June 23, 2009

Via Email

To:

Kim Petrone FASB Senior Project Manager krpetrone@fasb.org

Denise Gomez IASB Project Manager dgomez@iasb.org

Re: Preliminary Views on Financial Statement Presentation

Comments to FASB and IASB on Preliminary Views on Financial Statement Presentation

The American Accounting Association's Financial Accounting Standards Committee is pleased to express its views in the accompanying document on the SEC's recent call for comments on The Roadmap for adoption of IFRS by U.S. Issuers.

Please contact me (<u>bob.colson@gt.com</u> or 212-624-5300) as Committee chairman, or Stephen Moehrle, (<u>Moehrle@umsl.edu</u> or 314-516-6142) or Thomas Stober (<u>stober.1@nd.edu</u> or 574-631-714) who are the principal drafters of the comments, for clarifications or discussion.

Sincerely,

Robert H. Colson

Robert H. Colon

Chair, AAA Financial Accounting Standards Committee 2008 - 2009

This comment was developed by American Accounting Association's Financial Accounting Standards Committee and does not represent an official position of the American Accounting Association.

#### INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comments from standard-setters on issues related to financial reporting. The committee appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB's) and the International Accounting Standard Board's (IASB's) joint Discussion Paper entitled, "Preliminary Views on Financial Statement Presentation." The comments in this response reflect the views of the individuals on the Committee and are not necessarily those of the American Accounting Association.

The Boards are seeking comments on whether their proposed model for financial statement presentation would improve the usefulness of the financial statement information for financial decision makers. We begin by questioning the timing of the proposals on two grounds. First, an implicit conceptual framework is woven into the document. Prudence suggests completion of the conceptual framework itself first to ensure that the views in the financial statement presentation standard are entirely consistent with the ultimate conceptual framework. Second, there is significant momentum for the development and proliferation of XBRL and data tag-based reporting. Many of the principles in this document would complicate the production and use of reports under these emerging technologies. To this end, we encourage the Board to conduct deliberations about financial statement presentation with the dynamic nature of the current reporting environment foremost in mind.

In addition, the Boards' dramatic revision of financial statement presentation will require start-up costs for users to adapt to the new presentation format and for educators to develop and disseminate appropriate pedagogical approaches. Indeed, several of our comments in this letter

refer to user learning issues and impediments to this learning, which are equally valid in educational settings. Since the proposal concerns presentations of financial reports designed to be more useful to the readers, we suggest that the Board propose asking companies to provide electronic worksheets of interlinked financial statements on their websites on a trial basis, a process that would involve little additional cost.

Overall, the proposed model has several intuitively appealing qualities. There are potential problems with the model as well. In the remainder of this comment letter, we indicate several views and offer general questions and additional considerations about the model within the context of certain of the objective and principles-related questions posed by the Boards.

### Chapter 2: Objectives and Principles of Financial Statement Presentation

Would the objectives of financial statement presentation proposed in paragraphs 2.5–
 2.13 improve the usefulness of the information provided in an entity's financial statements and help users make better decisions in their capacity as capital providers?
 Why or why not? Should the Boards consider any other objectives of financial statement presentation in addition to or instead of the objectives proposed in this Discussion
 Paper? If so, please describe and explain.

### **Cohesiveness objective**

The abstract definition provided for the cohesiveness objective in paragraph 2.5 of the Preliminary Views raises many issues:

"A cohesive financial picture means that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible."

While the inconsistencies in financial statement presentation identified in paragraphs 1.11-1.13 of the preliminary views are well known, we are not aware of user complaints phrased in terms of cohesiveness. We recommend that the Boards not appropriate new terms or coin new phrases when simpler, more familiar ones would work. During earlier deliberations by the Boards and project staff, the cohesiveness concept has been identified as "linkage" or "articulation" between financial statements.

