AMERICAN ACCOUNTING ASSOCIATION

5717 Bessie Drive • Sarasota, FL 34233-2399 • Phone: (941) 921-7747 • Fax (941) 923-4093
Email: Office@aaahq.org • http://AAAhq.org

April 14, 2009

LETTER OF COMMENT NO. 133

Financial Accounting and Reporting Section of the American Accounting Association

Financial Reporting Policy Committee

File Reference No. 1630-100
Response to the Preliminary Views on Financial Statement Presentation

Patrick E. Hopkins, Chair; Mark Bradshaw (principal co-author); Carolyn Callahan; Jack Ciesielski; Elizabeth Gordon, Mark Kohlbeck; Leslie Hodder; Robert Laux; Sarah McVay (principal co-author); Thomas Stober; Phillip Stocken; and Teri Lombardi Yohn.

The Financial Reporting Policy Committee ("Committee") of the Financial Accounting and Reporting Section of the American Accounting Association ("AAA") is charged with responding to discussion papers and exposure drafts related to financial accounting and reporting issues.[1] The Committee is pleased to respond to the *Preliminary Views on Financial Statement Presentation* issued jointly by the Financial Accounting Standards Board and the International Accounting Standards Board ("Boards"). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association or the Financial Accounting and Reporting Section of the American Accounting Association.

In the *Preliminary Views*, the Boards pose 27 questions about the proposed changes. This document contains a summary response by the Committee that is most applicable to seven of these questions: 1, 3, 5, 9, 16, 23, and 26. Rather than respond to each question separately, we discuss the issues generally drawing on prior research, with particular emphasis on empirical evidence and relevant theories from academic research.

---

[1] The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

The Boards' goal is to improve the usefulness of the information provided in an entity's financial statements to help users make decisions in their capacity as capital providers. We first discuss how the expanded disclosure is expected to affect an investor's ability to forecast future cash flows based on academic research (Question 1). We next discuss the cost/benefit tradeoff of the management presentation approach and related issues (Questions 5, 16 and 26). Finally, we offer several miscellaneous comments and suggestions regarding the presentation and categorization of certain elements within the financial statements (Questions 2, 9, 23).

OVERVIEW OF COMMITTEE'S CONCLUSIONS

The perspective taken in the *Preliminary Views* is to provide improved presentation of financial information to users of financial statements, with a clear emphasis on providers of capital (i.e., debt and equity investors).[2] The *Preliminary Views* enumerate three objectives of the proposal:

i. Financial statements provide a cohesive financial picture of activities;

ii. Information is disaggregated to assist in the prediction of future cash flows; and

iii. Financial statements should help users assess a firm's liquidity and financial flexibility.

The Committee agrees that the objective of providing a cohesive picture of activities through a standardization of activity/function/nature categories (i.e., business, financing, income taxes, discontinued operations, and equity) is desirable, but the rigidity of this restriction results in potentially aberrant or confusing outcomes (e.g., treatment of cash and tax items, segregation

[2] The Board acknowledges that there are other users that might potentially benefit, but the emphasis is clearly on users that provide capital.

of equity itself, etc.). The objective of disaggregating financial information also has the potential to improve investors and creditors judgments and decisions. However, disaggregation will enhance the decision usefulness of financial information only if the managerial approach (i.e., the basis for such disclosures) proves to be effective. The Committee acknowledges that the managerial approach has potential to be more informative than a standardized approach, but only if it encourages managers to provide the granularity presumed in the Illustrations in the *Preliminary Views*.

The objective of providing users with information that enables an assessment of the liquidity needs and financial flexibility of an entity is also commendable. However, with the current proposal the Boards appear to be bordering on the fine line between decision usefulness and excessive information complexity. Moreover, we get the sense that various aspects of the proposed presentation format seem focused on reporting cash flows rather than accrual earnings. Whether this objective is a reaction to recent financial reporting failures or incorporates user feedback that predated these failures, the seemingly elevated importance of reported cash flows relative to earnings conflicts with over four decades of academic research (e.g., Ball and Brown 1968, Kormendi and Lipe 1987, Easton and Harris 1991, Dechow 1994, Barth, Elliott and Finn 1999, etc.).

