3. Core (operating) and non-core (non-operating) activities

We refer to these three issues as “financial performance measures” and discuss them in greater detail below in section I.

4. Consistent classification of earnings components with cash flow components
6. Comprehensive income.

See discussion below in section II.

5. Income or expense relating to fair values of financial instruments.

The Committee believes that this issue should be addressed as part of the project on fair value rather than as part of a project on financial performance. The Committee has provided comments on both the FASB's December 1999 Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*, and on the Joint Working Group's December 2000 Special Report, *Financial Instruments and Similar Items*.

In summary, there are two separate issues on which we provide further comment below as potential elements of a project on financial reporting: identification and display of key financial performance measures; and the format of the income statement, including other comprehensive income, and the format of the statement of cash flows.

I. Financial Performance Measures

The Committee recommends that the FASB examine the conceptual issues underlying the proposed project on reporting financial measures when considering whether to add the project to its agenda. In particular, changes to the reporting format and required disclosures in financial statements should be based on principles and not on current trends or fads in financial markets or financial reporting. During the past several years, providers and users of financial statement information have apparently placed increased emphasis on alternative (to GAAP) measures of earnings, including "cash earnings," pro forma earnings, adjusted earnings, and operating earnings. There is also anecdotal evidence that summary measures of performance such as EBITDA, revenue growth, and free cash flows are being used (or at least touted) more extensively. Some interpret these perceived changes as indicating a reduced focus on or increased dissatisfaction with GAAP net income.

Management has generally been the impetus for this perceived change in reporting emphasis. Typically, management reports non-GAAP performance measures (in addition to GAAP net income) in its investor relations communications as well as in its published financial statements. According to some reports, management also works to convince securities analysts to focus on these non-earnings numbers for their forecasts and their analyses. Securities analysts have complied and, as a result, several of the services that organize analysts' forecasts into databases (e.g., FirstCall, I/B/E/S, Zacks) include non-GAAP "earnings" forecasts rather than EPS forecasts in their databases.

The Committee does not believe that these alleged circumstances provide a sufficient justification for allocation of the FASB's limited resources. There are three underlying reasons for our position, all related to factors that the FASB relies on when considering new projects. First, we believe that this issue is **transitory and unlikely to persist**. The use of non-GAAP summary performance measures is not a new phenomenon as evidenced by historical securities analysts' reports and informational sources such as Standard & Poor's. It is only the professed concern over the use of these measures that is new. We, in turn, are concerned that the FASB respond too hastily to a current trend that will likely be superseded in short order by a different trend. The emergence, followed by the rather rapid demise, of "whisper forecasts" during the past several years represents a similar short-lived trend. The financial press and

many securities analysts emphasized the whisper forecasts and some academic researchers examined whether whisper forecasts rather than the previously used consensus earnings forecasts should be used in assessing the association between unexpected earnings and unexpected security returns at the earnings announcement date. Today, whisper forecasts have all but disappeared.

There is already evidence that the putative trend away from GAAP earnings is reversing. A recent article in *Barron's* (September 3, 2001) notes that investors are returning to GAAP earnings because of the difficulty in interpreting the so-called adjusted and pro forma earnings numbers. The real estate industry provides another example. Firms in the real estate industry report funds from operations (FFO) in addition to EPS and, similar to the use of pro forma earnings forecasts, some aggregators of analysts' forecasts compile forecasts using funds from operations rather than GAAP earnings per share for real estate companies. Recently, evidence appeared that the use of FFO is being discontinued by some real estate companies (*Wall Street Journal*, August 29, 2001) as well as by some securities analysts including Morgan Stanley, Merrill Lynch, and SalomonSmithBarney (*WSJ*, July 13, 2001) in favor of a return to GAAP earnings per share.

Academic accounting research has also explored whether, as claimed by the popular financial press, the value relevance of earnings has declined over time. Although most research has been consistent in reporting evidence of a decline (e.g., Collins, Maydew, Weiss, 1997; Francis and Shipper, 1999; Lev and Zarowin, 1999), others have questioned the appropriateness of the statistical methods used to document the decline (Kin, Lo and Lys, 1999). Furthermore, there is no consensus on the reason for the decline. Collins, et al. attribute the decline to the increased reporting of losses and nonrecurring items as well as to the increased importance of unrecorded intangible assets. Lev and Zarowin concur on the importance of unreported intangibles but also add a general criticism of the current financial reporting model. Francis and Schipper do not find results consistent with the others on intangibles but find that the increased volatility of the market over time biases results toward a decline in the relevance of earnings. Kin, et al., provide evidence that the results are due to misspecification of the statistical models and, when corrected, the evidence of a decline in the value relevance of earnings disappears.