As an operational definition, paragraph 2.15 of the Preliminary Views refers to aligning line items, their descriptions, and their order across financial statements and paragraph 2.16 cites the Boards' preference for cohesiveness at the line item level but backs away from this preference significantly by qualifying this statement with the observation that "an entity should comply with the spirit of that goal." Such a qualification may be necessary and appropriate on cost-benefit grounds if cohesiveness at the line item level is costly and difficult to achieve by reconciling successive statements of financial position via traditional flow statements such as the income statement and statement of cash flows or by summarized transaction data as proposed in the July 2007 CFA Institute white paper A Comprehensive Business Reporting Model: Financial Reporting for Investors. Nonetheless, in response to rather straightforward requests for alignment and linkage of financial statements at the line item level, creating an abstract notion of cohesiveness and elevating it to the level of financial statement objective risks ignoring legitimate concerns of financial statement users. Simply put, while reconciliations of successive balance sheets at the line item level may be a costly disclosure, if sufficient numbers of users find reconciliations of at least certain line items useful enough that they would attempt to create such reconciliations on their own, it may be less costly overall for firms to provide the

<sup>&</sup>lt;sup>1</sup> Available at http://www.cfapubs.org/doi/abs/10.2469/ccb.v2007.n6.4818

disclosures. Such a demand also might be satisfied by footnote or other disclosures that are less comprehensive than the reconciliation schedules in the proposed reporting model.

#### Disaggregation objective

Similarly, the disaggregation objective is too abstract to be a useful principle. The Boards' original version of the disaggregation "working principle" (in, for example, the July 17, 2006 FASB board meeting handout):

"Disaggregate items into groups that respond similarly to changes in the same economic condition and present subtotals and totals where appropriate."

is a more succinct and concrete statement of the disaggregation objective than that found in paragraph 2.7 of the Preliminary Views:

"An entity should disaggregate information in the financial statements in a manner that makes it useful in assessing the amount, timing, and uncertainty of the future cash flows."

While the current statement of the objective picks up the language of the conceptual framework, we recommend that the Boards and staff present their views in terms of principles (even "working" principles) rather than vaguely defined objectives.

# Other objectives

Because the excessive use of financial leverage has been cited as a key factor leading to failures of financial firms in 2008 that has stressed financial markets, we propose that the Boards also consider an additional objective:

(d.) Helps users assess the extent to which an entity employs financial leverage.

We would like to see this objective be presented as a separate objective of financial statement presentation on the same level as objective (c.) "Helps users assess an entity's liquidity and

financial flexibility." Alternatively, objective (c.) might be revised to incorporate an assessment of financial leverage alongside assessments of liquidity and financial flexibility. Assessing financial leverage may be implicit in objective (c.). Given its paramount importance, we would at least like to see it made more explicit.

One reason for segregating financing activities from other activities is to focus attention on the non-financial (business or operating) activities by which an enterprise creates value. A parallel objective is to indicate how financial leverage is employed to enhance shareholder returns. A key attribute of the proposed reporting model is that it helps clarify the extent to which net financial liabilities lever a firm's operating [or business] activities.

- 2. Would the separation of business activities from financing activities provide information that is more decision useful than that provided in the financial statement formats used today (see paragraph 2.19)? Why or why not?
- 9. Are the business section and the operating and investing categories within that section defined appropriately (see paragraphs 2.31–2.33 and 2.63–2.67)? Why or why not?

[Note: The issues raised in questions 2 and 9 are inextricably linked; thus, we respond to these two questions together, below.]

The separation of operating activities from financing activities provides information that is decision useful, but we would redefine operating activities to represent what the Preliminary Views labels business activities. Contemporary finance theory relies on a dichotomy between operating and financing activities, where on an ex-ante basis, operating activities encompass the firm's value creating activities while financing activities are viewed, at least at first approximation, as zero net present value activities. Accordingly, financial statement analysis

based on this view of contemporary finance theory would split a firm's operating activities from its financing activities, but treat these categories as not only mutually exclusive but exhaustive.

