FASB INVITATION TO COMMENT

Issued: August 4, 2016
Comments Due: October 17, 2016

Agenda Consultation

Comments should be addressed to:

Technical Director
File Reference No. 2016-290

Notice to Recipients of This Invitation to Comment

The Board invites feedback on all matters in this Invitation to Comment. We request comments by October 17, 2016, by one of the following methods:

- Emailing comments to director@fasb.org, File Reference No. 2016-290 or
- Sending a letter to "Technical Director, File Reference No. 2016-290, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

A copy of this Invitation to Comment is also available at www.fasb.org.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Invitation to Comment

Agenda Consultation

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Purpose of This Invitation to Comment

The purpose of this Invitation to Comment (ITC) is to solicit feedback about the financial reporting issues that the Financial Accounting Standards Board (FASB) should consider adding to its agenda. The FASB requests feedback about the following:

1. Are the financial reporting issues described in this ITC areas for which there is potential for significant improvement?
2. What is the priority of addressing each issue?
3. What approach should the FASB take to address each issue?
4. Are there other major areas of financial reporting not described in this ITC that the FASB should consider adding to its agenda?

The FASB would like broad stakeholder feedback before it makes decisions about which issues, if any, should be added to the agenda and in what order.

Background

The FASB recently completed many of the major projects on its agenda. The standards issued as a result of those projects are Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, and Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

Now that many of the major projects are complete, the FASB has begun to consider other major areas of financial reporting for which improvement might be warranted. To accomplish this, over the last year, the FASB has been seeking feedback from its advisory groups and other stakeholders about financial reporting issues that the FASB should address. This consultation process began in June 2015 with the periodic Financial Accounting Standards Advisory Council (FASAC) survey about the FASB's agenda priorities. This survey was extended to the FASB's other advisory groups, including the Emerging Issues Task Force, the Investor Advisory Committee, the Not-for-Profit Advisory Committee, the Private Company Council, and the Small Business Advisory Committee.

The FASB continued its consultation process by seeking feedback from members of the recently formed Academic Resource Group, which is composed of five accounting academics. The FASB also sought input from participants at its annual Financial Reporting Issues Conference (FRIC) in January 2016. The FRIC participants primarily included accounting academics, but they also included financial statement users, board members and staff from other accounting standard setters, and practitioners.

The following is a summary of the most common responses to the FASAC survey from each stakeholder type:

Areas of Financial Reporting in Need of Improvement by Stakeholder Type				
Topics	**Preparer**	**User**	**Practitioner**	**Academics and Other**
Income statement	X	X	X	X
Statement of cash flows	X	X	X	X
Pensions and other postretirement benefit plans	X	X	X	X
Distinguishing liabilities from equity	X		X	
Intangible assets		X		X
Other comprehensive income	X			
Consolidation			X	
Segment reporting		X		
Inventory and cost of sales				X

On the basis of the results of the FASAC survey and other input from stakeholders, the FASB identified the following major financial reporting topics to include in this ITC:

1. Intangible assets (including research and development)
2. Pensions and other postretirement benefit plans
3. Distinguishing liabilities from equity
4. Reporting performance and cash flows (including income statement, segment reporting, other comprehensive income, and statement of cash flows).

The FASB decided not to include consolidation and inventory and cost of sales in this ITC. With respect to consolidation, the FASB recently added a research project to its agenda to potentially reorganize and clarify the consolidation guidance in Topic 810, Consolidation. The FASB thinks that this clarification approach will address many of the concerns raised by stakeholders. With respect to inventory and cost of sales, the FASB recently added a research project to its agenda to understand specific stakeholder concerns and to understand whether there are viable solutions to address those concerns. Because of the early stage of this research, the FASB thinks that it is premature to include the topic in this ITC.

Although consolidation and inventory and cost of sales are not further addressed in this ITC, the FASB welcomes feedback from stakeholders on those areas.

The financial reporting topics included in this ITC are not new. They are well-known to the FASB and likely to many stakeholders that read this ITC. Each of those broad topics has been on the agendas of the FASB and other standard setters a number of times. The FASB's past standard-setting efforts have resulted in improvements to financial reporting; however, the topics continue to be identified as areas for which the guidance could be improved. In some cases, issues remain unresolved because the FASB decided to focus its resources on issues that U.S. stakeholders thought were more critical at that time or on convergence efforts with the International Accounting Standards Board (IASB). In addition, stakeholders sometimes had polarizing views about the changes, if any, that the FASB should make in those areas, which hampered progress.

Although this ITC is about major areas of financial reporting that the FASB should consider adding to its agenda, the FASB will continue to allocate its limited resources to address a wide range of stakeholder concerns. This includes allocating resources to:

1. Complete critical projects currently on the agenda (for example, the Conceptual Framework, disclosure framework, hedge accounting, and insurance)
2. Complete narrow projects currently on the agenda that are designed to reduce diversity in practice, reduce cost and complexity in financial reporting, and address other practice issues
3. Address new stakeholder concerns as they arise
4. Monitor implementation of the recently completed major projects, address related practice issues timely, and educate stakeholders about the new guidance.

Overview of the Invitation to Comment

This ITC includes four chapters, one for each of the four major financial reporting topics resulting from the FASAC survey. Each chapter includes a summary of the financial reporting issues and some of the approaches that the FASB could consider in responding to the issues. However, the FASB does not have preconceived notions about how to resolve the issues. The approaches are included in this ITC to help stakeholders understand the potential magnitude of financial reporting changes that might result if the topics are added to the agenda. Respondents should consider both the potential costs to implement the changes and the potential benefits of the changes in assessing the projects identified. The FASB is interested in feedback about whether there are other approaches that it should consider.

Looking at the Whole Picture

The major financial reporting topics discussed in this ITC will require deliberations on some vexatious issues, which will take time to address in a thoughtful manner. Even if the financial reporting topics discussed in this ITC are added to the agenda immediately, it would take several years before they become effective. Consequently, the FASB will need to be thoughtful in identifying which financial reporting topics to add to its agenda. The FASB will consider its current agenda (see Appendix A) and the feedback collected through its agenda consultation to determine which projects it should address in its future agenda.

It is important to consider the relationships between the issues when providing feedback about which issues should be addressed, the potential approach to addressing those issues, and the order in which those issues should be addressed. Considering how one project could affect another is informative to (1) evaluating the approaches to address each issue and (2) determining the most effective and efficient way for the FASB and stakeholders to work together to make improvements to financial reporting.

For example, the following two broad questions are relevant to all of the issues described in this ITC:

1. Should certain assets and liabilities be measured at fair value?
2. How should those changes in fair value each period be presented in the performance statement?

Some stakeholders may prefer more instruments to be classified as liabilities at fair value rather than equity (see Chapter 3). Those stakeholders may not be troubled by measuring certain liabilities at fair value that are highly correlated with the reporting entity's credit standing or share price resulting from the entity's performance.

If the FASB were to pursue this approach to measuring those instruments at fair value, questions could arise about whether more of the entity's assets should be recognized and measured at fair value (for instance, intangible assets as discussed in Chapter 1). For example, assume that the fair value of an entity increases significantly over a period of years because of technology it invented as a result of an extended period of research and development. This increase in fair value of the entity might result in an increase in the fair value of certain instruments classified as liabilities and measured at fair value. Despite the increase in fair value of the entity as a result of technology assets, those assets are neither recognized nor measured at fair value. Consequently, some stakeholders might question whether it is appropriate to measure the liabilities at fair value if the assets responsible for the increase in value are not recognized and measured at fair value.

If those assets or liabilities are measured at fair value, there inevitably would be questions about whether and how those changes in fair value should be presented in the income statement (see Chapter 4). Some stakeholders might be concerned that the current income statement is not adequately designed to reflect changes in fair value of those assets and liabilities in a manner that is helpful to financial statement users.

Similar recognition, measurement, and presentation questions exist for pensions and other postretirement benefit plans (see Chapter 2).

The FASB strongly encourages stakeholders to think holistically about these financial reporting issues when providing feedback.

Questions for Respondents

Individuals and organizations are invited to comment on all matters in this ITC, particularly on the issues and questions that are specifically asked in this document. General questions about the FASB's agenda are included below, and questions that are relevant to a specific topic are included in each chapter. While it would be helpful to receive feedback on all of the questions in this ITC, comments also are requested from those who are only interested in a specific chapter or in specific chapters of this ITC. Comments are most helpful if they identify and clearly explain the issue or question to which they relate.

Question 0.1: Are there major financial reporting issues that are not considered in this ITC that should be addressed by the FASB before any of the issues discussed in the ITC are addressed? What are the considerations or criteria that you used to identify these issues? Please describe any of those issues and your perspective about how the FASB should resolve the issues.

Question 0.2: What is your view about the priority of addressing the major financial reporting issues addressed in this ITC? In other words, is addressing one or more of the issues more critical than others? Please describe your assessment criteria and why you prioritized certain issues above others.

Question 0.3: Is it necessary to resolve one or more of the issues before resolving others? In other words, is the resolution of any of the issues dependent upon the resolution of one or more other issues? Please identify any of the projects that should be completed before others and why.

Public Roundtable Meetings

The FASB plans to have public roundtable meetings on this ITC during the fourth quarter of 2016. The purpose of the meetings is to facilitate a dialogue among stakeholders and the FASB about the major financial reporting issues that the FASB should consider adding to its agenda. The FASB plans to seek participants for the meetings that represent a wide spectrum of stakeholders, including financial statement users, preparers, auditors, academics, and others to ensure that the dialogue includes a broad perspective.

Any individual or organization that would like to participate in a meeting should notify the FASB by sending an email to director@fasb.org and submitting its written comments on the ITC by October 17, 2016. Roundtable meetings can accommodate a limited number of participants. Depending on the number of responses received, the FASB may not be able to accommodate all requests to participate.

Chapter 1—Intangible Assets (including Research and Development)

Background and Relevant History

1.1 Accounting for intangible assets (including research and development) has been a contentious issue throughout standard-setting history. The FASB has examined and made improvements to the accounting for intangible assets several times. Each time, the FASB has learned that stakeholders have diverse views about which intangible assets should be recognized on the balance sheet. Equally important, stakeholders also have diverse views about how recognized intangible assets should be measured (for example, at amortized cost, fair value, or some other basis).

1.2 The FASB, other standard setters (including the IASB and the Australian Accounting Standards Board [AASB]), and academics have performed significant research on the topic over the years to evaluate whether and what specific improvements should be made to accounting for intangible assets and whether the benefits that would result from improved financial reporting for intangible assets justify the costs of providing such information.

Current Generally Accepted Accounting Principles (GAAP)

Internally Generated Intangible Assets

1.3 Under Topic 350, Intangibles—Goodwill and Other, the costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and are related to an entity as a whole are recognized as an expense if incurred. Other than that guidance, current GAAP does not have overarching recognition and measurement guidance for internally developed intangible assets. Instead, current GAAP has different guidance for recognizing and measuring some internally developed intangible assets, including software, certain oil and gas industry assets, film costs, record costs, title plant costs, and some other costs associated with obtaining a contract with a customer. For example, an entity is required to capitalize the costs incurred in creating computer software after technological feasibility has been achieved under Topic 985, Software.

Research and Development

1.4 Under Topic 730, Research and Development, research and development costs are expensed as incurred. An entity is required to disclose the total amount of research and development costs incurred in each period for which an income statement is presented.

1.5 When that guidance on research and development originally was issued in 1974, the FASB decided that research and development costs should be expensed as incurred for the following reasons:

a. Future economic resource. At the time most research and development costs are incurred, the future benefits are at best uncertain, and there is no indication that an economic resource is created.
b. Measurability. Even if future benefits from a particular research and development project may be foreseen, they generally cannot be measured with a reasonable degree of certainty.
c. Correlation. There is normally little, if any, direct relationship between the amount of current research and development expenditures and the amount of resultant future benefits to the entity.
d. Matching. Because there is a lack of discernible future benefits at the time that the costs are incurred, the immediate recognition principle for expenses should apply.

Other Internally Generated Intangibles Not Recognized

1.6 Although stakeholders often consider research and development when considering unrecognized internally generated intangibles, there are several other intangibles that are not recognized. Depending on the entity, those other unrecognized internally generated intangibles might be individually or in the aggregate more valuable to an entity than research and development. Examples of other intangible items that are commonly asserted as assets include:

a. Brands and logos
b. Supply agreements with terms that are more favorable than current market terms
c. Specially-trained employees
d. Noncompetition agreements
e. Collaboration agreements
f. Goodwill
g. Data.

1.7 Over time, Board members have had various views about whether those other intangibles meet the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements* (Concepts Statement 6), which states in paragraph 25, “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted).

1.8 In addition, some Board members have questioned whether recognizing other intangibles, such as those listed in paragraph 1.6, would (a) provide useful information to investors or (b) have associated financial reporting benefits that justify the costs. However, as discussed below, some of the items identified in paragraph 1.6 are recognized as assets if externally acquired.

Acquired Intangible Assets

1.9 The accounting for acquired intangible assets differs on the basis of both the manner in which the asset is acquired (an asset purchase or a business combination) and the type of reporting entity (public company, private company, and not-for-profit entity).

1.10 In 2001, the FASB issued Statement No. 142, *Goodwill and Other Intangible Assets*, which requires identifiable intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) to be recognized and measured at cost.

1.11 In 2007, the FASB issued Statement No. 141 (revised 2007), *Business Combinations*, which requires intangible assets, including research and development, acquired in a business combination to be recognized and initially measured at fair value.

1.12 In 2014, the FASB issued Accounting Standards Update No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* (Update 2014-18), which is based on a consensus reached by the Private Company Council. The guidance in that Update provides private companies with an accounting alternative to not recognize separately from goodwill (a) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (b) noncompetition agreements.

1.13 In response to Update 2014-18, the FASB added a separate project to its agenda for public business entities and not-for-profit entities on the accounting for identifiable intangible assets in a business combination to evaluate whether certain intangible assets should be subsumed into goodwill, with a focus on customer relationships and noncompetition agreements.