The Committee is not aware of any claim that EPS is, or should be, the only metric appropriate for gauging a firm's performance, and we are not aware of any evidence that the use of additional or alternative performance measures detracts from GAAP earnings. For these reasons, we believe that the use of such measures is a normal part of financial analysis and that the current concern is a transitory issue and, as such, inappropriate for consideration by the FASB.

Second, we question whether there is a **technically sound solution** to the issue of alternative financial performance measures. We have seen no evidence of a conceptual link between alternative financial performance measures and some goal of interest to users of financial statements such as predicting future firm performance. There are many generic claims for the alternative financial measures but there is no solid supporting evidence, leaving the claims empty and ad hoc. It is not clear on what basis the FASB could establish objective criteria for identifying and defining the alternative financial measures.

Third, we question the **practical consequences** of the issue. That is, if the FASB does not act, is there likely to be widespread dissatisfaction with the FASB and a possible intervention or inappropriate assertion of jurisdiction by either the SEC or Congress? We doubt such an outcome because the reported performance measures are in addition to, not instead of, GAAP required disclosures. The SEC already has asserted itself with respect to analysts with Regulation FD. In fact, the popular financial press has documented a decline in the credibility, on average, of securities analysts during the past several years. There is a general perception that many analysts respond to incentives tied to their employer's investment banking business, thus compromising their objectivity. Academic research supports the existence of such bias (e.g., Dugar and Nathan, 1995; Lin and McNichols, 1997). Managements likewise have come under

significant criticism for earnings management, including the management of the analysts' expectations as reflected in earnings forecasts (e.g., Levitt, 1998). We do not believe that perceived problems with security analyst bias lie within the purview of the FASB. We likewise do not believe that perceived problems with earnings management or quality of earnings should be addressed with alternative measures of financial performance; they are more effectively addressed with projects such as that proposed for revenue recognition.

Related to the question of practical consequences is the issue of jurisdiction. Pro forma reporting and reporting of alternative summary performance measures originated in earnings announcements and other investor communications and are now also included in some published financial statements. We do not believe there is any basis for the FASB to try to regulate the content of such management communications, conditional on the published financial statements being consistent with GAAP and disclosure requirements. Furthermore, academic research supports the importance of discretionary management communication (e.g., Verrecchia, 1983; Dye, 1985). We believe that such communication should be encouraged and not curtailed, subject of course to SEC rules and regulations. Unless communications by management are restricted, management would likely find ways to circumvent any efforts by the FASB (and other agencies such as the SEC) to define constructs such as pro forma or cash earnings. That is, management could define another term to meet its reporting objectives such as "adjusted" pro forma earnings.

The FASB's proposal includes three categories of financial performance measures which we discuss in turn below.

a) Pro forma reporting. Although there are several working papers examining the effects of pro forma reporting there are not any published research papers to date on the topic. The working paper results are too preliminary to cite specifically and there is no consistent pattern to the results. Therefore, our recommendations cannot be based on research results but only upon our concern about a conceptual basis for FASB activities, as discussed above.

b) Non-GAAP Financial Performance Measures. The identification and definition for measurement purposes of key financial measures are difficult issues and the Committee questions whether there is a conceptual basis to guide the FASB for either. The definition of "key" financial measures apparently differs by industry, across members of a given industry, and through time, raising questions of who would determine what constitutes an industry and who would identify the key success factors that must be reported by members of each industry. For example, the Steering Committee of the Business Reporting Research Project (2001) identifies key performance measures for firms in eight industries based on publicly available information. Although transcripts of presentations to analysts were included in the materials, analysts' opinions per se on key financial performance measures were not elicited. These measures vary significantly across industries. Furthermore, some of the industries in the report use Stern-Stewart's EVA™ measure as a key performance metric. Would EVA™ then be a candidate for inclusion in the set of key financial performance measures defined by the FASB?

A quick review of past work illustrates how the relevant performance measures have changed through time. Lev and Thiagarajan (1993) search the financial press, analysts' reports, and investment newsletters during 1984-1990 to identify a set of financial statement (not necessarily GAAP) fundamentals used to evaluate firms' performance and to estimate future earnings. They identify twelve measures, none of which are among the currently touted financial measures (e.g., EBITDA, pro forma earnings). Likewise, the AIMR (1993) position paper does not include the current "hot" items in making its recommendations for future changes in financial reporting disclosures.