Attaching the label business activities to what finance theorists and practitioners identify as operating activities detracts from many of the benefits offered by embracing this basic dichotomy. Consequently, some of the proposed categorizations in the Preliminary Views and the concepts underlying them are rendered unduly complex and others lack a clear focus. Such difficulties are largely unnecessary as they could be avoided by reverting to the basic dichotomy of operating versus financing as used in the contemporary finance theory.

While the Boards intend that the business section proposed in the Preliminary Views encompass two subsections or categories labeled and defined in the document as operating and investing, in contemporary finance theory, operating activities is the label generally applied to all of the firm's activities other than financing activities. If the label investing activities is used, it is usually identified with investments in operating assets, particularly capital expenditures, which the Preliminary Views appropriately classifies within operating activities.

While coupling the two categories in the business section (operating activities and investing activities as defined in the Preliminary Views) with the financing section would appear to parallel the three sections in today's statement of cash flows, this apparent correspondence actually has the potential to mislead. As paragraph 2.65 of the Preliminary Views correctly points out, while the captions for the categories used in the statement of cash flows today (under IAS 7 and FSAB Statement No. 95) are the same as the categories in the proposed presentation model of the Preliminary Views, what is included in the respective categories is distinctly different. In particular, some cash flows that would be classified as investing in today's statement of cash flows would be classified as operating cash flows in the proposed model (for

example, acquisitions and divestitures of property, plant, and equipment--net capital expenditures) while others might be classified as financing cash flows (for example, purchases or sales of certain marketable securities).

When one thinks of a natural way to dichotomize a firm's activities, business is not the label one would start with. The category that most naturally comes to mind as the complement to business activities is non-business activities, not financing activities. Moreover, operating activities are distinguished from investing activities in the business section in the Preliminary Views, essentially using notions of core activities and non-core activities. If that distinction captures the essence of the contrast the Boards are trying to draw, it would be more straightforward to label the categories as core activities and non-core activities. Relabeling the business category as operating and labeling the categories within this section as core and non-core (instead of operating and investing) would be a simple yet powerful way of implementing the concepts the Boards have in mind without creating unnecessary confusion.

Attributes other than core and non-core may also characterize what the Boards and others have in mind for the contents of the investing activities category. Core operating activities would generally involve multiple line items beginning with sales revenue followed by expenses. Items cited as candidates for the investing activities category are often reported net, such as (equity method) income from subsidiaries, income from available for sale securities, income from real estate holdings, and so on. An income statement label that could properly be attached to the subtotal core operating income items would be "income from sales." This label might even be appropriate for an income subtotal within core operating income if management wishes to distinguish core sales profit margins from other items of core income that are reported net (for example, rent income).

While some might view labeling as pedantic or excessively focused on terminology, terminology almost always matters, especially in accounting. The caption "business" has been attached to what we would prefer to see labeled the operating section in most of the discussions that the Boards have had with the project staff and with various advisory groups (for example, FASAC, JIG, and FIAG). Hence, the Boards might be reluctant to change this label at this juncture because individuals who have been closely involved in the Financial Statement Presentation project (including those who are now commenting on the Preliminary Views) are familiar with the label and what it represents. The task of reorienting the thinking of those closest to the project is minor compared to the potential for confusion if the financial statement presentation model goes forward as proposed. Indeed, a massive education effort might be required to reorient the thinking of financial statement users surrounding the use of the term investing activities, especially users who are less sophisticated. A better approach would be to not reuse the term investing because operating, investing, and financing will be, at least for the current generation of financial statement preparers and users, inextricably linked to the captions for the sections in the current cash flow statement. In contrast, generations of business students, many with limited exposure to accounting, should appreciate the basic dichotomy between financing activities and operating activities, at least at a conceptual level.<sup>2</sup>

3. Should equity be presented as a section separate from the financing section or should it be included as a category in the financing section (see paragraphs 2.19(b), 2.36, and 2.52–2.55)? Why or why not?