There is little doubt that the proposed changes to financial statement presentation represent a radical, exogenous shock to the extant structure of financial statements. The ability of preparers to formulate information in the required formats and users to process this information is of heightened importance relative to the typical, incremental, topically focused changes in financial reporting standards. Thus, the Committee is highly interested in the outcomes of both the field test being conducted by the Joint International Group and Financial

Institutions Advisory Group and studies by the Financial Accounting Standards Research Initiative. These efforts should provide insight into the abilities of both preparers and users to work effectively within (and benefit from) the scope of the proposed change in financial reporting presentation.

BENEFITS OF A PRESENTATION MODEL THAT PARITIONS FINANCIAL STATEMENTS INTO BUSINESS AND FINANCING ACTIVITIES

All of the proposed changes to financial reporting presentation are conditioned on an objective of 'cohesiveness', which presumes that financial statement articulation will be greatly enhanced if groupings of line items are contained within similar categories across the statements of financial position, comprehensive income, and cash flows. The existing partition of activities into operating, investing and financing in the statement of cash flows is incorporated into the proposed standardized categories of business activities (including operating and investing activities), financing activities, income taxes, discontinued operations, and equity.[3]

Within the constraint of providing standardization along these five categories, the most important change in the proposal is to delineate business versus financial activities of a firm. This is an intuitively appealing objective, and one that has clear basis in valuation practice and theory. The well-established approach to firm valuation rooted in discounted cash flow analysis is dependent on analysts' ability to appropriately categorize firm activities as either operating or financing. Valuation texts such as Bodie, Kane and Marcus (1989), Damodaran (1996), and

[3] However, the current classification of investing activities on the statement of cash flows does not map directly into the proposal, as the current categorization includes items that the proposal defines as operating (e.g., purchase of fixed assets used in primary operating activities). Investing activities under the proposal are meant to include activities that are not related to the central purpose of the firm, but that otherwise provide a return to the firm. As noted by the Boards, the proposal would result in many firms recording only limited or no activities as investing, and they are presumably aware that such a change in the notion of 'investing' activities will be a change for most users.

Koller, Goedhart and Wessels (2005) all specify the adjustment of reported income to derive free cash flows. The most common approach is to define free cash flows as a measure of profitability of operating activities (e.g., after-tax operating profit adjusted for non-cash changes in net operating assets plus depreciation and minus capital expenditures). The present value of a forecasted series of free cash flows is then added to the current value of net financial assets (i.e., after deduction current value of financial obligations), yielding the analysts' estimate of value. Thus, clearly, the partition of firm activities into business and financing activities would be useful to the many financial statement users who adopt this valuation approach.

A recent analysis by Nissim and Penman (2001) provides a useful basis for viewing much of the existing research on financial statement analysis and also maps well into the objectives of the *Preliminary Views*.[4] For example, Nissim and Penman (2001) outline a methodical approach to financial statement analysis, based on the objective of reformulating financial statements according to business and financing activities (although they use the terms 'operating' and 'financing' activities). In a similar manner that line items on the statement of financial position are categorized as business or financing activities and netted within each category, Nissim and Penman (2001) define net operating assets and net financial obligations. Likewise, the *Preliminary Views* partition the statement of comprehensive income into business and financing activities, which Nissim and Penman (2001) define as operating income and net financing expense, respectively. Acknowledging that their approach is equivalent to a discounted free cash flows approach, Nissim and Penman (2001) indicate that their reformulation of financial