Some of the proposed financial performance measures are expressed as financial ratios (e.g., EBITDA per share). White, Sondhi, and Fried (1998), a textbook widely-used by students preparing for the CFA exam, point out the lack of consensus among securities analysts on the appropriate definition, relative importance and interpretation of even common financial ratios. It is well-known (and easily verified) that there is little consistency in the computation of ratios that are reported by firms or that are included in reports by securities' analysts, including common ratios such as ROA, ROE and debt to equity. The Committee is not aware of a conceptual basis for the FASB to mandate the definition and computation of such ratios. The emphasis on EBITDA is particularly curious given the hybrid nature of this measure; that is, EBITDA does not measure cash flow or cash flow from operations as is widely claimed. It removes some but not all noncash expenditures. It excludes taxes, generally an unavoidable cash outflow. The removal of interest may be to abstract from capital structure but interest is certainly a cash expense. However, the Committee does believe that addressing the measurement and disclosure issues related to the GAAP inputs to these ratios is a conceptual issue that is appropriately addressed by the FASB. For example, in computing the debt to equity ratio, it is necessary to define debt and equity, a project currently on the agenda of the FASB.

There is significant academic research on non-GAAP financial measures, much of it comparing the association of earnings and potentially competing summary performance measures with share prices or share returns. On average, across many different studies, bottom line GAAP earnings outperforms the competitors. The following is a representative, not an exhaustive, list of pertinent research. Biddle, et al. (1995) compares the incremental and relative information content of earnings, operating cash flows and net sales for forty industry groups. The authors find that net income dominates the other two measures in terms of relative information content although all three metrics provide incremental information content to the others. Biddle, et al. (1997) performs similar tests comparing earnings, residual income, cash from operations, and EVA™, concluding that earnings dominates EVA as well as the other two measures. Vincent (1999) likewise compares funds from operations (FFO) for real estate investment trusts (REITs) to EPS, CFO and EBITDA. Earnings has greater association with returns but both earnings and FFO have incremental value relevance. Amir and Lev (1996) examine the association of wireless communications firms' stock returns with two industry measures, the service area population (POPS) and the penetration of the firm in the service area (PEN). They find that earnings alone is not significantly associated with returns but that in combination with POPS and PEN, earnings adds significant explanatory power.

Academic research has established the importance of credible reporting (e.g., Gigler, 1994). An important aspect of published financial statements is that they confirm or verify the results that are reported in press releases and other forms of investor communications. Audited financial statements continue to be perceived as more credible than non-audited financial statements. If pro forma computations are regulated by the FASB, would these financial measure be subject to audit?

Although segment reporting is specifically excluded from this proposed project, the recent experience with changes to the segment reporting requirements may inform this issue on financial performance measures. That is, firms may now report non-GAAP numbers for segment performance if these numbers are used for internal performance reporting. These disclosures (effective for 1998) should potentially provide some evidence on the effectiveness or usefulness of non-GAAP performance measures. Unfortunately, academic accounting research in this area is minimal and does not address the issue at hand.

c) Core vs. Non-core activities. The distinctions between core versus non-core, recurring versus non-recurring, and operating versus non-operating (see Johnson and Lennard, 1998, for a more complete list of dichotomous performance measures) are also difficult and subjective. There is a significant amount of academic research examining the permanent and transitory portions of earnings. To summarize results

briefly, investors put more valuation weight on the permanent portion relative to the transitory portion of earnings. Both analytical and empirical-archival academic research support the view that predictive ability is associated with earnings persistence. However, the difficulty lies in identifying what is permanent and what is transitory. Most research categorizes results by inference. That is, earnings are decomposed and smaller earnings response coefficients (the coefficient from a multiple regression of stock returns on earnings components) identify the transitory earnings components. In other words, the distinction between permanent and transitory is not activity-based (e.g., the nature, frequency or expected regularity of the activity) but outcome-based. As a result, academic research provides little guidance for identifying *ex ante* what is permanent and what is transitory. The Committee does not believe that this issue meets the FASB's stated criterion of technical feasibility for consideration of new projects. That is, we do not believe that it is possible to identify persistent versus transitory components of earnings or core versus non-core components. We provide more detail on this issue in our comment of approximately one year ago on the G4+1 Special Report, *Reporting Financial Performance: A Proposed Approach*. One of the main points of that comment was that there was not a clear articulation of the conceptual goals for reporting core versus non-core activities.