1.14 In contrast to public business entities, not-for-profit entities could be subject to merger (carryover basis) or acquisition accounting for acquired intangible assets. If acquisition accounting is used, there are certain types of organizations that write off goodwill immediately.

International Financial Reporting Standards (IFRS)

1.15 IAS 38, *Intangible Assets*, issued in 2004, specifies recognition criteria for capitalizing initial costs incurred to acquire or internally generate an intangible asset and subsequent costs incurred to add to, replace part of, or service the asset. An entity is required to recognize an asset if the intangible asset is identifiable and if the following criteria are met:

a. It is probable that the expected future benefits that are attributable to the asset will flow to the entity.
b. The cost of the asset can be measured reliably.

1.16 Under IAS 38, internally generated intangible assets that meet the criteria described in paragraph 1.15 are recognized on the balance sheet at cost, and intangible assets acquired in an asset acquisition are recognized at the purchase price plus any directly attributable cost of preparing the asset for its intended use. Under IFRS 3, *Business Combinations*, intangible assets acquired in a business combination are recognized at fair value as of the acquisition date.

1.17 One of the most significant differences between IAS 38 and current GAAP is the accounting for research and development costs. IAS 38 makes a distinction between accounting for research costs and accounting for development costs. Expenditures incurred during the “research phase” should be expensed as incurred, while expenditures incurred during the “development phase” should be recognized as an intangible asset if an entity can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset such that it will be available for sale
b. Its intention to complete the intangible asset and use or sell it
c. Its ability to use or sell the intangible asset
d. How the intangible asset will generate probable future economic benefits (for example, the existence of a market or the usefulness of the intangible asset)
e. The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset
f. Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

1.18 Stakeholders have indicated that there is a high amount of subjectivity involved in capitalizing development phase costs under IAS 38.

Stakeholders also have indicated that although the requirements for internal development costs in current GAAP and in IFRS are different, the financial reporting outcomes are not always significantly different because the threshold for recognizing development under IFRS is both high and subjective.

Perceived Issues

2015 FASAC Survey

1.19 Members from three of the six advisory groups that participated in the 2015 FASAC Survey identified intangible assets, including the capitalization of certain development costs, as a financial reporting issue that should be a top priority of the FASB. Survey respondents stated the following concerns:

a. Accounting for intangible assets does not have an overarching framework, which creates a lack of comparability for similar intangible assets.
b. There is inconsistent accounting between internally generated and purchased intangibles (for example, many intangibles, including in-process research and development, commonly are recognized as an intangible asset in a business combination, but the costs of the same efforts generally are recognized as an expense if incurred outside a business combination).
c. Accounting for intangible assets could be simplified and potentially converged with IFRS, including accounting for development costs.
d. Financial statements are incomplete because they are missing information about intangible assets. Some stakeholders say that one of the reasons for a significant difference between the book value and fair value of some entities' equity is that some intangible assets are not recognized for financial reporting purposes while investors consider intangible assets in their valuations.

FASB's Previous Standard Setting

1.20 The FASB completed a research project in 2001 about a potential disparity between information provided in financial statements and the information needs of investors and creditors about intangible assets and published the Special Report, *Business and Financial Reporting, Challenges from the New Economy* (the Special Report). The Special Report indicates that because of a "new economy," financial statement users need more information about intangible assets.

1.21 The Special Report identifies the following two hurdles that historically have impeded attempts for creating accounting standards in the United States that would lead to capitalizing costs associated with the generation of intangible assets:

a. The time gap. The period of time cannot be determined between when research and development costs are being incurred and when those expenditures and efforts can be demonstrated to have probable future benefits.
b. The correlation gap. The cost of research and development is not a reliable measure of the future economic benefit that research and development may generate.

1.22 The Special Report identifies the following possible standard-setting projects that might provide users with additional information about intangible assets:

a. A project to require disclosures about internally developed intangible assets
b. A project to require recognition of intangible assets created as the result of research and development projects and potentially discrete efforts to expand the capitalization of other intangible assets.

1.23 In response to the Special Report, the FASB issued in August 2001 a Proposal for a New Agenda Project, *Disclosure of Information about Intangible Assets Not Recognized in Financial Statements*, which requested stakeholders to provide comments on the objective and scope of a project to establish standards for improving disclosure of information about intangible assets that are not recognized in financial statements.

1.24 The primary goal of the project was to provide financial statement users with more information about research and development costs. Financial statement users generally were in favor of the project. However, preparers expressed reservations about disclosing additional information about research and development expenditures because of concerns about disclosing proprietary information.

1.25 In January 2002, the FASB added to its technical agenda a project on disclosure of information about intangible assets not recognized in financial statements in response to the favorable feedback received from financial statement users.

1.26 In January 2004, the FASB removed the project from its agenda. The FASB acknowledged the importance of this project but decided that the nature and timing of such a project should be considered in the context of its plans for a coordinated agenda with the IASB. Intangible assets was one of the projects included in the 2006 Memorandum of Understanding (MoU) between the IASB and the FASB when the Boards agreed to work together to minimize the differences between current GAAP and IFRS; however, it was not added to either the FASB's technical agenda or the IASB's technical agenda.

Other Research

1.27 Over the past decade, various academic research papers and studies have been published with mixed views about the benefits of recognizing intangible assets. Some of this research was performed broadly on intangible assets, while other research was specifically focused on research and development. Some of the studies assert that recognition of intangible assets would provide better information to users, while others assert that more information about intangible assets would not be useful because it would be too subjective.

1.28 On the basis of an investor survey completed by the FASB in 2006 about internally generated research and development, many investors did not support recognition but rather requested additional disclosures. In addition, the majority of investors commented that if internally generated research and development were to be recognized, it should be measured at fair value. This is because they assert that historical cost is not relevant for this type of asset.

1.29 The AASB issued a Discussion Paper in 2008, *Initial Accounting for Internally Generated Intangible Assets*, which includes alternatives for identification, recognition, measurement, presentation, and disclosure for internally generated intangible assets. In the Discussion Paper, the AASB observes that how an intangible item is derived is irrelevant to whether it is an asset and, therefore, all intangible assets should be evaluated in the same way, regardless of their manner of acquisition.

Potential Standard-Setting Alternatives

1.30 Stakeholders reported four broad approaches to improve the accounting for intangible assets (including research and development). The FASB and other standard setters have considered those alternatives to varying degrees over the years. The four potential approaches to provide financial statement users with more information about intangible assets are:

a. Recognize at cost or fair value internally generated intangible assets (Alternative A)

b. Recognize at cost or fair value research and/or development costs (Alternative B)
c. Disclose internally generated intangible items (Alternative C)
d. Adopt IAS 38 (Alternative D).

Alternative A—Recognize Internally Generated Intangible Assets

1.31 This alternative has some overlap with current FASB projects. Reconsideration is planned for accounting for (a) intangible assets acquired in a business combination for public business entities and not-for-profit entities, (b) in-process research and development costs acquired in an asset acquisition as part of Phase 3 of the Clarifying the Definition of a Business project, and (c) goodwill for public business entities and not-for-profit entities. Additionally, the FASB is in the initial deliberations phase of a project to improve the Conceptual Framework by adding a chapter on measurement. The objective of that project is to provide a better foundation upon which it can make standard-level decisions about how to measure assets, liabilities, and equity.

1.32 The FASB would need to determine which internally generated intangible items should be included within the scope of the project. The FASB also would need to determine whether and, if so, when those intangible assets should be recognized (for example, after a specified threshold is met) and how the assets would be initially and subsequently measured (for example, measured at fair value at each reporting period). A few options that could be considered are:

a. Develop guidance as a broad principle on the basis of the definition of an asset in Concepts Statement 6
b. Keep the scope consistent with assets that would have been recognized in a business combination
c. Adopt the scope of IAS 38.

Recognition on the balance sheet at cost

1.33 Under this alternative, internally generated intangible assets could be initially recognized on the balance sheet at historical cost. The FASB would need to determine whether and, if so, which costs would be recognized and when those costs would be recognized. Furthermore, the FASB would have to address issues involving the unit of account (for example, whether cost should be capitalized only for successful efforts of research and development on an individual basis). Options for the criteria about which cost to recognize and when to recognize the cost as an asset include the following:

a. Apply the software capitalization guidance from Topic 985
b. Adopt the IFRS intangible asset capitalization criteria within IAS 38
c. Create new capitalization criteria.

1.34 Additionally, consideration would need to be given to whether and how the asset would be amortized and tested for impairment.

1.35 This alternative could be a cost-effective way to address the concerns of those stakeholders that have said that recognition would reflect their perception that intangible items create future economic benefits that are controlled by the entity and, therefore, should be recognized as an asset. Some users have indicated that recognition at cost would be a helpful measure to calculate return on investment.

1.36 However, some users historically have been opposed to recognition of intangible items at cost because cost may not be a relevant or reliable measure of the benefit a company will receive from those expenditures. Additionally, some preparers have said that tracking and allocating cost can be time consuming and difficult, especially if users would not find a benefit from the cost information.

Recognition on the balance sheet at fair value

1.37 Instead of measuring intangible assets at cost, the FASB could require measurement at fair value on a recurring basis. Under this approach, consideration would not need to be given to amortization or impairment. However, if a company had to determine fair value at every reporting date, this alternative would be costly to apply.

1.38 If intangible assets were measured at fair value each period, consideration would need to be given to where the changes in fair value would be recognized. Some stakeholders have expressed a preference for intangible assets to be measured at fair value; however, some of those stakeholders have said that the effects of the fair value measurement should not be included in the income statement.

1.39 If a threshold was required to be met before recognizing an intangible asset and measuring it at fair value, an entity would recognize a gain in the period in which the recognition threshold was met. It is unclear whether and how the gain should be recognized in the income statement.

Alternative B—Recognize Research and/or Development Costs

1.40 This alternative has a narrower scope than Alternative A and Alternative D. As suggested by the Special Report, a first step toward recognition of all or most intangible assets on the balance sheet could be requiring recognition of research and/or development costs on the balance sheet, either at cost or at fair value.

1.41 This alternative would address the concerns of those stakeholders that assert that research and development is among the most important assets not recognized on the balance sheet.

1.42 Alternative B might lead stakeholders to question whether recognition of research and development costs on the balance sheet would provide useful information if there are other intangible assets that are not recognized. Additionally, if research and development were to be measured at fair value, stakeholders might question the benefits of doing so because there are many other assets recognized in the balance sheet that are not measured at fair value.

Alternative C—Disclose Internally Generated Intangible Items

1.43 Expanded disclosures about internally generated intangible items might provide users with additional information to assist in analyzing similar companies in industries in which intangible items are significant to future prospects. This alternative would be similar to the objective of the project that was removed from the FASB's agenda in 2004 because the Board's intention at that time was to address the topic during convergence efforts, rather than abandon the topic altogether.

1.44 Some stakeholders have asserted that the benefits of recognizing internally generated intangible assets on the balance sheet do not justify the related financial reporting costs, but they have asserted that incremental disclosure would provide useful information at a reasonable cost. However, it is unclear what specific information could be disclosed that balances the desire for incremental disclosure from users with concerns about providing proprietary information.

1.45 One disclosure option that could be considered is to disclose the cost and/or fair value of internally generated intangible items. However, the costs of disclosing the cost and/or fair value of intangibles might be similar to recognizing the items on the balance sheet, and many of the potential issues identified with the previous two alternatives would need to be addressed.

Alternative D—Adopt IAS 38

1.46 Another alternative is to adopt IAS 38 to increase consistency of accounting for intangible assets between current GAAP and IFRS. Because the guidance is applied in practice outside the United States, the FASB's standard-setting activities could include understanding investors' experiences of using the information reported as a result of IAS 38.

1.47 Alternative D would require the application of significantly more judgment by preparers and auditors compared with current GAAP for development costs. Alternative D also might lead to only minimal amounts being recognized. For example, international pharmaceutical preparers informed the FASB that the threshold for recognition of development costs is so high under IAS 38 that costs commonly are not capitalized until after drug approval. After approval, often only minimal direct costs related to a drug are incurred. Therefore, it is possible that the information conveyed by the recognition of the asset might be too late to provide significant new information to users. Additionally, some users have historically questioned whether cost is a useful measure, and research and development costs are already required to be disclosed under GAAP.

Topic-Specific Questions for Respondents—Intangible Assets (including Research and Development)

Question 1.1: Is the accounting for intangible assets (including research and development) a major financial reporting issue that the FASB should consider for improvement? Please explain why.

Question 1.2: If yes, should the issue be addressed broadly for all intangible assets or should it first be addressed for a subset of intangibles (for example, research and development)? Please explain why.

Question 1.3: Which approach to addressing the issue is appropriate, considering the benefits and costs of each approach and why? If you recommend a recognition approach, please explain your view about (a) the threshold for recognizing the asset and (b) the measurement of the asset (cost or fair value). If you recommend a disclosure approach, please explain the disclosure objective and recommend what specific information should be disclosed. If you recommend an approach to adopt IAS 38, please explain any implementation concerns.

Question 1.4: Recognition of an intangible asset if a threshold is met and measurement of that asset at fair value would likely result in (a) a gain in the period in which the asset initially is recognized and (b) gains or losses in each period for the change in the fair value of the asset. How should those initial and subsequent gains and losses be presented in the income statement?

Chapter 2—Pensions and Other Postretirement Benefit Plans

Background and Relevant History

2.1 Three features from historical practice that have shaped accounting for defined benefit plans today are (a) delaying recognition of certain events, (b) reporting net cost, and (c) offsetting liabilities and assets. Some stakeholders have asserted that those three aspects conflict in some respects with accounting principles in other areas of current GAAP and may be the root cause of suggestions for changing those perceived issues about the accounting for defined benefit plans.

2.2 The first aspect of delaying recognition of certain events refers to changes in the obligation (including those resulting from plan amendments) and changes in the value of plan assets, which are not required to be recognized in earnings as they occur but are recognized systematically and gradually over subsequent periods. All changes ultimately are recognized except to the extent that they may be offset by subsequent changes. Some have referred to this aspect applied in practice as smoothing.