[4] There are well over 100 published studies or current working papers that incorporate to varying degrees the framework articulated in Nissim and Penman (2001). Examples of such studies include the persistence of the cash flow component of earnings (e.g., Dechow and Ge 2006, Dechow, Richardson and Sloan 2008), the predictive ability of profit margins and asset turnover (e.g., Fairfield and Yohn 2001), the impact of measured conservatism on future stock returns (e.g., Easton and and Pae 2004), and the valuation of cross-listed firms components of earnings under alternative financial reporting standards (e.g., Ashbaugh and Olsson 2002).

statement information assists in identifying structural ratios that can be used to predict future payoffs for the firm. They also provide descriptive evidence of the historical levels of the ratios included in their structural decomposition of financial statements, with the obvious implication that knowledge of historical levels of various ratios is an important input into the forecasting of such ratios and overall firm performance, and hence payoffs, in the future.

A current difficulty faced by analysts attempting to use the current financial statement presentation formats is the allocation of taxes between business and financial activities. For example, a typical starting point for computing cash flows is NOPAT (net operating profit after taxes) or EBIAT (earnings before interest after taxes). Such a computation requires the analyst to make simplifying assumptions regarding the associated tax effects of business and financial items in the financial statements. A significant benefit to the user community would be any presentation or disclosure that enabled them to separately allocate income tax expense to business and financial components (and similarly, deferred tax effects to business and financial assets and liabilities). Unfortunately, paragraph 2.74 of the *Preliminary Views* labels any such attempt to accomplish such informational needs of users as necessarily requiring "complex and arbitrary allocations that are unlikely to provide useful information." Given the likely increase in preparer costs elsewhere in the presentation requirements, the overall spirit of the management approach, and the objective of providing users with information helpful to them, this abrogation will not likely be satisfactory to the intended users of such financial statements.

There is no dispute that a presentation model that assisted users in parsing the business versus financial activities of a firm would be useful to external users, particularly those that provide capital. The question then is whether the formats proposed by the *Preliminary Views* are likely to achieve this objective, taking into consideration issues of transparency and various costs

(i.e., costs to preparers and costs of information processing by users). The Boards are aware of the importance of considering both the benefits and costs of the proposed changes to financial statement presentation, acknowledging in paragraph 2.10 that "there is a delicate balance between having too much information and having too little information." Accordingly, in the following discussion of the disaggregation of the proposed formats and likely information processing costs of such presentation external users are likely to incur, we describe the relevant research findings to help inform the deliberations of these key issues.

Disaggregation of financial information. Both the Conceptual Framework and Regulation S-X highlight that there are likely benefits to disaggregated information. In addition to the reformulation of existing financial statement line items, the *Preliminary Views* specify as one of three objectives that financial statements present disaggregated information to assist users in predicting the amount, timing, and uncertainty of an entity's future cash flows. There is a rich literature on the ability of disaggregated financial statement information to help predict future measures of profitability and cash flows. For example, early work by Bowen (1981) examines the utility industry, where firms report allowance for funds used during construction (AFC), which is deemed as nonoperating by most financial statement users. He reformulates reported profitability into operating and nonoperating, and finds that there is a discount on the valuation implications of nonoperating amounts such as AFC relative to operating earnings.

Lipe (1986) provides a seminal analysis of the information contained in six disaggregated earnings components: gross profit, SG&A, depreciation, interest, taxes, and other. He documents a statistically significant increase in the explanatory power of earnings components for stock returns relative to earnings alone. Additionally, the incremental explanatory power of the disaggregated components appears to be explained by the differential persistence of the