\_

<sup>&</sup>lt;sup>2</sup> Regarding the investing terminology, whether in a section labeled investing activities or in one of the other sections, we view it as important to specify the object of all investments in the statement presentation (i.e., investments in marketable securities or investments in affiliated companies), as we believe that the term "investments" has come to mean little in contemporary reporting without appropriate modification.

It is appropriate to present common equity in a section separate from the financing section. The Preliminary Views did not specifically address the classification of preferred stock as financing or equity. Accordingly, we wondered if treatment of preferred stock as equity was implicit in the document or, alternatively, if classification as either financing or equity would be acceptable under a management approach to classification. Many analysis models treat preferred stock as interchangeable with debt as a source of financing. Also, if the Boards choose to revisit the definition of equity in other standards setting projects, such an equity section would be consistent with the notion of basic equity (lowest priority claims of the current shareholders).

4. In the proposed presentation model, an entity would present its discontinued operations in a separate section (see paragraphs 2.20, 2.37, and 2.71–2.73). Does this presentation provide decision-useful information? Instead of presenting this information in a separate section, should an entity present information about its discontinued operations in the relevant categories (operating, investing, financing assets, and financing liabilities)? Why or why not?

Congruent with the notion of operating activities and financing activities as both mutually exclusive and exhaustive, we would prefer to see discontinued operations presented in the relevant categories. Discontinued operations logically should be viewed as part of operating activities, more in the nature of special items that warrant separate disclosure. The emphasis on its presentation in a separate section in the Preliminary Views could reflect a desire to continue reporting certain familiar subtotals on the income statement (Income from Continuing Operations and Net Income). While backward compatibility with existing reporting models is desirable in order to continue providing familiar inputs to user decisions models and a reasonable objective to seek compromise on, reporting discontinued operations in a completely separate

section on par with operating [business] and financing sections as potentially moving financial reporting in the wrong direction and may set a dangerous precedent. In particular, reporting the financing liabilities of a held for disposal group outside the financing section of the balance sheet before the disposal takes place is questionable and affects key measures of financial leverage.

A logical way to organize an income statement capturing the familiar subtotal for income from continuing operations in the proposed reporting model is to present operating [business] income first (pretax), followed by income taxes on operating [business] income (that is, income taxes not otherwise allocated to discontinued operations, other comprehensive income, or equity). Adding income from discontinued operations (net of tax) yields profit or loss (in IFRSs) or net income (in U.S. GAAP). Adding other comprehensive income (net of tax) yields comprehensive income. But, the Preliminary Views (paragraph 2.22) specifically states that:

"An entity may present the sections and categories within a section in a different order as long as the order is the same in each statement."

In order for this statement not to be an empty promise, the reporting model should contemplate providing line items that are specifically intended to provide backwards compatibility as supplemental information, perhaps as footnote disclosures, similar to the disclosures of short-term assets, short-term liabilities, long-term assets, and long-term liabilities specified in paragraph 3.22 of the Preliminary Views.

5. The proposed presentation model relies on a management approach to classification of assets and liabilities and the related changes in those items in the sections and categories in order to reflect the way an item is used within the entity or its reportable segment (see paragraphs 2.27, 2.34, and 2.39–2.41).

a. Would a management approach provide the most useful view of an entity to users of its financial statements?

This question revolves around the issue of accounting choice, which the academic accounting literature has studied extensively, with mixed evidence: Accounting choice can be a net positive or a net negative depending upon facts and circumstances in the particular case. For example, if the incentives of the firm's management are aligned with those of the shareholders then accounting choices are more likely to convey incremental valuable information to financial statement users (Dye and Verecchia, 1995; Warfield et al. 1995). Conversely, if management's incentives are not aligned with those of the shareholders then it is more likely that accounting choices will be made for opportunistic reasons (e.g., earnings management) (Healy, 1985, Guidry 1999; Gaver and Gaver 1998; Chen and Lee 1995; Burgstahler and Dichev 1997; Defond and Park 1997; Kasznik 1999; among others). Such opportunism was the subject of concerns expressed by then SEC Chairman Arthur Levitt in an often quoted 1998 speech (Levitt 1998).