2.3 The second aspect of reporting net cost refers to the recognized consequences of events and transactions affecting a pension or other postretirement benefit plan, which are reported as a single net amount in the plan sponsor's financial statements. This aspect aggregates at least three items that might be reported separately for any other part of an employer's operations: the compensation cost of benefits promised, the interest cost resulting from deferred payment of those benefits, and the results of investing plan assets.

2.4 The third aspect of offsetting liabilities and assets refers to the recognition on a net basis (to the extent that the plan assets meet certain criteria) in the employer's statement of financial position of the amount of assets contributed to pension and other postretirement benefit plans and the liabilities for the plans. This presentation offsets the liabilities and the assets. Even though the liability has not been settled, the assets may be still largely controlled, and substantial risks and rewards associated with both of those amounts are borne by the employer.

2.5 Over the years, the FASB has made improvements to financial reporting for an employer's defined benefit pension and other postretirement benefit plans. More recently, the FASB issued Accounting Standards Updates in 2011 and 2015 to improve the disclosures about an employer's participation in a multiemployer plan and to provide a practical expedient for the measurement date of an employer's defined benefit obligation and plan assets.

2.6 Also, the FASB issued two Exposure Drafts in January 2016. The proposed Accounting Standards Update, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Changes to the Disclosure Requirements for Defined Benefit Plans*, proposes to improve disclosure requirements for defined benefit plans, and the proposed Accounting Standards Update, *Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, proposes to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The Exposure Draft on the presentation of net periodic benefit cost could change the fundamental aspect of reporting net cost (see paragraph 2.3) in a plan sponsor's financial statements by requiring an employer to report the service cost component of net benefit cost in the same line item or items as other compensation costs and to present the other components in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented.

2.7 This ITC focuses on two major issues that have garnered recent attention from stakeholders on the related potential improvements or changes that could be made to pension and other postretirement benefit plan accounting.

Issue 1—Delayed Recognition (Smoothing) in Earnings

Perceived Issues

2.8 Current GAAP permits an immediate recognition or delayed recognition (smoothing) of gains and losses from a change in the value of either the projected benefit obligation or the plan assets. Most plan sponsors elect to smooth those gains and losses by deferring them into other comprehensive income and then reflecting an amortized portion in earnings if those gains and losses exceed 10 percent of the greater of the projected benefit obligation or the market-related value of plan assets (often called the corridor approach).

2.9 Smoothing also may result from the delayed recognition of plan amendments. Prior service cost from plan amendments is recognized in other comprehensive income at the date of the amendment and then amortized as a component of net periodic benefit cost over future periods (typically over periods of expected future service).

2.10 As a result of smoothing, the measurement of curtailment or settlement gains or losses often is affected by part or all of the unamortized gains and losses and prior service costs in other comprehensive income. The curtailment or settlement gains or losses, therefore, are a net result of recycling past economic events in addition to recognizing the current transaction.

2.11 Some users of financial statements have criticized the option given to employers for applying either the immediate recognition method or the smoothing method in accounting for pension and other postretirement benefit plans. Those users have said that the accounting is difficult to understand, reduces relevance, and compromises comparability of financial reporting.

2.12 Stakeholders also have raised concerns that recognizing gains and losses initially in other comprehensive income and then later reflecting a portion in earnings in subsequent periods make it difficult to understand the entity's performance for a reporting period because the amounts reported in earnings are not correlated to the economic performance of the current period.

2.13 Stakeholders also have noted the following differences between current GAAP and IFRS:

Item	GAAP	IFRS
Actuarial Gains and Losses	Recognized immediately in earnings or recognized in other comprehensive income and subsequently amortized to earnings.	Recognized in other comprehensive income and not amortized to earnings.
Return on Plan Assets	The expected return on plan assets is determined by multiplying the market-related value of plan assets by the expected long-term rate of return on plan assets.	Interest income on plan assets is determined by multiplying the fair value of the plan assets by the same discount rate used to calculate the interest cost on the defined benefit obligation.
Prior Service Cost	Recognized in other comprehensive income and subsequently amortized to earnings.	Immediately recognized in earnings.

Item	GAAP	IFRS
Curtailment or Settlement Gain/Loss	Affected by the unamortized net gains and losses, transition assets or obligations, and prior service cost or credit in the other comprehensive income.	Not affected by gains and losses in other comprehensive income.

Potential Standard-Setting Alternatives

2.14 Two potential alternatives that could address the perceived issues caused by smoothing are discussed below.

Alternative A—Converge with IAS 19, Employee Benefits

2.15 Converging with IAS 19 would address some of the concerns about smoothing. This alternative would eliminate recycling of the effect of past economic events into earnings and eliminate the effect of actuarial gains and losses from the income statement. This alternative also would present net interest on the net defined benefit liability (assets) in the income statement.

2.16 Some may argue that there is no sound conceptual basis for recording all gains and losses in other comprehensive income instead of earnings. However, the potential solutions and research on other comprehensive income, as discussed in paragraphs 4.44–4.65, may shed some light on this concern.

Alternative B—Eliminate All Smoothing and Recognize the Measured Changes Immediately in the Income Statement

2.17 Some may argue that recognizing changes immediately in earnings would make earnings more representative of the current period's economic transactions and events. Certain entities already recognize all gains and losses immediately in their income statements. However, most of those entities then report non-GAAP measures eliminating the effects of immediate recognition from their reported results.

2.18 While Alternative B is simpler and resolves many of the perceived issues about smoothing, many would argue that it results in unfavorable outcomes, such as increased earnings volatility. However, the recently issued

Exposure Draft on the presentation of net periodic pension cost and net periodic postretirement benefit cost could mitigate this concern. If the Exposure Draft were to be finalized, actuarial gains and losses would no longer affect operating earnings. Under Alternative B, the Board would have an opportunity to consider whether interim reporting should be performed on the same basis, thus potentially requiring remeasurement at each reporting date.

2.19 Alternative B might impede future convergence with IFRS on this issue.

Issue 2—Measurement of Defined Benefit Obligation

Perceived Issues

2.20 When measuring a defined benefit obligation, some have questioned:

a. The rates used to discount the pension and other postretirement benefits obligation
b. The measurement of the benefit obligation for hybrid plans
c. Whether there should be financial reporting alignment between plan sponsors and plans, including discount rates, the measurement date, and the measurement of the defined benefit obligation.

2.21 Generally, not many users have raised concerns about these issues, and there is no significant difference between current GAAP and IFRS in the measurement of the defined benefit obligation. However, the increasing use of hybrid plans, such as cash balance plans and pension equity plans, which credit a rate of return to employer's contributions and have elements of both defined benefit plan and defined contribution plan, is, in the view of some, challenging the faithfulness of the current accounting model by classifying and measuring these plans and traditional defined benefit plans in the same manner, despite their identifiable differences.

2.22 Some stakeholders have noted that plan sponsors can choose among different discount rate methodologies (for example, bond indexes approach or yield curves approach) in measuring a defined benefit obligation, which leads to inconsistency in practice and reduces comparability among entities. In addition, some have argued that the guidance on selecting an assumed discount rate on the basis of a current rate instead of an expected long-term rate or average historical rate overstates pension and other postretirement benefit obligations because of the current low interest rates in comparison with historical norms.

2.23 There is diversity in practice in measuring the present value of the defined benefit obligation for cash balance plans with variable interest crediting rates. For example, some entities assume that the current rate (for example, the 10-year Treasury bond rate) will continue until the employee terminates or retires, while others assume changes to current rates. For those entities that include changes to variable interest crediting rates in their projections, many assume that interest rates will return to a long-term average.

Potential Standard-Setting Alternatives

2.24 The many varieties of postretirement benefit plans (including hybrid and annuity plans) and the numerous assumptions used to estimate the postretirement benefit obligation complicate the analysis of alternatives to address the different issues highlighted above. The following are preliminary ideas to address the perceived issues in measuring the benefit plan obligations:

a. Redefine employee benefit plans to reflect a broader classification of different types of plans. For example, establish hybrid plans or mixed-feature benefit arrangements as a new class of plans along with traditional defined benefit plans and defined contribution plans, and provide updated definition and accounting guidance on each class of the plans.
b. Change the discount rates for hybrid plans. For example, consider whether the discount rates for cash balance plans should be based on the interest crediting rates. They may or may not be directly related to returns on actual portfolio or hypothetical portfolio of assets.
c. Change other measures for hybrid plans. For example, for the plans in which benefits depend on the actual return on plan assets, consider whether the defined benefit obligations should be measured by projecting forward the cash outflows at the discount rate instead of at the expected rate of return on plan assets, or for the plans with a minimum guaranteed rate of return, consider whether the contribution component and the guaranteed return component should be accounted for separately.
d. Fully or partially change the financial statements of a plan to be consistent with the financial statements of a plan sponsor by requiring the plan to measure the actuarial present value of the accumulated plan benefits as of the end of the plan year and/or to use the same assumptions to measure the benefit obligation.

2.25 While these ideas appear to address many of the concerns about measurement, more research and analyses need to be performed to determine whether those alternatives are feasible.

Potential Path Forward

2.26 This chapter of the ITC focused on targeted improvements to address issues about delayed recognition (smoothing) in earnings and the measurement of defined benefit obligations.

2.27 There are other financial reporting issues that are not explored in this ITC about pension and other postretirement benefit plan accounting. Some might think that a comprehensive change to pension and other postretirement benefit plan accounting could be a more effective approach to address the concerns discussed in this ITC. Under this approach, there would be a comprehensive reconsideration of financial reporting for pension and other postretirement benefit plans within the scope of Topic 715, Compensation—Retirement Benefits, which means that all of the fundamental aspects (that is, the delayed recognition feature, net cost feature, and offsetting feature) of the current accounting model would be assessed for improvement. This approach may start with fundamental changes in financial reporting for plan assets and defined benefit obligation in the statement of financial position, which would lead to corresponding changes in financial reporting for net benefit cost in the income statement.

Topic-Specific Questions for Respondents—Pensions and Other Postretirement Benefit Plans

Question 2.1: Is the accounting for pensions and other postretirement benefit plans a major financial reporting issue that the FASB should consider for improvement? Please explain why.

Issue 1—Delayed Recognition (Smoothing) in Earnings

Question 2.2: Would Alternative A (see paragraphs 2.15–2.16) and/or Alternative B (see paragraphs 2.17–2.19) improve the usefulness of financial information provided to users and be operable?

Question 2.3: If you support Alternative A (convergence with IAS 19), would you recommend any modifications to IAS 19 or would you expect any implementation issues? Please explain why.

Question 2.4: Are there other approaches to consider for addressing the issue of delayed recognition in earnings? If so, please provide them in sufficient detail so that the FASB can consider your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

Issue 2—Measurement of Defined Benefit Obligation

Question 2.5: Is the current measurement of a defined benefit obligation appropriate? If not, what changes do you suggest and why (for example, what characteristics of plans are not adequately reflected in the current measurement of the benefit obligation)?

Potential Path Forward

Question 2.6: What approach (that is, targeted improvements or comprehensive reassessment) would you recommend and why?

Question 2.7: Are there other issues for pension and other postretirement benefit plan accounting that should be considered for improvement?

Chapter 3—Distinguishing Liabilities from Equity

Background and Relevant History

3.1 The FASB's history of distinguishing liabilities from equity dates back to 1986 when the FASB added to its technical agenda a broad project on financial instruments. The dates and titles of key documents issued over the years as part of the project on liabilities and equity are as follows:

a. August 1990—FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both* (1990 Discussion Memorandum)
b. October 2000—FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* (2000 Exposure Draft)
c. October 2000—FASB Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* (Concepts Statement Exposure Draft)
d. May 2003—FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (Statement 150)
e. November 2003—FASB Staff Position (FSP) FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*" (FSP FAS 150-3)
f. November 2007—Preliminary Views, *Financial Instruments with Characteristics of Equity*.

3.2 The 2000 Exposure Draft addressed a broad range of liability and equity classification issues. At the end of 2002, the FASB affirmed its conclusions in the 2000 Exposure Draft that classification of the following types of instruments as liabilities was appropriate:

a. Mandatorily redeemable instruments
b. Instruments that obligate the issuer to repurchase its own equity instruments for cash or other assets
c. Certain instruments that the issuer must or can settle by issuing a variable number of its own equity shares.

3.3 Although its deliberations on some of the issues addressed in the 2000 Exposure Draft were unfinished, the FASB decided to issue a limited-scope standard (Statement 150) to provide necessary and timely guidance for the instruments in paragraph 3.2 because practice problems were clear and resolvable. In Statement 150, the FASB stated that it planned to continue redeliberations for the remaining issues and would issue another Statement at a later date. Changes proposed in the Concepts Statement Exposure Draft were delayed because the FASB thought that resolution of the remaining issues in the 2000 Exposure Draft could affect any modification to the definition of a liability.

3.4 After the issuance of Statement 150, stakeholders raised concerns. Most notably, many questioned the classification of certain types of mandatorily redeemable instruments. To give itself time to resolve those issues, the FASB issued FSP FAS 150-3 to defer the effective date for applying the provisions of Statement 150 for:

a. Mandatorily redeemable financial instruments of certain nonpublic entities
b. Certain mandatorily redeemable noncontrolling interests.

3.5 After the issuance of Statement 150 and FSP FAS 150-3, the FASB changed its plan about redeliberating the remaining issues discussed in the 2000 Exposure Draft. The new plan was to develop a set of classification principles that would avoid the issues raised by Statement 150 while resolving the remaining issues.

3.6 In November 2007, the FASB issued its Preliminary Views on financial instruments. In February 2008, the IASB issued a Discussion Paper, *Financial Instruments with Characteristics of Equity,* which included an Invitation to Comment and the FASB's Preliminary Views. In July 2008, the IASB added the Financial Instruments with Characteristics of Equity project to its agenda. In 2010, the Boards developed a joint Exposure Draft on the topic. The draft was provided to external reviewers and after reviewing the comments, the Boards decided that the document had significant unresolved issues and, consequently, never issued the document.