individual components, which is demonstrated by means of associations with contemporaneous changes in the components and stock returns. However, Lipe (1986) emphasizes that although statistically significant, the apparent economic significance of the additional explanatory power of disaggregated earnings components seems relatively small. Ohlson and Penman (1992) extend Lipe's (1986) analysis to provide insight into the relative impact of variance in measurement error among disaggregated components. Under the notion that accounting measurements over longer reporting periods is characterized by lower measurement error, Ohlson and Penman (1992) examine associations between disaggregated profitability measures and stock returns, and demonstrate that as the measurement interval lengthens (i.e., up to ten years), the differential valuation coefficients on disaggregated earnings components as documented in Lipe (1986) converge to approximate equivalence. We note that the Boards have specifically excluded interim presentation from the scope of the financial statement presentation project, which is understandable given the current differential reporting requirements for interim relative to annual financial information. However, we note that an implication of the findings in Ohlson and Penman (1992) (and Dechow 1994 discussed below) is that the benefits to users of disaggregated financial information is more compelling for interim financial statements (i.e., quarterly) than annual financial statements.

In a more general examination, Wilson (1986) and Sloan (1996), among others, examine the simple partition of earnings into accruals and cash flow components, noting a differential association with each component and future profitability and stock returns, such that users do not appear to fully appreciate the different associations. In a similar spirit to the Ohlson and Penman (1992) result discussed above, Dechow (1994) shows that the differential associations of accruals and cash flow components of earnings with future profitability and returns is attenuated as the

measurement interval increases. Mashruwala, Rajgopal and Shevlin (2006) note that these prior findings on the differential association of accruals and cash flows with future returns may have been arbitraged away such that the only remaining association exists for small, low-volume stocks where transactions costs prove prohibitive for arbitrageurs. One explanation of the attenuation in the documented differential associations between accruals and cash flows with future stock returns is that the widespread dissemination of these research results informed sophisticated investors. Moreover, the revised presentation of cash flows under Statement of Financial Accounting Standards No. 95, that was effective in 1988, likely enhanced users' ability to analyze the separate components of accruals and cash flows.

Overall, it is clear from empirical research that disaggregation of financial statement line items, particularly measures of accounting profitability, explains more of the market pricing variation than summary components only. Moreover, as the measurement interval lengthens, the importance of separately analyzing disaggregated data is lowered. Thus, the emphasis in the *Preliminary Views* on the provision of disaggregated data under the new presentation guidelines is well-placed. The disaggregated data that appears as Illustration 1 for ToolCo clearly provides more useful information relative to that typically provided in most existing financial statement presentations. However, it is not clear from the *Preliminary Views* how likely it would be that companies would provide a similar level of granularity in any reformulated financial statements (e.g., overhead disaggregated into depreciation, transportation, and other, for example). Much of the disaggregation would depend on managers' subjective determination under the 'management approach', which is addressed in more detail below. Based on the existing evidence, one hypothesis would be that absent any bright line requirements, it is unlikely that the level of disaggregated line item disclosures apparently envisioned by the Boards would be achieved.

Information processing costs. The *Preliminary Views* provide several significant changes to the current reporting model. In this section, we consider the impact of several of the more significant changes on the processing costs of external users. The most significant is the maintained objective of providing cohesiveness across the individual statements, which leads to the standardized partition of each statement into the categories mentioned above (i.e., business activities, financing activities, income taxes, discontinued operations, and equity). There are a number of additional changes that stand out in the *Preliminary Views*, including the disaggregated presentation of various line items (discussed previously), which is meant to be an integral aspect of the new presentation. The direct presentation of the statement of cash flows, that is favored in SFAS No. 95, is also part of the required presentation. Finally, the *Preliminary Views* requires disclosure of a schedule reconciling cash flows to comprehensive income by line item. The combined level of these and other changes included in the *Preliminary Views* will require users to overcome a substantial learning curve.

The proposed formats in Illustrations 1 and 2 (i.e., ToolCo and Bank Corp) are helpful in assessing the likely demands of the more substantial changes in financial statement presentation on users. The revised presentation of the statement of financial position is significant, as is the requirement that the statement of cash flows presented under a direct approach (and is discussed further below); the reformulation of the statement of comprehensive income is less extensive than the changes to the other statements.