II. Format of the Income Statement (Comprehensive Income and Other Components) and of the Statement of Cash Flows

The Committee believes that the FASB should reconsider the presentation and level of decomposition of earnings, including other comprehensive income, and the components of cash flows that are complementary to earnings components. The scope of such an investigation would be consistent with the minimal approach outlined in the FASB's proposal. We discuss three aspects of such a project below.

a) Comprehensive Income. As discussed in our commentary on the G4+1 Special Report on Reporting Financial Performance, two academic accounting studies using behavioral-experimental techniques find evidence that financial statement users are affected by the presentation format for other comprehensive income (OCI), either because of information processing costs or due to irrationality. Hirst and Hopkins (1998) find that a single income statement approach facilitates securities analysts' ability to identify earnings management and reduces the bias in their valuation estimates. Maines and McDaniel (2000) find that nonprofessional investors interpret the OCI disclosures differently depending on whether a single income statement is used rather than reporting the other comprehensive income in the statement of shareholders' equity. Based on these results, the Committee believes that additional study of the presentation of other comprehensive income is warranted.

b) Format and presentation of the income statement. There is significant academic accounting research examining the value relevance of earnings components. Some of this research examines components of earnings that are most frequently removed from net income to arrive at some measure of pro forma or operating earnings. For example, Jennings, et al. (1998) reports that restructuring charges increase the relation between a firm's book value and market value, providing indirect support for separately reporting restructuring charges. Lipe (1986) disaggregates income from continuing operations into gross profit, general and administrative expenses, depreciation, interest expense, income taxes, and other items. He finds that each component has a different earnings multiplier (measuring its relation to returns as well as its persistence) and that each is associated with security prices, although depreciation expense has a low level of association. In general, these studies report that components of earnings are value relevant and that decomposing earnings increases the association between returns and earnings, thus supporting the argument for reporting decomposed earnings, at least from a valuation perspective. From that perspective there is no disadvantage to increased disclosures and finer decomposition of net income. However, such studies do not assess or estimate the costs, if any, of the additional disclosures. These costs may take the form of bookkeeping costs, competitive disclosure costs, or an increase in the

opportunity for earnings management. Nor do these studies address issues of opportunistic behavior by managers in reporting components of net income. Schrand and Walther (2000) report that managers are more likely to highlight prior period gains from that the sale of PP&E than they are losses and conjecture that the reason is to lower the benchmark against which current earnings are evaluated. Furthermore, they find some evidence that investors' reaction to the earnings announcement is consistent with the benchmark provided by managers to assess current performance, resulting in mispricing of shares at the time of the announcement. However, the mispricing is only temporary and reverses with the release of the financial statements.

The G4+1 Special Report, *Reporting Financial Performance*, recommended that a single statement of financial performance be prepared and that the statement be divided into three sections, separately reporting results for operating (trading) activities, financing and other treasury activities, and other gains and losses. The Committee expressed reservations about such a format because of the lack of explicitly articulated linkages among the conceptual goals, the proposed structure of the performance reporting statement, and the characteristics of earnings components that would determine classification within this structure. We believe that such linkages should be a key part of a study on the format and presentation of the income statement.

c) Format and presentation of the statement of cash flows. The issue of presenting components of cash flows that complement income-statement components relates, in part, to the use of the direct versus indirect methods of presenting the operating section of the statement of cash flows. Although the academic literature on this issue is relatively small, it is based on multiple methods (e.g., survey, experimental, empirical-archival data) and consistently supports use of the direct method. Survey evidence indicates that loan officers and financial analysts in Australia prefer the direct method, primarily because it facilitates better understanding and analysis of cash flow data (Jones and Widjaja, 1998). This preference coincides with opinions of U.S. analysts expressed in the AMIR (1993) position paper. Experimental research shows that use of the direct method leads to greater consensus among loan officers' credit-granting decisions than the indirect method (Klammer and Reed, 1990). Finally, based on a sample of companies that choose the direct method, Krishnan and Largay (2000) provide evidence that the direct method outperforms the indirect method in predicting future cash flows. The authors attribute this to differences in the relations between current and future values of cash flows for different cash flow components (e.g., cash collected from customers, cash paid to suppliers). We note that the results of Krishnan and Largay (2000) should be interpreted with caution because the economic characteristics of companies that voluntarily choose the direct method may differ from companies that currently choose the indirect method. The Committee believes that the overall results of the literature on the direct versus indirect methods warrant consideration of the classification between the income statement and the statement of cash flows.

In conclusion, although the Committee believes there are sound reasons for the FASB to consider the proposed project on financial performance measures with the scope as defined by the minimal approach in the proposal, we believe that there are higher priority projects before the FASB that should take precedence, including fair value, debt and equity, and revenue recognition.

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