The management approach to classification has the potential to convey additional information about what management sees as the core value-creating activities within an enterprise versus a more prescriptive classification scheme. The choices therein also present the potential for opportunistic classification. For example, it would be difficult for management to make a case that capital (finance) lease liabilities recorded under current US GAAP (IFRS) are not interchangeable with other sources of financing, and thus should be classified in the financing section. Paragraphs 2.34 and 2.58 of the Preliminary Views suggest that lease financing would be indeed interchangeable with other sources of financing and would properly belong in the financing section. Yet in the Toolco illustration in Appendix A, lease liabilities are classified in the operating section. If this is an illustration of the latitude that a management

approach to classification would allow, perhaps a more prescriptive approach is preferable. (We recognize that the Toolco illustration may have a narrow intent to capture classification of an expanded set of capital or finance lease liabilities that would arise under a revised lease accounting standard.)

b. Would the potential for reduced comparability of financial statements resulting from a management approach to classification outweigh the benefits of that approach? Why or why not?

The management approach can convey valuable information at the cost of potential opportunistic classification. It is difficult to assess and quantify these costs in the current reporting environment. Further, the reporting technology is changing rapidly at this time given the momentum in user and preparer circles for emerging reporting technologies such as XBRL and "data tagging." We implore the Board to deliberate this issue within the context of the current environment as well as future expectations. Regarding the current environment, consideration of the impact of proposed changes on sophisticated users' computer models that access and process machine readable versions of company reports to make financial decisions is necessary. Also, the disposition of price changes under the asset and liability recognition approach has emerged as a high profile topic in contemporary reporting. The Boards' consideration of guidance regarding financial statement presentation of short-term price fluctuations is especially timely.

6. Paragraph 2.27 proposes that both assets and liabilities should be presented in the business section and in the financing section of the statement of financial position. Would this change in

presentation coupled with the separation of business and financing activities in the statements of comprehensive income and cash flows make it easier for users to calculate some key financial ratios for an entity's business activities or its financing activities? Why or why not?

This is an inherently difficult question to answer with any precision because the range of user decision models and key financial ratios is broad. In general, segregation of activities that are clearly financing does move in the direction reflected in common user decision models which focus attention on the aspect of the firm that generates value - core operations. Whether the reporting model matches a user decision model is highly dependent on the management approach to classification. Line item cohesiveness as the operational standard would facilitate adjusting for differences between the reporting model and user decision models. If cohesiveness is seen as requiring linkage between financial statements only within broad financial statement categories, the ability of users to adjust for such differences is greatly diminished.

Viewed as an "off the shelf" reporting model, the failure to allocate income taxes within sections and categories within sections will inhibit the ability of users to readily calculate ratios that require after tax income numbers in the numerator. For example, enterprise level ratios such as the rate of return on net operating assets (or, equivalently, the rate of return on invested capital) are often calculated on an after tax basis, using operating income after tax in the numerator. This requires income tax allocations between, at a minimum, the operating [business] and financing sections. (An equivalent way to view the calculation of the numerator of an enterprise level ratio such as the rate of return on net operating assets is to begin with net income or comprehensive income and add back the net financing expenses, after tax.) While users need to understand that any allocation of income taxes is arbitrary, the question is who is in a better position to make a reasoned allocation - financial statement preparers or financial

statement users. Allocating income taxes to sections becomes more desirable if preferred stock is viewed as interchangeable with debt and, accordingly, classified as financing, because under U.S. tax law interest on debt is tax deductible while dividends on preferred stock generally are not.