Prior research demonstrates that even simple formatting aspects of financial statement presentation affect the ability of both unsophisticated and sophisticated users to process financial information (e.g., Maines and McDaniel 2000, Hirst, Hopkins and Whalen 2004). Although we know of no formal evidence, our experience with students and practitioners makes it clear that

the current elemental structure of the statement of financial position (i.e., assets = liabilities + equity) is well-understood. The reformulation of this statement is substantial and effectively dismisses this presentation format due to the partitioning and netting of assets and liabilities. Further, as noted above, users who engage in a typical free cash flow valuation (or the modified earnings-based approach as detailed in Nissim and Penman 2001) have a particular need for financing components of financial information to be separately presented. We suspect, however, that the presentations in Illustrations 1 and 2 will be extremely challenging to such users. As an example, it is difficult to simply assess whether the statement of financial position balances, in the familiar sense of total assets equaling total liabilities and equity (or equivalently, in the sense that net operating assets equal net financial obligations plus equity).

With respect to the statement of cash flows, the Committee appreciates the intuitive appeal of requiring companies to use the direct approach. When compared to the cumbersome balance-sheet differencing presented in the currently required indirect-approach cash flow statement, the direct approach seems quite straightforward, with its easy-to-understand functional categories of cash inflows and outflows (e.g., cash received from customers and cash paid to suppliers). However, if the goal of financial statement users is to predict future cash flows, the Committee is not convinced that the direct approach provides *better* information than the indirect approach. Prior research suggests that current period reported earnings explain more variation in future period operating cash flows than current period operating cash flows (Dechow, Kothari and Watts 1998; Barth, Cram and Nelson 2001). This relation is not surprising; the definitions of assets and liabilities in Statement of Financial Accounting Concepts No. 6 (FASB 1985) suggest that the relation between current-period change in operating accruals and future cash flows is positive and causal. The current period change in operating accruals is included in current period

earnings and is separately reported, in detail, in the operating section of the indirect approach statement of cash flows.

Although the indirect approach should provide more useful information for prediction of future cash flows, a recent study by Hodder, Hopkins and Wood (2008) suggests that the current format of the indirect approach statement of cash flows could be improved. They argue that the currently required structure of the operating section of the indirect-approach statement is a reverse or negatively framed orientation. For example, an increase in accounts receivable should lead to an increase in future periods' cash flows, but the indirect approach operating section presents that information as a negative number. A robust finding in psychology research is that reverse-coded information is much more difficult to learn and apply in forecasting and prediction tasks. Hodder, Hopkins and Wood (2008) provide evidence that reversing the currently required operating section of the indirect approach statement of cash flows (i.e., starting with cash flows from operations and ending with earnings) significantly increases users' ability to forecast future periods' cash flows. These results suggest that some minor reformatting of the current financial statements might improve investors' ability to extract and use relevant financial statement information.

Finally, the *Preliminary Views* includes a proposed disclosure (i.e., reconciliation schedule) that reconciles cash flows to comprehensive income, with line item reconciliations disaggregated into cash flows, accruals, valuation adjustments and other adjustments. Academic researchers would find the data presented in such a reconciliation to be immensely useful in answering many empirical questions (e.g., measurement error in managerial estimates, bias in estimates, cash flow versus accrual associations with prices, etc.). Notwithstanding this benefit to academics, we do believe the reconciliation would be a complex disclosure from both

preparation and processing perspectives, even more so than the complexity of the redesigned statement of financial position. Prior research demonstrates that information complexity has at least two effects on analysts using information for predictive activities (e.g., Plumlee 2003). Analysts tend to adopt simpler strategies for dealing with complex information, and they tend to exhibit greater forecast errors in the face of complex information or disclosures. It is not immediately clear that users will benefit from the combined effects of the proposed financial statement presentation that increases the granularity of information disclosed, reformats this information in a different manner from that to which users are accustomed, and introduces a complex reconciliation of the statement of comprehensive income and cash flows. The Committee suggests that *incremental* financial statement format changes—informed by extant empirical research and theories from applied psychological fields, like human factors—have a much greater likelihood of improving presentation efficacy and resulting in better-informed investor and creditor decisions.