3.7 Currently, the FASB is approaching the topic of liabilities and equity through targeted improvements that are designed to address issues particular to down-round features and navigation in the *FASB Accounting Standards Codification*® (Accounting Standards Codification).

Perceived Issues

Current GAAP Is Difficult to Apply

3.8 The FASB has been told that practice continues to use the legacy literature rather than the Accounting Standards Codification to address issues about the classification of specific instruments as either liabilities or equity. Before the Accounting Standards Codification existed, there were numerous disparate pieces of literature that addressed various aspects of the accounting for financial instruments with characteristics of liabilities and equity. The disparate pieces of literature created a path-dependent set of complex standards that were sometimes difficult to interpret and apply. Complexity and difficulties with interpretation and application were not addressed when the FASB developed the Accounting Standards Codification because making the literature easier to understand might have had the unintended consequence of changing the accounting outcomes for various instruments or features. Consequently, the Accounting Standards Codification only reorganized the legacy literature. The disparate pieces of literature continue to exist throughout different Topics and Subtopics, which creates a risk that stakeholders may inadvertently fail to consider all of the relevant aspects of the guidance for a specific fact pattern.

3.9 Regardless of form (that is, codified or not), stakeholders continue to find the guidance to be internally inconsistent, conceptually flawed, rules-based, and subject to financial structuring to achieve a desired result. Consequently, distinguishing between liabilities and equity continues to be a focus of the U.S. Securities and Exchange Commission (SEC) and has been the subject of a significant number of comment letters and restatements.

3.10 Many stakeholders continue to list distinguishing between liabilities and equity as a high-priority topic for improvement in various feedback surveys conducted by the FASB. The most often repeated reasons for addressing the topic include the following:

a. The topic is a source of errors and significant confusion because of complexity and difficulties with interpretation and application
b. The accounting does not provide useful information because answers are inconsistent due to the “form-based” or “terms-dependent” nature of the guidance
c. The information is costly to provide.

Potential Standard-Setting Alternatives

Will Targeted Improvements Work?

3.11 For some, distinguishing between liabilities and equity may seem relatively straightforward. The most obvious liabilities are those that require delivery of a specified amount of cash or other assets, while the most obvious equities represent perpetual instruments with the most residual claim to an entity’s assets. However, difficulties arise when the terms of particular instruments place the accounting between the obvious. The difficulties tend to arise in the following broad areas:

a. Redeemable equity instruments (for example, mandatorily redeemable shares)
b. Equity linked or indexed instruments (for example, options and forwards)
c. Convertible instruments (for example, debt and preferred shares).

3.12 Some stakeholders have said that the difficulties noted in paragraphs 3.8–3.10 can be resolved over time through targeted improvements. Those favoring targeted improvements have suggested that if the guidance for specific troublesome instruments or features is amended, the accounting will become less complex and result in more useful information. While this may be true in certain instances, a broader application of the approach is not a long-term sustainable solution.

3.13 Targeted improvements appear effective because the issues addressed focus on specific instruments or features and discrete accounting outcomes. Consider the latest deliberations on targeted improvements for down-round features. For simple instruments such as warrants, the targeted improvements may be implemented easily. However, for more complex hybrid instruments, the targeted improvements are more challenging to implement because of the overlapping accounting guidance and potential unintended consequences. Consequently, the FASB will need to be careful about how it incorporates any proposed changes in current GAAP to strike a balance between reducing cost and complexity in one area of guidance and not significantly increasing cost and complexity in another.

3.14 Because targeted improvements tend to have consequences for other transactions or instruments, continuing to amend the guidance through targeted improvements, beyond that which is already being deliberated, is not sustainable. The current patchwork of guidance developed over the years to address primarily specific issues, instruments, or features is significantly interconnected. Consequently, it is nearly impossible to amend or update one area of guidance without having at least a marginal effect elsewhere. Such an approach also is likely to perpetuate the current system of instrument-specific rules resulting in the potential for inconsistent and complex guidance.

3.15 The interconnection and difficulties encountered with attempting targeted improvements may suggest that the problems with distinguishing between liabilities and equity likely stem from incomplete conceptual work before the issuance of Statement 150. This ITC considers an approach in which the FASB must first address some of this incomplete work. This approach involves more than simply developing solutions that resolve specific issues for individual instruments in isolation. The work is critical for all instruments because classification affects the way that all instruments are measured, which ultimately determines an entity’s comprehensive income.

3.16 This ITC considers a holistic examination of the accounting requirements for distinguishing between liabilities and equity. The examination would include simple instruments (for example, shares, options, and forwards) and complex instruments (for example, convertible debt and convertible preferred shares). The initial research aims to answer the question of whether a present obligation to transfer shares of the reporting entity meets the definition of a liability.

Possible Alternatives by Instrument Type

3.17 To assist in framing the discussion of the alternatives under consideration to address the general difficulties identified in paragraphs 3.8–3.10, this ITC identifies the potential characteristics of two types of simple instruments:

- a. Perpetual instruments (for example, common shares and some preferred shares). Instruments do not require settlement if the reporting entity is a going concern and, therefore, do not contain present obligations to transfer assets to instrument holders. The instruments may entitle holders to a fixed or variable portion of the issuer's net assets in liquidation.
- b. Equity linked or indexed instruments (for example, options on common shares).
  1. Potential characteristics of equity linked and indexed instruments include:
     - i. Instruments are not perpetual.
     - ii. Instruments' terms link fair values to fair values of perpetual instruments and cause fair values to change in the same direction as fair values of perpetual instruments.
     - iii. Instruments do not include contingent exercise provisions that are based on either of the following factors:
       - a. Market prices for anything other than the reporting entity's perpetual instruments
       - b. Price indexes other than indexes calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity).

Simple instruments

3.18 With the broad types of instruments in mind, there are two general alternatives under consideration for the initial phase of research.

3.19 The following discussion assumes that instruments within the scope of Topic 718, Compensation—Stock Compensation, and Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees, are outside the scope of these discussions.

Alternative A: Equity classification—no obligations to transfer assets or shares (indexation and settlement are irrelevant)

3.20 Under Alternative A, a reporting entity potentially would classify instruments on the basis of the nature of the return and the lack of a present obligation to transfer assets or shares. Consequently, only perpetual instruments (see paragraph 3.17(a) for potential characteristics) would meet the requirements for equity classification.

3.21 Alternative A is a view taken from the perspective of the holders of financial instruments. Specifically, present obligations to transfer either assets or shares create liabilities for reporting entities because, from the holder's perspective, they are receiving an asset. The alternative is designed to draw a line between liabilities and equity in a simple and informative way that is also responsive to prior feedback about perpetual instruments other than basic common shares.

3.22 Simplicity means making the reported information easier to understand by those that prepare, audit, and use that financial information. Classifying only perpetual instruments as equity potentially would allow users of the financial statements to easily identify claims that would reduce the share of the reporting entity's net assets to those holders considered owners.

3.23 Under the alternative, a reporting entity potentially would classify all perpetual instruments as equity because when viewing the reporting entity from a going-concern perspective, perpetual instruments appear much closer to equities than liabilities because there is no present obligation to transfer assets or shares. Because the holders of those instruments cannot require the entity to make a payment, other payments automatically come first despite the fact that the interests are at least partially protected from risk by common shares in liquidation. Except in unusual and deliberately contrived circumstances, under a going-concern scenario, perpetual instruments are, in every practical sense, equity.

Alternative B: Equity classification—distinguishes between obligations to transfer assets versus shares (indexation and settlement matter)

3.24 Under Alternative B, a reporting entity potentially would classify instruments on the basis of the nature of the return and what the reporting entity is obligated to transfer (that is, assets or shares). Consequently, the following types of instruments potentially would meet the requirements for equity classification:

a. Perpetual instruments (see paragraph 3.17(a) for potential characteristics)
b. Some equity linked or indexed instruments (see paragraph 3.17(b) for potential characteristics).

3.25 Alternative B is a view that is focused on settlement and on the reporting entity's ability to control that settlement. Under the alternative, a reporting entity would classify as equity all of the same instruments classified under Alternative A and would include some equity linked or indexed instruments (as potentially defined). This alternative views some equity linked or indexed instruments settled with the related shares as nascent equity. The holder of equity linked or indexed instruments may eventually become a holder of shares and does not have a claim that is senior to perpetual instruments. Moreover, issuing common shares to satisfy certain outstanding obligations will not reduce the reporting entity's assets.

3.26 One of the important issues to address is the extent to which meeting the definition of equity linked or indexed instruments is dependent upon the holder having exposure to the same risks and rewards as the holder of common shares. To demonstrate that evaluation, consider the following simple example. A reporting entity issues (writes) a call option on its common shares. The instrument is not perpetual and does not contain a contingent exercise provision outside of the market price for the reporting entity's common shares. When the option is "in-the-money" (that is, has an intrinsic value greater than zero), the return to the holder of the option has a similar profile to the return of a holder of the related common share. That is, as the fair value of the common share increases, the fair value of the call option generally increases as well. The call option is an equity linked or indexed instrument.

3.27 Once an instrument meets the definition of an equity linked or indexed instrument, to meet the requirements for equity classification, the reporting entity would assess the obligation to transfer and the ability to control the choice of what to transfer (that is, assets or shares). The reporting entity potentially would classify the option as equity if the instrument obligated the reporting entity to settle it by transferring (that is, issuing) common shares. If the reporting entity was obligated to transfer cash or other assets, the reporting entity potentially would classify the option as a liability.

Complex instruments

3.28 Discussions about complex instruments might be premature at this stage because many of the decisions about simple instruments directly affect complex instruments. For example, some may think that if Alternative A is selected for simple instruments, questions about bifurcating conversion features become moot if Alternative A resulted in the remeasurement of the entire instrument each reporting period. However, others may think that either alternative presented for complex instruments could have merit because they do not think that classification questions about particular features of a complex instrument should affect the measurement of the entire instrument. Said differently, they think that bifurcation of conversion options is primarily an “accounting mechanics” decision. Once the conversion feature is bifurcated, determining whether the feature should be classified as a liability or equity is still needed with either alternative above, which is equally applicable because there may be other reasons for bifurcation.

3.29 The following brief discussion is provided as an indicator of the initial thinking about conversion options, acknowledging that there are several aspects of complex instruments that will need to be researched in follow-on phases (for example, measurement).

Alternative A: Bifurcate all conversion options from the host contract

3.30 Under Alternative A, a reporting entity would separate all complex instruments by bifurcating all conversion features from the host contract without regard for the embedded derivative literature. The alternative is similar to that in IFRS, which considers complex instruments as “compound” instruments composed of a liability and equity component. Alternative A is grounded in the concepts provided in the basis for conclusions of FSP APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement),” which states in paragraph B7:

> The fundamental principle underlying the separation approach in this FSP is that an issuer of a convertible debt instrument that requires or permits partial cash settlement upon conversion should recognize the same interest cost it would have incurred had it issued a comparable debt instrument without the embedded conversion option.

Alternative B: Bifurcate conversion options from host contract if the instrument is “compound”

3.31 Under Alternative B, a reporting entity would not separate complex instruments into liability and equity components unless the instruments were truly “compound” instruments. That is, the exercise of the equity component does not eliminate the debt but, rather, is separately exercisable. Alternative B is grounded in the concepts provided in APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, which states in paragraph 7:

> A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash.

Benefits and Consequences of a Holistic Examination

Simple instruments

3.32 The outlined potential alternatives highlight the trade-offs between simplicity in approach and what may be considered by some as unfavorable outcomes. The view that some outcomes are unfavorable will likely be driven by long-standing opinions about the classification of particular instruments. To be clear, it is anticipated that for either alternative, classification will change for instruments accounted for today as a result of the FASB's deliberations because it is somewhat impossible to address stakeholder concerns about complexity in this area of current GAAP without some changes. Additionally, the changes in classification could result in far more volatility in earnings than is currently experienced today for those entities issuing instruments with a change in classification to a liability classification.

3.33 Despite what potentially could be a significant change, the outlined alternatives offer potential benefits. The most significant benefit of a holistic examination of distinguishing between liabilities and equity is the development of a complete approach with a conceptual underpinning, thereby potentially eliminating the patchwork of guidance developed over time to address specific instruments or features within instruments. Eliminating the patchwork of guidance potentially addresses most, if not all, of the problems most often cited by stakeholders (namely, inconsistent results obtained for instruments that are economically similar, continued difficulties with interpretation and application, results that lack decision usefulness for financial reporting purposes, and the cost of providing such information).

3.34 With respect to simplicity, Alternative A (outlined from paragraphs 3.20–3.23 for simple instruments) is arguably the simpler of the two alternatives for classification purposes. The alternative draws a line for equity at those instruments that are perpetual before liquidation and that do not contain an obligation to transfer assets or shares to the transferee. The most valuable by-product of simplicity in Alternative A is that it would reduce the opportunities to structure very similar transactions or arrangements differently to achieve a different financial reporting result (structuring opportunities) because questions about indexation and settlement become irrelevant. Many of the complications with distinguishing liabilities from equity stem from the difficulties with interpreting and applying this guidance, which would exist in some form under Alternative B.

3.35 Moreover, by classifying instruments that are perpetual before liquidation as equity, a reporting entity can more clearly distinguish between the interests of different stakeholders under this alternative. Under current GAAP, the interests of several different classes of stakeholders are commingled in equity. Classifying only perpetual instruments as equity results in reporting amounts that will accrue to other stakeholders as components of earnings. If the components of earnings are identified clearly, stakeholders of any class will be able to determine more easily which amounts are attributable to them and which are not.

3.36 Alternative A may be viewed as simpler than Alternative B because, as with Alternative B, classifying perpetual instruments as equity could make the alternative complex because the FASB will likely need to resolve the issue of economic compulsion. For example, if an entity issues perpetual preferred stock with a dividend requirement that increases over time, the dividend rate could eventually become so high that the entity is compelled by the economics of the arrangement to repurchase the instruments. While not a legal obligation, unless the entity files for bankruptcy, it is highly likely that it will repurchase the preferred shares. Some might suggest that an obligation exists due to the inevitable settlement.