7. Paragraphs 2.27, 2.76, and 2.77 discuss classification of assets and liabilities by entities that have more than one reportable segment for segment reporting purposes. Should those entities classify assets and liabilities (and related changes) at the reportable segment level as proposed instead of at the entity level? Please explain.

We agree with classification at the reportable segment level. We are not at all certain that classification at the entity level (one policy for all of an entity's business) would automatically be "less complex" than classification at the reportable segment level (a separate policy for each reportable segment) as asserted in paragraph 2.76. It may be more difficult for management to establish one entity-wide approach to classification than a disciplined approach applied repetitively to individual segments.

10. Are the financing section and the financing assets and financing liabilities categories within that section defined appropriately (see paragraphs 2.34 and 2.56–2.62)? Should the financing section be restricted to financial assets and financial liabilities as defined in IFRSs and U.S. GAAP as proposed? Why or why not?

Restricting the financing section to financial assets and financial liabilities precludes the possibility of preferred stock being classified as financing, an outcome that runs counter to a new standard that would define equity as common equity or more narrowly (for example, as basic

equity). Of course, no conflict with the definitions would arise if preferred stock were to be redefined as a financial liability in a revised standard on liabilities and equity. To this end, please refer to our comments on question 3, above.

Categorizing capital (or finance) lease liabilities as financing or operating is bound to be problematic, especially under a management approach to capitalization. This classification issue is bound to become more acute under any expanded lease capitalization standard, which means that standards setters will eventually have to establish additional guidance (see our comments on question 5a above).

#### References

Burgstahler, D. and I. Dichev (1997). Earnings management to avoid earnings decreases and losses. *Journal of Accounting and Economics* 24, 99-126.

Chen, K. and C. Lee (1995). Executive bonus plans and accounting trade-offs: the case of the oil and gas industry, 1985-1986. *The Accounting Review* 70, 91-111.

Defond, M. and C. Park (1997). Smoothing income in anticipation of future earnings. *Journal of Accounting and Economics* 23: 115-139.

Dye, R. and R. Verecchia (1995). Discretion vs. uniformity: choices among GAAP. *The Accounting Review* 70: 389-415.

Gaver J. and K. Gaver (1998). The relation between nonrecurring accounting transactions and CEO cash compensation. *The Accounting Review* 73: 235-253.

Guidry, F., A. Leone, and S. Rock (1999). Earnings-based bonus plans and earnings management by business-unit managers. *Journal of Accounting and Economics* 26: 113-142.

Healy, P. (1985). The impact of bonus schemes on the selection of accounting principles. *Journal of Accounting and Economics* 7: 85-107.

Kasznik, R. (1999). On the association between voluntary disclosure and earnings management. *Journal of Accounting Research* 37: 57-81.

Levitt, A. (1998). The Numbers Game. Speech at New York University, September 28.

Warfield, T., J. Wild, and K. Wild (1995). Managerial ownership, accounting choices, and informativeness of earnings. *Journal of Accounting and Economics* 20: 61-91.

## **American Accounting Association**

# Financial Accounting Standards Committee 2008 – 2009

Robert Bloomfield, Cornell University (Endorse)

Theodore E. Christensen, Brigham Young University (Endorse)

Robert H. Colson (Chair), Grant Thornton LLP (Endorse)

Karim Jamal, University of Alberta (Endorse)

Stephen Moehrle, (Principal Drafter) University of Missouri at St. Louis (Endorse)

James Ohlson, New York University (Endorse)

Stephen Penman, Columbia University (Endorse)

Gary Previts, (Liaison to AAA Executive Committee), Case Western Reserve University (Endorse)

Thomas Stober (Principal Drafter, Liaison to Financial Accounting and Reporting Section), University of Notre Dame (Endorse)

Shyam Sunder, (AAA Executive Committee Liaison designee), Yale University (Endorse)

Ross L. Watts, Massachusetts Institute of Technology (Endorse)