MANAGERIAL APPROACH

Allowing managers to have greater latitude over the classification and presentation of transactions enables the altruistic manager to better inform investors, but provides the opportunistic manager greater opportunity to manipulate the perceptions of investors. We see two major areas where the *Preliminary Views* increase the latitude available to managers. First, managers determine the section in which transactions are presented: operating, investing or financing. Second, as noted above, managers determine the detail to be provided beyond the required subtotals.

Accounting research has investigated how managers execute the decision between aggregating transactions under the management approach and utilizing income statement presentation to either inform or mislead investors. Most related to the general management approach prescribed by the *Preliminary Views*, SFAS No. 131 requires that managers present segment information that reflects the firm's organizational design. Generally speaking, research examining the changes following the release of SFAS No. 131 has found that this rule improves the informativeness and faithful representation of segment disclosures. The number of segments and amount of information about each segment increased following SFAS No. 131 (Herrmann and Thomas, 2000; Berger and Hann, 2003) and the segment disclosures are more in line with the discussion in the firm's annual report (Street, Nichols and Gray, 2000). Also consistent with more meaningful information being provided in these disclosures, Ettredge, Kwon, Smith and Zarowin (2005) find that the forward earnings response coefficient increased in the SFAS No. 131 period. Finally, Botosan, McMahon and Stanford (2009) examine the representational faithfulness of the disclosures. They find that segments formed under SFAS No. 131 appear to be more in line with the firm's underlying operations than segments formed under SFAS No. 14. Overall, these results support the Boards' preliminary stance that the management approach will improve the quality of information provided to financial statement users.

The Committee notes, however, that this conclusion is subject to two important caveats. First, managers implementing SFAS 131 do not face uncertainty about how to track segments for internal decision-making purposes; however, managers attempting to partition their transactions between operating, investing and financing may face uncertainty. Second, the presentation of segments does not change aggregate net income, and managers' incentives to report faithfully may change when the decisions affect income from continuing operations and operating cash

flows. As such, the Committee suggests that the applicability of the SFAS No. 131 literature is limited and should be interpreted with caution.[5] We expand on each of these concerns in the following paragraphs.

First, it is not clear that managers will be able to adequately separate their transactions into operating, investing and financing activities. As noted in the *Preliminary Views*, some transactions will be related to more than one category, and some balance sheet items will change categories over time, based on their current use and structure. These ambiguities will present challenges to managers that are unrelated to the challenges in the segment disclosure arena; thus, the classification may be less informative and representative in these instances than would be suggested by the previously discussed research on SFAS 131.

Second, it is not clear that managers will continue to provide representationally faithful information when the classifications change income or cash flows from operations.[6] Generally, research suggests that managers use latitude in choice of income statement presentation to influence users' perceptions of performance: for example, Kinney and Trezevant (1997) show that managers are far more likely to break out income-decreasing special items than income-increasing special items on the face of the income statement, consistent with them wishing to highlight the transitory nature of expenses, but not income; Davis (2002) finds evidence that managers of internet firms gross up both revenues and costs of sales to maximize reported

---

[5] Academic research finds that prior to SFAS No. 131, some managers had grouped together segments in a way that obscured the profitability of their segments to minimize exposure to proprietary and/or agency costs of disclosure (Harris 1998; Botosan and Stanford 2005; Berger and Hann 2007).

[6] This argument extends to the balance sheet classifications, as investors value firms differently based on where similar items are classified within the balance sheet (e.g., debt versus equity; Hopkins 1996), and managers have been shown to manage the classification of balance sheet accounts accordingly (e.g., Engel, Erickson and Maydew 1999).

revenues, an especially relevant metric for these firms.[7] Thus, the Committee strongly questions the Boards' reliance on the management approach because, in this instance, the choice affects income from continuing operations and cash flows from operations, two important performance metrics relied upon by investors and other users of the financial statements.