3.37 Additionally, perpetual instruments with provisions specifying redemption do not literally have the characteristic described in paragraph 3.17(a). Few would disagree that a requirement to make a fixed payment on a fixed date is a liability feature. Taken in isolation, that could lead to the suggestion that only perpetual instruments without redemption features should be classified as equity. However, some entities do not issue perpetual instruments (as defined) and, therefore, those entities would report no equity instruments. Reporting no equity instruments potentially would not faithfully represent the economic structures of those entities. The FASB will need to resolve which redeemable instruments qualify for equity classification.

3.38 Simplicity in classification could be somewhat offset by an increase in complexity with respect to measurement, which could be viewed unfavorably. Because more instruments would be classified as liabilities, the number of instruments requiring remeasurement (that is, fair value or intrinsic value) at each reporting period would likely also increase, thereby increasing costs and complexity. The additional costs could be significant for illiquid or thinly traded instruments measured at fair value.

3.39 In contrast to Alternative A, Alternative B is arguably more closely aligned with current GAAP while still offering an opportunity to develop a complete approach to address issues of inconsistency in accounting and difficulties with interpretation and application in order to provide more decision-useful information for financial reporting. Although Alternative B is closer to current GAAP, there would likely still be changes to the classification of particular instruments.

3.40 Moreover, the introduction of equity linked or indexed instruments for potential equity classification inherently increases the complexity of the alternative by introducing an element of judgment for preparers and auditors. These areas of judgment have historically created some of the most significant areas of complexity and problems with interpretation under current GAAP and will likely necessitate the FASB developing implementation guidance to address the following potential issues (not all inclusive):

a. An issuer's control over transfer options
b. The contemplation of an issuer's past practices with respect to the transfer of assets or shares if a choice of settlement exists
c. The degree to which a holder of an equity linked or indexed instrument is subject to the same risks and rewards as a holder of a common share.

3.41 The FASB also will likely need to resolve how to distinguish between instruments used as currency to settle fixed amounts and those that are a necessary part of obtaining equity capital. For example, entities with common shares that can quickly and easily be sold for a known price could effectively use those instruments as currency. Using particular instruments as currency may not result in financial reporting that is representationally faithful because entities could avoid recognizing liabilities by choosing to issue common shares instead of cash.

3.42 Finally, while the classification requirements for Alternative B would be more complicated than that of Alternative A, issuers could experience potentially less complexity under Alternative B from a measurement perspective. Because the alternative would result in more instruments meeting the classification requirements for equity, the natural result is fewer instruments requiring remeasurement at each reporting period, whether at fair value or at intrinsic value. Furthermore, remeasurement of liabilities has been criticized by users in the past.

Complex instruments

3.43 The initial stages of research for complex instruments focus on conversion options because these areas of the guidance are some of the most complex and interconnected, leading to significant difficulties with interpretation and application. Similar to simple instruments, the outlined approaches offer a trade-off between simplicity in approach and what may be considered by some as unfavorable outcomes. As with simple instruments, views about unfavorable outcomes will likely be driven by long-standing opinions about the accounting treatment for particular features.

3.44 Either alternative presented would significantly reduce the complexity of the current guidance because it would effectively eliminate much of the path-dependent literature addressing specific features (that is, derivative assessments and separate guidance specific to cash conversions and beneficial conversion features).

3.45 Because a reporting entity (see paragraph 3.30) would bifurcate all conversion options from the host contract under Alternative A, the number of issues that may exist today about extinguishment would likely increase. That is, separating all conversion options effectively creates “hypothetical” instruments whereby at extinguishment the sum of the parts will not equal the whole because the equity component would not be remeasured.

3.46 Moreover, bifurcating all conversion options from the host contract without regard for derivative literature could raise questions about the treatment of other embedded derivatives or increase the overall complexity, either of which would require resolution. For example, considerations for a complex instrument containing multiple embedded features might be the following (not all-inclusive):

a. An issuer’s accounting for all other embedded components. Separating all conversion features might suggest separate accounting for all embedded components (other than conversion options).
b. A valuation basis of the conversion feature (and other features if separated).
c. The treatment of interest expense and consideration of potential changes to existing earnings per share calculations.

3.47 Because only truly “compound” instruments (see paragraph 3.31) would be separated into liability and equity components under Alternative B, the number of instruments subject to bifurcation potentially would decrease. Many of the conversion options existing today are not separately exercisable. That is, if the conversion option is exercised, the debt would not remain outstanding. As with Alternative A, this alternative also could raise other questions and potentially increase complexity. For example, considerations for a complex instrument containing multiple embedded features (including a conversion option) might be the following:

a. Overall measurement basis for the instrument
b. Presentation differentiation for debt with “equity-like” components relative to “straight debt”
c. Bifurcation applicability for other embedded derivatives
d. Consideration of potential changes to existing earnings-per-share calculations.

Cross-Cutting Issues

3.48 While all alternatives presented address several of the areas that have plagued the current accounting for distinguishing between liabilities and equity, all would still fall short of addressing potential presentation and measurement issues. Namely, some stakeholders view the changes in value of those instruments classified as liabilities as nonoperating and take issue with the effect that those changes have on what they define as operating income, which ultimately makes its way to net income under today’s construct.

3.49 Ultimately, much of the work currently being performed in the FASB’s project on the Conceptual Framework should inform the decisions made in this project and others about measurement and presentation. Conversely, the work conducted in this project can serve as a direct input for revisions to the definition of a liability. In the interim, the FASB is requesting feedback on other projects for which the resulting deliberations could have a direct effect on distinguishing between liabilities and equity.

3.50 For presentation, the FASB currently has a project on financial performance reporting on its research agenda that is considering ways to improve the structure of the income statement. This is discussed further in Chapter 4. One area of focus for that project is evaluating how to categorize the income statement with operating and nonoperating activities categories in an attempt to provide more decision-useful information. That project could address the outstanding issues highlighted by potentially segregating those changes in value that stakeholders have expressed are indicative of nonoperating activities.

3.51 The FASB is also requesting feedback in this ITC about a potential future project related to other comprehensive income, which may evaluate the components that are classified in other comprehensive income and the basis for which those items may be reclassified into net income. This is also discussed further in Chapter 4. This work, if undertaken by the FASB, may offer another avenue for addressing stakeholder concerns about changes in value being recognized in net income.

3.52 As mentioned in the introduction of this ITC, many of the opinions about remeasurement in general are based on opinions of relevance, which can potentially change from one user of financial statements to the next. For example, some stakeholders are of the view that fair value is relevant for balance sheet presentation but do not hold the same opinion for the income statement. Therefore, while the approaches above contemplate remeasurement of liability-classified instruments (that is, fair value or intrinsic value) at each reporting period, this is largely provided on the basis of today's accounting for such instruments. Deliberations should contemplate the relevance of remeasurement in general along with presentation.

Topic-Specific Questions for Respondents—Distinguishing Liabilities from Equity

Question 3.1: Is the accounting for distinguishing liabilities from equity a major financial reporting issue that the FASB should consider for improvement? Please explain why. In making your assessment, what criteria were used (for example, is the issue not sufficiently addressed in current GAAP, or is it addressed in a way that makes compliance costly or creates diversity in practice because the guidance is conceptually or economically flawed)?

Question 3.2: Is the issue of distinguishing between liabilities and equity a financial reporting issue that requires a holistic approach to resolve as opposed to targeted improvements? Please explain why.

Question 3.3: Are there other alternatives for simple instruments that the FASB should consider for resolving the issue of distinguishing between liabilities and equity? If so, please provide the alternatives in sufficient detail such that the FASB can consider your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

Question 3.4: Are there other alternatives for addressing the financial reporting issues with conversion options in complex instruments that the FASB should consider? If so, please provide sufficient detail such that the FASB can consider your proposal(s). Please provide your rationale for why your proposal provides the users of financial statements with more useful information.

Question 3.5: Considering the alternatives described for simple instruments, which alternative provides more useful information to the users of financial statements and why?

Question 3.6: Considering the alternatives described for complex instruments, which alternative provides more useful information to users of financial statements and why?

Question 3.7: Which provides more useful information to the user of financial statements: remeasuring liability classified instruments at fair value or at intrinsic value? Please provide the rationale for your choice.

Question 3.8: Are there instances in which the remeasurement of liability-classified instruments at each reporting period is not useful? If so, which instances and why?

Chapter 4—Reporting Performance and Cash Flows

4.1 Performance reporting includes the presentation and display of revenues, expenses, gains, and losses that can be reported in (a) the statement of performance, (b) segment information, and (c) the notes. Most users also have said that the statement of cash flows is an important tool for analyses because it communicates how a company's performance is converted into cash receipts and payments over longer periods of time and helps predict future earnings and cash flows.

4.2 The performance statement structures financial information by classifying revenues, expenses, gains, and losses into either (a) the statement of net income (that is, the income statement), which reports a total for net income, or (b) the statement of other comprehensive income, which reports a total for comprehensive income.

4.3 This chapter of the ITC considers some of the perceived issues and potential improvements that could be made to those aspects of reporting. It also contemplates how those issues and alternatives could be approached in a variety of narrow, broad, or holistic projects. Some of these projects could be undertaken sequentially or contemporaneously. Accordingly, respondents' feedback should discuss the relative importance of the issues and solutions and the type of projects that the FASB should prioritize.

Income Statement

Background and Relevant History

4.4 Presentation and disclosure guidance for the income statement is established by the FASB and the SEC through their regulations. The SEC regulations establish certain minimum income statement presentation requirements that are generally applied by U.S. registrants and certain other entities. Current GAAP contains a few general presentation requirements for the income statement, but aside from reporting a total for net income, it does not require that revenues, expenses, gains, or losses be arranged into categories, such as operating or nonoperating activities.

4.5 Entities often engage in a wide range of activities, transactions, and events that result in performance information that is ultimately simplified, condensed, and aggregated together into different types of revenues, expenses, gains, and losses. Current GAAP, similarly, contains few general requirements for aggregating performance information into lines. Most lines displayed on the income statement aggregate performance information on the basis of the judgment of management. Stakeholders have said that the practice has developed such that performance information tends to be aggregated into a few primary lines.

4.6 Over the years, the FASB has considered making improvements to the structure and content of the income statement. In 2008 and 2010, the FASB and the IASB jointly issued a Discussion Paper, *Preliminary Views on Financial Statement Presentation*, and a Staff Draft of an Exposure Draft on Financial Statement Presentation (2010 Staff Draft), respectively. The focus of those documents was to structure the income statement into operating, investing, financing, and other categories and apply those categories consistently across the statement of cash flows and the statement of financial position. The Boards also sought to disaggregate the income statement using a variety of methods. For various reasons, those proposals were not finalized.

4.7 The FASB currently has a project on financial performance reporting on its research agenda, which considers how to improve the structure and the display of revenues, expenses, gains, and losses within the income statement.

Historical Challenges to Improving the Organization and Structure of the Income Statement

4.8 Improving the structure of the income statement involves creating categories in addition to the total for net income and organizing the way performance information is arranged within that statement. The most challenging aspect of creating additional categories is defining or describing those categories in a way that can be applied by vastly different types of reporting entities. A number of previous standard-setting attempts have sought to define an operating activities category and to require an operating income subtotal. However, the earnings components that might be categorized within operating activities of a manufacturer are potentially very different from what might be classified within operating activities for a financial institution such as a bank or insurance company.

Historical Challenges to Combining or Separating Earning Components within the Income Statement

4.9 The challenge with combining or separating items into lines on the income statement is that there are few concepts on which to anchor the guidance to achieve consistent and comparable results. In the FASB's current Conceptual Framework project, the FASB has decided to focus on developing presentation concepts, including concepts for aggregation.

4.10 Previous standard-setting attempts have considered a number of disaggregation approaches such as (a) disaggregating functional lines into natural components, (b) disaggregating infrequently occurring or unusual items from other items, and (c) disaggregating by measurement method. It has been difficult, however, to make broad changes to performance reporting without clear concepts to describe how performance information should be combined or separated from other items.

Perceived Issues

The income statement does not have a common structure

4.11 Aside from a total amount for net income, there are limited requirements in current GAAP to organize the income statement into structured categories. In contrast, the statement of cash flows (that is, the cash flow statement) is structured into three categories (operating, investing, and financing), while the statement of financial position is structured into groups of assets, liabilities, and equity, and is then, for some entities, further structured into current and noncurrent categories for assets and liabilities. Many stakeholders have said that organizing the performance information within net income into categories would improve an investor's understanding of both the individual lines and the information as a whole.

Desire to increase the transparency of items that are useful for making predictions of future earnings

4.12 Many stakeholders have said that the income statement could be improved to increase the utility of that statement in terms of making predictions of future earnings and cash flows. For example, some items may have unique significance for estimating future cash flows and earnings, such as nonrecurring items. While current GAAP defines and requires infrequently occurring items to be presented or disclosed in the financial statements, most users ascribe a more conventional meaning to this term than what is defined in current GAAP. As a result, many items that are ordinarily thought of as being nonrecurring or infrequently occurring are not always separately displayed in financial statements. Conversely, other stakeholders have said that management commentary is the more appropriate place to provide a discussion of unique items and earnings that might be reasonably expected to differ in the future.

4.13 Some stakeholders have said that both the absence of structured information and the limited transparency of infrequent items within net income have contributed to the increased use of non-GAAP performance metrics.

Aggregation of earnings components into a few lines

4.14 Many stakeholders have said that performance information tends to be aggregated into a few primary lines in the income statement. There is limited guidance on aggregating performance information into lines and the display of revenues, expenses, gains, and losses. Entities have considerable latitude in making their presentation decisions. Users also have argued that less aggregation of information to show the different sources and characteristics of earnings would provide more decision-useful information. Research in the project on financial performance reporting indicates that this concern is more pronounced in functional lines.

Potential Standard-Setting Alternatives

Categorize the income statement into operating and nonoperating activities

4.15 One area of focus for the project on financial performance reporting is whether to further categorize net income into operating and nonoperating activities. A subtotal would be presented to display income from operating activities.

4.16 The FASB is evaluating three alternatives for determining which transactions and events are reported within each category. Under Alternative A, the FASB would describe, not define, operating activities, and would allow for management to determine its composition through an accounting policy. This approach would provide flexibility for management to categorize items in a way that reflects the circumstances of the entity.

4.17 Under Alternative B, the FASB would define operating activities with a standardized definition that would be supported with detailed descriptions and examples. It would apply to different types of reporting entities such as banks, insurers, and manufacturing companies. This approach would increase comparability because the definition would be standardized. As with previous standard-setting efforts, the FASB has found it difficult to define the operating activities category in a way that is relevant for all types of entities.

4.18 Under both of these alternatives, the FASB would consider nonoperating activities to be the residual category (that is, the items that are not first considered to be part of the operating activities). An open question is whether nonoperating activities should be further subdivided into additional categories such as financing and investing activities.

4.19 Alternative C is the inverse of the previous two alternatives. Under Alternative C, the FASB would describe or define the composition of nonoperating activities, and the operating activities category would be the residual earnings category.

Combining or separating earnings components and presenting discrete lines

4.20 A second area of focus for the project on financial performance reporting is how to combine or separate performance information in the income statement and establish standards-level guidance that improves the way in which revenues, expenses, gains, and losses are displayed. To date, the FASB has considered three alternatives.

4.21 Under Alternative A, the FASB would reexamine the current guidance in Topic 225, Income Statement, on infrequently occurring transactions or events. This approach would redefine the GAAP definition for *infrequency of occurrence* to apply a more conventional understanding of this term. In its place, a range of factors would be considered when evaluating an item's frequency of occurrence. The objective of this approach would be to display the effects of infrequently occurring transactions and events separately from other performance components.

4.22 Under Alternative B, there would be a requirement to identify and define a type of earnings component that is termed a remeasurement, which would isolate changes in the carrying amounts of existing assets and liabilities that are recognized in net income (for example, fair value gains and losses). These transactions or events may recur at each reporting period but do not recur in the same amount. Alternative B also may include a separate presentation of the items identified in Alternative A.

4.23 Under Alternative C, functional lines would be disaggregated into natural components. This alternative includes describing the characteristics of both natural and functional lines to separate a functional line into natural components. This approach potentially involves aspects of distinguishing both infrequently occurring items and remeasurements.

4.24 The current project on financial performance reporting primarily focuses on improvements to the structure and content of the income statement. The next topics on segment reporting, other comprehensive income, and cash flows are not the main focus of that project.

Topic-Specific Questions for Respondents—Income Statement

Question 4.1: Is income statement presentation a major financial reporting issue that the FASB should consider for improvement? Please explain why. In making your assessment, what criteria were used?

Question 4.2: How should the components of net income be categorized, if at all? If the FASB were to develop an operating activities category and display a subtotal for operating income, how should the category be defined or described?

Question 4.3: Could an operating activity category be defined or described consistently and effectively for all types of reporting entities (for example, entities involved in financial services, investing, banking, and financing)?

Question 4.4: How should the FASB evaluate the benefits of a standardized definition versus a management determination of an entity's operating activities?

Question 4.5: Which, if any, of the three alternatives described for combining or separating items provides more useful information to users of financial statements, and why?

Question 4.6: Are there other alternatives for presenting lines within the income statement that the FASB should consider?

Segment Reporting

Background and Relevant History

4.25 Segment reporting is another way of reporting an entity's performance and has been required for public entities since the issuance of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (Statement 14) in 1976. Many users found Statement 14 to be helpful but insufficient. After several consultation documents in the 1990s, the FASB issued FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (now codified into Topic 280, Segment Reporting) in 1997, which requires certain information to be disaggregated on the basis of its operating segments.

4.26 An operating segment is a component of a public entity (a) that engages in business activities from which it may earn revenues and incur expenses, (b) whose operating results are regularly reviewed by the public entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and to assess its performance, and (c) whose discrete financial information is available.

4.27 Once identified, operating segments may be combined into a reportable segment if certain aggregation criteria are met. Certain disclosures are required for each reportable segment if the information forms part of the segment profit or loss or is otherwise reviewed by the CODM. The segment disclosures are based on the amounts that the public entity uses internally, rather than on current GAAP measurement methods.

4.28 This method of segment identification and reporting is termed the management approach and results in segments being identified on the basis of the internal organization of an entity.

Previous Considerations by the FASB on Segment Reporting

4.29 Over the years, the FASB has considered making improvements to the segment reporting standard. In 2005, the FASB proposed additional guidance to clarify the aggregation criteria and the meaning of similar economic characteristics. Those proposals were not finalized because any additional guidance would not reduce the level of judgment required.

4.30 In the 2010 Staff Draft, the FASB proposed additional disclosures by segment, regardless of whether that information was prepared or reviewed by the CODM, such as operating profit or loss, operating assets, operating liabilities, and operating cash flows. Many users supported the proposal; however, preparers and practitioners commented that the additional disclosures contravened the management approach by requiring information that was not reported or reviewed by the CODM on a segmental basis. Those proposals were not finalized.

4.31 In 2012, the Financial Accounting Foundation completed its Post-Implementation Review (PIR) of Statement 131. The PIR report concluded that Statement 131 is effective, although some improvements could make the standard more operable. Advances in technology since Statement 131 was issued allow for the CODM to more easily review the operating results in a variety of formats. Consequently, it is often difficult to identify which discrete information set, among a range of financial information, should be used to identify the operating segments. After performing research on the PIR findings, the FASB agreed with the report's conclusion that Statement 131 is effective and decided that no further standard-setting action was needed.

Perceived Issues

Limited useful information by segment

4.32 Individual segment disclosures listed in Topic 280 are required to be displayed only if those items and amounts are included within the measure of segment profit or loss or otherwise are provided regularly to the CODM. This principle adheres to the management approach that segment disclosures should reflect management's view of the business.

4.33 While most users have said that it is important that segment information represents management's perspective of the organization, some noted that the management approach and the information package that is regularly reviewed by the CODM can be used to restrict the individual items that are disclosed by segment. Many users have said that the list of required disclosures is helpful but often is insufficient. Users would like more performance and balance sheet information by segment, and they place a unique significance on individual items such as gross margin, operating cash flows, and working capital balances by segment.

4.34 The total amounts reported by segment are required to be reconciled to the corresponding consolidated total for each balance sheet or income statement item reported by segment. In many cases, the reconciliations are displayed in a different schedule or format to the individual segment disclosures, which makes it difficult and time consuming for users to analyze the segment information holistically. Furthermore, there is no requirement in Topic 280 to explain how the consolidated totals relate to the individual lines in the financial statements. To reduce the cost of the analysis, some users have indicated that they would like the segment note to be reported with better contextual information that (a) displays within a single schedule the individual segments' disclosures that reconcile to the corresponding consolidated totals and (b) explains how the consolidated totals relate to individual lines on the primary statements.

Limited reportable segments

4.35 Individual operating segments may be combined to form a reportable segment if certain aggregation criteria are met. Implementing the aggregation criteria requires the use of judgment to test whether individual segments have similar (a) economic characteristics, (b) products and services, (c) production processes, (d) types of customers, (e) distribution methods, and (f) regulatory environment, if applicable.

4.36 Users are concerned that entities combine individual segments for which information would be useful if shown separately. The PIR report also commented that some entities may be aggregating segments to reduce transparency because of competitive harm concerns or to mask poor performing businesses. Many users would prefer that the aggregation criteria be made more rigorous and less judgmental, so as to require the display of additional reportable segments.

Limited consistency of segment information over longer periods of time

4.37 Reporting entities occasionally change their reportable segments and individual segment disclosures as a result of (a) changes to the structure of the internal organization, (b) changes to the information package that is reviewed regularly by the CODM, or (c) both. Topic 280 requires a restatement of segment data for earlier periods to reflect the revised segments, unless it is impracticable to do so. Many users have said that changing the composition of reportable segments and individual segment disclosures results in a loss of important trend data over longer time periods. Those users would prefer more consistency in segment information over longer periods of time.

Potential Standard-Setting Alternatives

Reconsider aspects of the Topic 280 Disclosure Requirements

4.38 There are three alternatives for additional disclosures by segment while adhering to the management approach. Under Alternative A, certain individual pieces of segment information that have unique significance to users would be added to the required segment disclosures and would be reported by segment if those items and amounts are reviewed regularly by the CODM, such as gross margin, operating cash flows, and working capital balances. However, if such items are not regularly reviewed by the CODM, those amounts would not form part of the required segment disclosures. Under Alternative A, conforming changes could be made to the segment disclosures on the same basis as any income statement changes (discussed in paragraphs 4.15–4.24). For example, if functional lines are disaggregated into natural components, then the disclosures in Topic 280 could be amended to require disaggregation of segment functional amounts into natural components if those items are reviewed regularly by the CODM.

4.39 Under Alternative B, additional disclosures would be added by segment, as discussed in Alternative A, and those disclosures would be reported in a single structured table. To better enable users to (a) analyze how the segment totals reconcile to consolidated totals and (b) understand how consolidated totals relate to the lines on the primary statements, Topic 280 would be amended under Alternative B to require a structured table that reconciles segment totals to consolidated totals and require a narrative description of the line captions on the financial statements where those consolidated amounts are located. Individual segment amounts would be disclosed in the table only if that information is regularly reviewed by the CODM. Information that is not regularly reviewed by the CODM would be reported as nil amounts in the table. Under Alternative B, the management approach would be maintained because segment amounts are disclosed if that information is regularly reviewed by the CODM, although the segment disclosures and reconciliations would be reported in a structured format. Page 66 (see Appendix B—Segments: Alternative B) provides an illustrative example of Alternative B.

4.40 Under Alternative C, segment disclosures and reconciliations would be reported in a structured table. However, this alternative would base the individual segment disclosures on management's perspective of how the lines from the income statement and the asset and liabilities from the balance sheet are managed and reviewed at a segmental level. In place of the list of required segment disclosures in Topic 280, under Alternative C, the Topic would be amended to introduce a disclosure principle that requires the reporting of segment items and amounts on the basis of the lines presented in the consolidated income statement and the assets and liabilities in the consolidated balance sheet. The segment disclosures would use the same captions as the financial statements and would display segment information that is regularly reviewed by the CODM on the basis of how it relates to the lines in the financial statements. Individual segment amounts would be disclosed in the table if that information is regularly reviewed by the CODM. Information that is not regularly reviewed by the CODM would be reported as nil amounts in the table. Under Alternative C, the management approach would be maintained because segment amounts are based on the information reviewed by the CODM, although it displays that segment information in context of how the amounts relate to the lines and captions from the income statement and the assets and liabilities from the balance sheet. Page 67 (see Appendix C—Segments: Alternative C) provides an illustrative example of Alternative C.

Reexamine the aggregation criteria

4.41 The aggregation criteria could be reexamined to introduce greater standardization. The criteria for similar economic characteristics could be clarified to emphasize the financial attributes of two segments. Quantitative thresholds (that is, bright lines) could be introduced to clarify when individual segments can be aggregated. Additional aggregation tests also could be introduced into the criteria.

Apply the segment reporting standard from a governance perspective

4.42 The management approach identifies segments using the perspective of an entity's business activities through the eyes of management. Within the management hierarchy, segments are identified from the CODM level and from the package of financial information that is reviewed regularly by the CODM. Advances in technology have improved the access to a variety of financial information at highly refined levels of detail, which has made it harder to determine which package of financial information is being reviewed regularly by the CODM. If this occurs, Topic 280 states that other factors, such as information presented to the board of directors, may assist the entity in deciding which package constitutes the entity's operating segments.

4.43 Some stakeholders have said that advances in technology and the changes to the package of financial information contribute to changes in the composition of operating segments over time. A more consistent package of financial information may be reported to the board of directors or trustees. In place of the CODM perspective, segments could be identified from the level of the governing body, such as the board of directors or trustees and the package of financial information that is reviewed regularly by that governance group. This package of financial information also may improve the understanding of how the governance body views the business activities. However, a governance perspective may potentially result in less segment information than a CODM perspective because segments would be identified from a higher level within the entity's hierarchy.

Topic-Specific Questions for Respondents—Segment Reporting

Question 4.7: Is segment disclosure a major financial reporting issue that the FASB should consider for improvement? In making your assessment, what criteria were used?

Question 4.8: Considering the three alternatives described for improving aspects of the Topic 280 disclosure requirements, which, if any, alternative provides more useful information to the users of financial statements and why?

Question 4.9: Would the described improvements to (a) reexamine the aggregation criteria and (b) apply the segment standard from a governance perspective provide more useful information to users of financial statements and why?

Question 4.10: Are there other alternatives for improving segment reporting that the FASB should consider? If so, please provide them in detail to help the FASB in considering your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

Other Comprehensive Income

Background and Relevant History

4.44 As discussed in paragraph 4.2, the performance statement represents, and sums to, an entity's total comprehensive income for a reporting period. Comprehensive income can be reported as either a single continuous statement that presents two categories (that is, net income and other comprehensive income) or two separate but consecutive statements (for the income statement, see paragraphs 4.4–4.24).

4.45 All revenues, expenses, gains, and losses are recognized in net income, except for items classified in other comprehensive income. Paragraph 220-

10-45-10A of the Accounting Standards Codification contains the complete list of items in other comprehensive income.

4.46 The individual components of other comprehensive income for a period are transferred to their separate corresponding components of equity. These separate equity balances are commonly referred to as accumulated other comprehensive income. An entity is to report on the face of the financial statements or in the notes the changes in the accumulated balances for each component of other comprehensive income.

Why Certain Components of an Entity's Performance Are Classified in Other Comprehensive Income

4.47 The decision to classify a certain component in other comprehensive income often is the result of complex circumstances. The following three examples illustrate this further.

4.48 Foreign currency translation. Foreign currency translation adjustments are classified in other comprehensive income because the FASB considers translation adjustments to be unrealized amounts that have no effect on the net cash flows generated by the foreign entity and, therefore, should be reported separately from net income. The translation adjustment is merely a mechanical by-product of the translation and consolidation process. Reclassification adjustments occur if there is a sale and complete or substantially complete liquidation of the related foreign investment.