The previously discussed research also speaks to Question 16 posed by the Boards. Based on these findings, the Committee urges the Boards to require more detail in the statement of comprehensive income, beyond the required line items (i.e., in bold). One solution would be to strike the phrase, "if doing so will enhance the usefulness of the information for predicting the entity's future cash flows" (Question 16).

Finally, the Committee comments on Question 26, which pertains to partitioning of *unusual or infrequent events or transactions in the reconciliation*. Given the Boards' position that the financial statements should be useful for predicting future cash flows, the Committee proposes that managers to be able to communicate the expected persistence of transactions. Fairfield, Sweeney and Yohn (1996) examine special items as a component of earnings and find that core earnings has an average persistence parameter of approximately 0.63, while the persistence of special items is much lower, at approximately 0.12. Thus, investors will likely benefit from having sufficient information to distinguish between these line items. Currently, however, investors do not appear to understand the full extent of the transitory nature of special items. Burgstahler, Jiambalvo and Shevlin (2002) examine all income-decreasing special items, and find that investors appear to be positively surprised by earnings improvements in the future. Similarly, Dechow and Ge (2006) examine the intersection of large negative accruals and special items and find that investors do not appear to understand that the large negative accruals

[7] This strategic reporting extends to earnings press releases as well (Schrand and Walther 2000; Bradshaw and Sloan 2002; Bowen, Davis and Matsumoto 2005).

associated with special items (such as an asset write-off), do not recur, on average. In light of these pervasive findings, the Committee supports including as much information as possible about unusual or special items.

There is evidence, however, consistent with managers misusing special items, which supports the IASB's reluctance to consider unusual or infrequent charges as "special." Managers have been found to overstate transitory expenses and then have these reserves offset future recurring expenses or be reversed into income in future periods (e.g., Moerle 2002). Managers also appear to inappropriately classify recurring expenses into line items such as restructuring charges that investors deem to be more transitory (e.g., McVay 2006). Although evidence suggests that by partitioning special items, managers have added ability to use these line items to manage earnings, the Committee agrees that the benefits of disaggregation outweigh the costs. First, even including these misuses, special items remain far more transitory than core earnings. Second, managers can use other mechanisms to highlight transitory charges, such as press releases, where the definition of "core" earnings is not defined or audited. By requiring managers to highlight these charges in their annual reports, the Committee suggests that the additional detail will help investors determine how transitory each special item might be. Finally, in recent work, Barua, Lin and Sbaraglia (2009) finds that the classification shifting of core expenses to special items is also present in discontinued operations. Thus, the Committee feels that the clear segregation of discontinued operations is inconsistent with the IASB's reluctance to highlight unusual or infrequent charges.

COMMENTARY ON SPECIFIC CHANGES TO THE CURRENT REPORTING MODEL

In this section, we offer brief observations about the specific presentation and categorization of certain items specified in the *Preliminary Views*.

1. A prevailing objection with the current statement of cash flows is that the cash component of interest expense ends up being included as an operating activity (as noted in para. 23 of SFAS No. 95). The emphasis on operating, investing, and financing activities 'fixes' this aspect of the statement of cash flows. However, a new 'problem' seems to emerge. It seems strange to include interest received in the financing section, while including dividends received in the investing section. Both seem to reflect the results of return-generating investments made by the firm, which is how investing activities are defined in the *Preliminary Views*.