4.49 Cash flow hedges. Gains and losses on derivative instruments that are designated and qualify as cash flow hedges are classified in other comprehensive income because without a special classification, the gains and losses would be reported in net income in a period that was different from when the effect of the hedged transaction occurred. This would have been contrary to the objective of entering into a cash flow hedge. The gains and losses are reclassified out of accumulated other comprehensive income and into net income when the forecasted hedged transaction affects net income.

4.50 Pensions or other postretirement benefits. Gains and losses associated with both (a) pension or other postretirement benefits (that are not immediately recognized as a component of net periodic benefit cost) and (b) prior service costs and credits are classified in other comprehensive income because the FASB requires entities to recognize the overfunded or underfunded status of their defined benefit plans within the financial statements of the sponsoring entity. This means that (a) previously unrecognized gains and losses and (b) previously unrecognized prior service costs and credits are now required to be recognized. To mitigate stakeholder concerns about the volatility being included in net income, the

FASB decided to classify these items in other comprehensive income. Reclassification adjustments occur if both the gains and losses and the prior service costs are subsequently recognized as a component of net periodic benefit cost on the basis of the recognition or amortization requirements of Topic 715.

Reclassification Adjustments

4.51 Items classified in other comprehensive income reflect the gains and losses associated with the economic phenomena being recognized. However, those gains and losses are required to be reclassified out of accumulated other comprehensive income and recognized within net income if certain transactions or events occur. Reclassifying amounts to net income is sometimes called recycling.

4.52 Amendments issued in 2011 and 2013 include requirements to provide greater transparency of the effect of reclassification adjustments within net income. If an entity presents reclassifications on the face of the financial statements, the effect of those items should be reported parenthetically with respect to each line of net income affected by the reclassification. An entity also may choose to display this information in the notes.

4.53 Reclassification adjustments occur because current GAAP has a notion that all gains and losses recognized in accumulated other comprehensive income should eventually be recognized in net income at some point in time. However, there is no concept within the Conceptual Framework that supports this notion, and there is no conceptual basis for classifying items in other comprehensive income in the first instance.

IFRS—Similarities and Differences

4.54 IFRS requires total comprehensive income and its components to be reported either in a single continuous financial statement or in two separate consecutive statements. Many of the requirements to report the effect of reclassification adjustments are similar between current GAAP and IFRS because the 2011 amendments were part of a joint project. However, two important differences remain.

4.55 First, certain balances in accumulated other comprehensive income are not reclassified to profit and loss under IFRS. Instead, those components stay within equity. Remeasurements of the net defined postretirement benefit liability (asset) is one such component that does not reclassify into profit and loss. This difference means that, unlike current GAAP, there is no equivalent notion in IFRS that assumes that all components of accumulated other comprehensive income should be reclassified eventually to net income over time.

4.56 Second, while under current GAAP and IFRS many of the components classified in other comprehensive income are similar, there are remaining differences between the two sets of standards.

Perceived Issues

Difficulty understanding what other comprehensive income means in terms of an entity's performance

4.57 Some stakeholders have said that the issue with other comprehensive income is that it is difficult to understand what these components mean in terms of an entity's performance for a reporting period. There is no conceptual basis for why these performance components are classified outside net income, and there is a lack of consistency in this classification treatment compared with other similar items recognized in net income. Performance metrics, such as earnings per share, exclude the effect of other comprehensive income, and these components commonly are presented on a separate statement from net income. This implies that the items in other comprehensive income have a different relevance for performance evaluation.

Difficulty understanding what certain reclassified amounts mean in terms of an entity's performance

4.58 Other stakeholders (in particular, academics) have said that the issue with other comprehensive income is that current GAAP requires all components of accumulated other comprehensive income to eventually be reclassified to net income at some point in time. Those stakeholders are less troubled that items are initially recognized in other comprehensive income, but they are concerned that reclassification adjustments are difficult to understand, at least in concept.

4.59 Reclassification adjustments mean that the components classified in accumulated other comprehensive income affect the entity's performance twice—first, when the transaction or event is initially recognized in other comprehensive income and, second, when the transaction or event is subsequently reclassified within net income. A common reason for a reclassification adjustment to net income is a result of a realization event. This selectively introduces a concept of realization into performance reporting when performance is more generally recognized through accrual accounting.

Potential Standard-Setting Alternatives

Minimize the use of reclassification adjustments

4.60 The notion that all components of accumulated other comprehensive income should be reclassified into net income at some point could be reexamined. There are two potential approaches.

4.61 Under Alternative A, the FASB would research and analyze the bases for triggering a reclassification adjustment to evaluate whether some of these bases could be rationalized. The research would then compare the analysis with the current items recognized in other comprehensive income. For some components, reclassification adjustments may provide relevant information, such as gains and losses on cash flow hedges. For other components, the use of reclassifications to net income could be minimized.

4.62 Under Alternative B, the FASB also would research and analyze the different bases for triggering a reclassification adjustment; however, that analysis would not be compared with all items currently classified in other comprehensive income. Rather, the analysis would review the basis for reclassification adjustments on a project-by-project basis when standards-level improvements are undertaken.

Remove the option for presenting comprehensive income over two statements

4.63 Over the years, the FASB has considered requiring a single performance statement to remove the option for presenting total comprehensive income over two separate but consecutive statements. Those proposals were not finalized. The FASB could consider this alternative again to require a single statement of comprehensive income. The total for net income and total comprehensive income would continue to be displayed with the effect of reclassification adjustments being shown parenthetically next to each affected line in net income. The purpose of presenting a single performance statement would be to improve cognition of the items classified in other comprehensive income and to improve the relevance of total comprehensive income as a performance measure.

Emphasize other earnings-per-share measures

4.64 Additional earnings-per-share calculations could be established to emphasize total comprehensive income or other measures of earnings, rather than relying on the net-income-per-share measure. The earnings-per-share metric could be retained, and an additional per-share metric would be required, such as total comprehensive income per share.

4.65 Changes to the income statement to categorize that statement into operating and nonoperating activities (see paragraphs 4.4–4.24) also could result in conforming changes to the earnings-per-share guidance to introduce an operating-income-per-share measure.

Topic-Specific Questions for Respondents—Other Comprehensive Income

Question 4.11: Is the presentation of other comprehensive income a major financial reporting issue that the FASB should consider for improvement? In making your assessment, what criteria were used?

Question 4.12: Considering the two alternatives described for minimizing the use of reclassification adjustments, which alternative provides more useful information to the users of financial statements and why?

Question 4.13: Do the described improvements to (a) remove the option for presenting comprehensive income over two statements and (b) emphasize other earnings per share measures improve the relevance of the performance information included in other comprehensive income?

Question 4.14: Are there other alternatives for improving the relevance of other comprehensive income that the FASB should consider? If so, please describe them in detail to help the FASB in considering your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

Statement of Cash Flows

Background and Relevant History

4.66 The main provisions for presentation of cash flows originate from FASB Statement No. 95, *Statement of Cash Flows*, which was issued in 1987 (now codified in Topic 230, Statement of Cash Flows). The guidance requires information about cash receipts and cash payments of an entity to be classified according to whether they are associated with operating, investing, or financing activities.

4.67 Classification of individual cash flows is based on the separate definitions of operating activities, investing activities, and financing activities and also is based on specific requirements within Topic 230 for certain types of cash flows.

4.68 The separate definitions are fundamental to how classification decisions are made by an entity. For example, *Operating Activities* is defined in the Master Glossary of the Accounting Standards Codification as follows:

> Operating activities include all transactions and other events that are not defined as investing or financing activities (see paragraphs 230-10-45-12 through 45-15). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

4.69 This definition generally means that cash flows from operating activities are the residual classification category after the investing and financing cash flows first are determined.

4.70 Two presentation methods are permitted when reporting the cash flows from operating activities. The direct method reports major classes of operating cash receipts and payments, such as cash received from customers and cash paid to suppliers, respectively. Alternatively, the indirect method displays a reconciliation of net income and reports major classes of noncash earnings, deferrals of past and accruals of future operating cash receipts and payments, including changes in receivables, and inventory and payables that pertain to operating activities.

Previous and Current Considerations by the FASB on the Statement of Cash Flows

4.71 The FASB has considered making improvements to the presentation and classification of cash flows over the years. In the 2010 Staff Draft, the FASB proposed defining operating, investing, and financing activities similarly across the income statement, cash flow statement, and balance sheet and classifying the elements and cash flows consistently across the three statements. Additional proposals also included mandating the use of the direct method for presenting operating cash flows. Those proposals were not finalized.

4.72 More recently, in 2016, the FASB's Emerging Issues Task Force has considered improving guidance on classification for nine specific cash flow issues, and the FASB issued proposed Updates on these matters. This effort aims to improve the comparability in classifying certain types of cash flows.

Perceived Issues

Preference for greater disaggregation of cash flow statement information

4.73 Some stakeholders have said that the issue with the statement of cash flows is that the level of detail with which entities report individual lines varies. Some entities report changes in working capital in considerable levels of detail, while other entities report the changes in only a few lines. Many users would like the cash payments to acquire property, plant, and equipment and other productive assets to be disaggregated (for example, into maintenance expenditure and expansionary expenditure). Many stakeholders have noted that greater disaggregation of cash flows would contribute to improving comparability across entities.

The principles differentiating operating, investing, and financing activities are not intuitive

4.74 Many preparers have expressed concern that the definitions of operating, investing, and financing activities are not intuitive for certain types of cash flows, which results in classification errors. Topic 230 contains limited guidance on how to classify specific cash flows, and preparers rely on the separate definitions to make classification decisions. Because cash flows from operating activities are considered to be the residual category, classification decisions do not necessarily result in intuitive outcomes.

4.75 There are several views on the nature of these concerns.

Acknowledge the Limitations but Promote Greater Comparability

4.76 Some stakeholders have acknowledged the limitations of the cash flow statement and have recognized that the categorization may not always result in intuitive classification decisions; nevertheless, the definitions provide comparability across entities. Those stakeholders would prefer to maintain the current three-category structure, and the statement of cash flows would be made even more comparable through additional guidance on the reporting of specific types of cash flows.

Acknowledge the Limitations but Promote Greater Relevance

4.77 Other stakeholders have said that the principles and the definitions should be made clearer to provide more relevant cash flow information. These stakeholders have said that, when viewed as a whole, the statement of cash flows does not provide meaningful information.

4.78 Of these stakeholders, some would prefer that the statement be restructured to present cash flow information that reflects how the entity internally evaluates its cash flows. Because cash management processes are usually entity specific, this outcome could involve different cash flow statement categories than those that are currently required today.

4.79 Other stakeholders would promote a standardized statement of cash flows and prefer to improve upon the current definitions, content, and structure.

These stakeholders would redefine the cash flow definitions of operating, investing, and financing activities and potentially establish a fourth residual category. Some have said that if the FASB establishes an operating activities category in the income statement (see paragraphs 4.15–4.19), that definition or description should be considered when redefining operating activities for the cash flow statement such that the two statements would have the same meaning of operating activities. Other proponents are skeptical that the operating activities category can be aligned across the income and cash flow statements and would prioritize making improvements to the separate cash flow definitions without seeking to further broaden any improvements.

Acknowledge the Limitations but Focus on Greater Line-by-Line Interrelationship with the Income Statement

4.80 Some stakeholders have acknowledged that the principles differentiating operating, investing, and financing activities are not always intuitive. These stakeholders would focus on the line-by-line interrelationship between the income statement and the cash flow statement rather than focus on the three category definitions. The Conceptual Framework states that the individual financial statements, by their nature, complement each other and reflect different aspects of the same transactions or events affecting the entity. To facilitate those relationships, the associations between the statements could be made more apparent. For some stakeholders, this concept could be used to display the cash receipts and payments in a way that is consistent with the structure, captions, and lines used in the income statement. For example, “cost of goods sold” in the income statement could have related lines and captions in the cash flow statement for “payments for goods to be sold.”

Potential Standard-Setting Alternatives

Targeted improvements to provide greater disaggregation of specific cash flows

4.81 Assuming the current three-category definitions are retained, targeted improvements could be pursued to disaggregate certain types of cash flows and line items. Research would consider whether cash flows from operating activities could disaggregate individual working capital changes reported under the indirect method. Research also could consider whether cash payments for capital expenditure could be disaggregated into maintenance expenditure and expansionary expenditures.

Provide additional classification guidance for certain types of cash flows

4.82 Also assuming the current three-category definitions are retained, additional classification guidance could be provided for specific types of cash flows, much like the current Emerging Issues Task Force project, to improve comparability. This solution would not address concerns that the definitions are not intuitive, but it would seek to make classification decisions more comparable across entities.

Reconsider the definitions of each classification category and the three-category structure

4.83 A broad project could be undertaken to reconsider the current definitions and the three-category structure. Such a project would reconsider the guidance in Topic 230 on operating, investing, and financing categories. If operating activities are no longer defined as the residual category, the cash flow statement may require a different categorical structure. There are three primary alternatives for this project.

4.84 Under Alternative A, a reporting entity would be required to prepare a standardized cash flow statement with defined categories. While there are many variations within this approach, a likely starting point would define operating activities directly rather than residually and would establish a fourth residual category. An important aspect of this approach would be providing application guidance to clarify the order or precedence in which the cash receipts and payments should be classified; for example, cash flows from operating activities would be classified first, after which the remaining cash flows would be classified within investing, financing, or residual activities.

4.85 Under Alternative B, a reporting entity would not be required to prepare a standardized and categorical cash flow statement. Rather, the classification and presentation of cash receipts and payments would be representative of how an entity internally evaluates its cash flows. There would be a requirement to reconcile opening to closing cash and cash equivalents on a consolidated basis, but individual cash receipts and payments would be communicated and categorized on the basis of how an entity internally evaluates its cash flows. The categories and the separate cash flows may differ across entities. Application guidance would clarify when cash payments and receipts should be separated and displayed.

4.86 Under Alternative C, the FASB would require the cash flow statement to be structured to focus foremost on a line-by-line interrelationship with the income statement to display the cash effects of the various income statement lines. This approach would separate cash payments and cash receipts on the basis of the linkage to the respective income statement caption to improve the way that associated financial information is displayed. Application guidance would assist in clarifying how to (a) display the cash flows of transactions that do not have an income statement effect, such as investment and finance transactions, and (b) associate income statement lines to the cash flow statement if there is no cash payment or receipt, such as impairment or amortization. An open question is whether this approach also should have a secondary focus area to categorize the cash flow statement on the same basis as the income statement (for example, into operating and nonoperating activities).

Topic-Specific Questions for Respondents—Cash Flow Statement

Question 4.15: Is the presentation of cash flows a major financial reporting issue that the FASB should consider for improvement? In making your assessment, what criteria were used?

Question 4.16: Do you recommend that the FASB retain or reconsider the three-category structure and the definitions of operating, investing, and financing activities within the statement of cash flows?

If the FASB *Maintains the Current Three-Category Structure and Definitions:*

Question 4.17: What specific cash flows should be disaggregated in the future that are not being disaggregated today and is that disaggregation feasible?

Question 4.18: What specific cash payments and receipts are in need of additional classification guidance?

If the FASB *Reconsiders the Current Three-Category Structure and Definitions:*

Question 4.19: How should the cash flow statement be categorized, if at all? Considering the three alternatives that would reconsider the current structure of the cash flow statement, which, if any, alternative provides more useful information to users of financial statements and why? How should the FASB define or describe those categories?

Question 4.20: How should the FASB evaluate the benefits of a standardized structure versus a management determination to classification of cash flows?

Question 4.21: If you prioritize a standardized structure and recommend an operating activities category, how should the Board evaluate the benefits of aligning the description or definition of that category across the income and cash flow statements?

Question 4.22: Are there other alternatives for improving the cash flow statement that the FASB should consider? If so, please describe in detail to help the FASB in considering your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

Potential Paths Forward—Addressing the Reporting of Performance and Cash Flow Information

4.87 Projects on performance and cash flow reporting, in general, are one of three different types—narrow, broad, or holistic. Narrow projects are useful in making incremental or phased improvements and can be undertaken gradually over time; however, narrow projects may be unable to address fundamental issues. Broad projects are useful when considering wide-ranging changes to current GAAP. However, they take longer to complete and may be unable to address issues when there are interrelationships between different performance reporting topics. Holistic projects address issues in a far-reaching manner. However, the improvements can be so substantial that the cost and complexity of those changes can hamper the ability to finalize the proposals.

4.88 The current research project on financial performance reporting is a broad project that is primarily focused on the income statement and, in particular, on how to (a) structure the performance information within net income into operating and nonoperating activities and (b) combine or separate earnings components into lines. That project also may consider making conforming improvements to segment reporting and other statements on the basis of the changes to the income statement. This ITC provides an opportunity to reconsider the scope of the current research project on financial performance reporting, decide whether to add additional technical projects, and consider when those projects are undertaken. Accordingly, respondents should provide feedback on the importance of the issues and solutions identified throughout this chapter and the type of projects the FASB should prioritize.

4.89 The perceived issues and potential alternatives discussed throughout this chapter could be prioritized and addressed together or incrementally. Not all issues and solutions need to be included in a project, and not all projects may be addressed together. Some issues could be addressed sequentially, contemporaneously, or not at all.

4.90 Different combinations of the issues and solutions can be assembled into a project. The following alignment is merely one way of doing so, although there are many ways that this can be undertaken. For ease of reference, the headings used to describe the potential solutions from each of the above topic areas are repeated here.

Narrow Projects

a. Segment reporting, including (1) reconsidering aspects of the Topic 280 disclosure requirements, (2) reexamining the aggregation criteria, and (3) applying the segment reporting standard from a governance perspective
b. Other comprehensive income, including (1) minimizing the use of reclassification adjustments, (2) removing the option for presenting total comprehensive income over two statements, and (3) emphasizing other earnings-per-share measures
c. Statement of cash flows, including (1) making targeted improvements to provide greater disaggregation of specific cash flows and (2) providing additional classification guidance for certain types of cash flows.

Broad Projects

d. Income statement, including (1) categorizing the income statement into operating and nonoperating activities and (2) combining or separating earnings components and presenting discrete lines
e. Statement of cash flows, including reconsidering the definitions and each classification category and the three category structure.

Holistic Project

f. A project that unifies one or more of the broad projects with other narrow or broad projects.

Topic Specific Questions for Respondents—Paths Forward

Question 4.23: What type of project or projects do you recommend that the FASB prioritize to improve the reporting of performance and cash flow information? If you recommend multiple projects or different combinations, please explain the recommended sequencing of those projects.

Question 4.24: What issues and solutions should be addressed within those projects? Please consider the priority of pursuing the issues and solutions.

Appendix A—List of Active Projects (as of August 2016)

Category	Project
Framework Projects	Conceptual Framework: Measurement
	Conceptual Framework: Presentation
	Disclosure Framework: Disclosure Review—Defined Benefit Plans
	Disclosure Framework: Disclosure Review—Inventory
	Disclosure Framework: Disclosure Review—Income Taxes
	Disclosure Framework: Disclosure Review—Fair Value Measurement
	Disclosure Framework: Disclosure Review—Interim Reporting
	Disclosure Framework: Board's Decision Process
	Disclosure Framework: Entity's Decision Process
Recognition & Measurement: Broad Projects	Accounting for Financial Instruments—Hedging
	Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts
Recognition & Measurement: Narrow Projects	Business Combinations: Clarifying the Definition of a Business (Phase 1)
	Business Combinations: Clarifying the Scope of Subtopic 610-20 and Accounting for Partial Sales of Nonfinancial Assets (formerly Clarifying the Definition of a Business (Phase 2))
	Business Combinations: Accounting for Goodwill Impairment
	Business Combinations: Subsequent Accounting for Goodwill for Public Business Entities & Not-for-Profit Entities
	Business Combinations: Accounting for Identifiable Intangible Assets in a Business Combination for Public Business Entities & Not-for-Profit Entities
	Consolidation: Interests Held through Related Parties That Are under Common Control
	Clarifying When a Not-for-Profit Entity That Is a General Partner Should Consolidate a For-Profit Limited Partnership (or Similar Entity)
	Accounting for Income Taxes: Intra-Entity Asset Transfers
	Liabilities and Equity—Targeted Improvements

Category	Project
	Nonemployee Share-Based Payment Accounting Improvements
	Revenue Recognition of Grants & Contracts by Not-for-Profit Entities
	Technical Corrections and Improvements to Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*
	Technical Corrections and Improvements (2016)
Presentation & Disclosure Projects	EITF Issue No. 15-F, “Statement of Cash Flows: Classification of Certain Cash Receipts & Cash Payments”
	EITF Issue No. 16-A, “Restricted Cash”
	EITF Issue No. 16-B, “Employee Benefit Plan Master Trust Reporting”
	Disclosures by Business Entities about Government Assistance
	Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost
	Accounting for Interest Income Associated with the Purchase of Callable Debt Securities
	Not-for-Profit Financial Reporting: Financial Statements (Phase 1 & 2)
	Simplifying the Balance Sheet Classification of Debt

Alternative B: Illustrative Table Based on Existing Topic 280, Segment Reporting, Disclosures XYZ Company, Inc.

Note: Supplemental segment items in the illustration below, such as gross margin, working capital, and cash flow from operating activities, are not currently required by Topic 280 but could be required in the future.

	Segment Information							
	Reportable Segment A	Reportable Segment B	Other Segments (a)	Total of Segments	Amounts Not Allocated to Segments (b) (c) (d)	Elimination of Intersegment Amounts	Entity-Wide Total	Financial Statement Caption
Information about Segment Profit								
Revenues from external customers	$ 17,500	$ 17,000	$ 1,000	$ 35,500				
Intersegment revenues	3,000	1,500	-	4,500				
Segment revenues	20,500	18,500	1,000	40,000	$ -	$ (4,500)	$ 35,500	Revenue
Interest expense	-	-	-	-	850	-	850	Interest expense
Interest income	400	500	-	900	75	-	975	Interest income
Depreciation and amortization	350	2,600	-	2,950	425	-	3,375	Costs of goods sold, SG&A
Segment profit	1,470	2,500	100	4,070	200	(1,200)	3,070	Income before income taxes
Other significant noncash items:								
Cost in excess of billings on long-term contracts	200	-	-	200	-	-	200	SG&A
Goodwill impairment	500	-	25	525	-	-	525	Goodwill impairment
Information about Assets and Capital Expenditures								
Segment assets	11,450	39,900	1,850	53,200	66,800	(2,000)	118,000	Total assets
Capital expenditures	-	-	-	-	3,900	-	3,900	Capital expenditures
Supplemental Segment Information								
Gross margin	7,180	4,420	300	11,900	(425)	(2,475)	9,000	Gross margin
Working capital	1,800	4,350	50	6,200	3,600	(3,000)	6,800	N/A
Cash flow from operating activities	-	-	-	-	5,500	-	5,500	Cash flow from operating activities

Reconciliation and Segment Notes

(a) Other segments include a small real estate business, a warehouse leasing operation, an electronics equipment rental business, and a software consulting practice.

(b) Certain income statement amounts are not allocated to reportable segments and are reviewed by the CODM at the consolidated level. The following amounts are not allocated to reportable segments: $850 related to interest expense, $75 related to interest income, and $425 related to cost of goods sold for depreciation and amortization.

(c) Certain assets, liabilities, and capital expenditures are not allocated to reportable segments and are managed at the consolidated level. Unallocated amounts include $66,800 in assets and $3,900 in capital expenditures.

(d) Certain supplemental segment information amounts are not allocated to reportable segments because they relate to assets and liabilities that are managed at the consolidated level. The following amounts are not allocated to reportable segments: $425 related to cost of goods sold for depreciation and amortization, $3,600 in working capital, and $5,500 in cash flow from operating activities.

Appendix C—Segments: Alternative C

Alternative C: Illustrative Table Based on Captions in the Consolidated Income Statement and Balance Sheet XYZ Company, Inc.

Note: This illustration was developed with the following assumptions: (1) only income statement and asset and liability lines and captions are required to be displayed on a segment basis, (2) only subtotals for total assets and total liabilities from the consolidated balance sheet are displayed on a segment basis, and (3) supplemental information for segment items such as capital expenditures, depreciation, and amortization may also be provided under this alternative.

				Segment Information			
	Consolidated Total	Amounts Not Allocated to Segments (a) (b) (c)	Elimination of Intersegment Amounts	Total of Segments	Reportable Segment A	Reportable Segment B	Other Segments (d)
Income Statement							
Revenue	$ 35,500	$ -	$ 4,500	$ 40,000	$ 20,500	$ 18,500	$ 1,000
Cost of goods sold	26,500	(425)	2,025	28,100	13,320	14,080	700
Selling, general, and administrative	7,030	500	1,275	8,805	5,610	3,020	175
Goodwill impairment	525	-	-	525	500	-	25
Interest expense	850	(850)	-	-	-	-	-
Interest income	975	(75)	-	900	400	500	-
Other income, net	1,500	(900)	-	600	-	600	-
Income before income taxes	3,070	(200)	1,200	4,070	1,470	2,500	100
Income tax expense	750	(750)	-	-	-	-	-
Net income	2,320	550	1,200	4,070	1,470	2,500	100
Information about Assets and Liabilities							
Cash and cash equivalents	15,050	(14,000)	-	1,050	300	550	200
Available-for-sale investment securities	4,250	(4,250)	-	-	-	-	-
Accounts receivable	17,100	(16,050)	2,000	3,050	1,300	1,650	100
Inventories	16,850	(5,000)	-	11,850	2,200	9,200	450
Prepaid expenses and other current assets	11,750	(8,500)	-	3,250	700	2,350	200
Property, plant, and equipment, net	31,000	(4,000)	-	27,000	3,500	23,000	500
Goodwill	5,000	(2,500)	-	2,500	2,400	-	100
Trademarks and other intangible assets	9,500	(7,500)	-	2,000	600	1,300	100
Deferred tax assets	4,500	(4,500)	-	-	-	-	-
Other assets	3,000	(500)	-	2,500	450	1,850	200
Total assets	118,000	(66,800)	2,000	53,200	11,450	39,900	1,850
Accounts payable	30,600	(22,000)	(1,000)	7,600	1,450	5,750	400
Accrued and other liabilities	22,400	(17,000)	-	5,400	1,250	3,650	500
Debt due within one year	5,200	(5,200)	-	-	-	-	-
Long-term debt	12,200	(12,200)	-	-	-	-	-
Deferred tax liabilities	7,300	(7,300)	-	-	-	-	-
Other noncurrent liabilities	10,300	(10,300)	-	-	-	-	-
Total liabilities	88,000	(74,000)	(1,000)	13,000	2,700	9,400	900
Supplemental Segment Information							
Capital expenditures	3,900	(3,900)	-	-	-	-	-
Depreciation and amortization	3,375	(425)	-	2,950	350	2,600	-

Reconciliation and Segment Notes

(a) Certain income statement amounts are not allocated to reportable segments and relate to amounts that are managed at a consolidated level. The following amounts are not allocated to reportable segments: $425 related to cost of goods sold for depreciation and amortization, $500 related to selling, general, and administrative expenses comprising a net of (i) $750 for litigation settlement received and (ii) $250 for a measurement adjustment to pension expense, $850 related to interest expense, $75 related to interest income, and $900 related to other income for lease rentals.

(b) Certain assets and liabilities are not allocated reportable segments and are managed at the consolidated level. Unallocated assets and liabilities are managed through the corporate headquarters.

(c) Certain supplemental segment information amounts are not allocated to reportable segments and are managed at the consolidated level. The following amounts are not allocated to reportable segments: $3,900 in capital expenditures and $425 for depreciation and amortization.

(d) Other segments include a small real estate business, a warehouse leasing operation, an electronics equipment rental business, and a software consulting practice.