2. The *Preliminary Views* separate equity from financing activities, under the argument that comprehensive income reflects transactions with nonowners. However, the *Preliminary Views* also correctly note that it is "common practice for users to analyze an entity's performance independently of its capital structure" (para. 1.16). For such users, equity is equivalent to debt; both are sources of financing. Thus, it seems only logical that equity should not be separately categorized (even though various items of comprehensive income may obfuscate the nature of financing activities in the financial statements). One seemingly simple approach to satisfy the 'nonowner' concern is to separately categorize equity and related components within the financing partition.

3. The *Preliminary Views* indicate that cash could be included in either operating or financing categories, but not both. Appealing to the typical user of financial statements as a representative provider of capital, it is instructive to consider one of the classification decisions present in valuation analyses. When identifying operating assets and liabilities separately from financing assets and liabilities in a valuation, users must designate cash as either an operating or financing asset (and the same is true for near-cash items). The ideal designation would typically result in an allocation of cash to both operating and financing assets. Operating cash would equal the amount that is necessary to carry out

operations; financing cash would equal amounts designated as 'excess' cash, held for reasons beyond the basic requirements of working capital (see Penman 2001, 269–270). Users typically adopt simple strategies, such as treating all cash as a financial asset or quantifying some arbitrary amount as operating (i.e., working capital), and the remainder as a financial asset. Obviously, the managerial approach adopted by the Boards would require managers to perform this allocation, but it is difficult to believe this would be inferior to the current restriction in the proposed presentation format.

4. Similar to the above point, users engaged in forecasting and valuation also seek information to help them project depreciation expense and capital expenditures. The proposed format change would merge what was previously viewed as operating and investing activities, where investing has been broader in scope, including investments in fixed assets as well as financial return-generating investments. Combining the clear linkage between depreciation and capital expenditures with the Boards' objective of making the financial statements cohesive, one would expect to be able to articulate these items across the financial statements. However, we argue that this new presentation is at least as difficult to process as the existing traditional format. For instance, the ToolCo example is a relatively straightforward example, but nevertheless, it is expected that a typically user would find it more difficult to quantify something as innocuous as depreciation expense using the proposed statements of comprehensive income and cash flows (relative to the existing traditional formats). Of course, footnote disclosures may overcome this difficulty, but it seems to be a step backwards if certain basic information becomes more difficult to discern from the statements themselves.

5. On the proposed statement of cash flows, short-term and long-term cash expenditures are aggregated within operating cash flows. This change will result, on average, in lower reported cash from operations, due to typically large capital expenditures. This may be misleading to unsophisticated users or those that have become accustomed to 'investing' cash flows including operating investments in fixed assets. To avoid confusion while possibly highlighting informative subtotals, the Boards might consider adding subtotals within cash from operations for short- and long-term operating cash flows.

6. Finally, we note that there are numerous classification issues that have not been addressed, but must be for any standard on financial statement presentation to be successful. The Boards are clearly aware of these, many of which are listed in paragraphs 2.42-2.45. One alternative is to simply carry through with the management approach and let managers decide how to classify, for example, their corporate headquarters (e.g., operating or investing activity). However, resulting variation across firms may actually decrease the usefulness of financial statements relative to current reporting practices. Moreover, it appears that users actually seek guidance on such procedures, which further emphasizes that other likely complicated classification issues should be addressed.

CONCLUSION

In sum, the Committee commends the Boards on such a large undertaking and makes the following recommendations.

1. The Committee suggests that *incremental* financial statement format changes—informed by extant empirical research and theories from applied psychological fields, like human factors—have a much greater likelihood of improving presentation efficacy and resulting in better-informed investor and creditor decisions.

2. If the Boards continue with the currently proposed classifications, users will benefit if taxes are allocated among operating, investing and financing activities.

3. The Boards should emphasize the requirements that companies provide a similar level of granularity as indicated in the Illustrations, anticipating that unless guidance specifies the level of detail to be presented in the financial statements, managers may be unlikely to voluntarily provide such detail.

4. The Boards should retain the proposed requirements regarding the underlying detail of special items.

5. Equity accounts should be incorporated within the financing category, rather than appear as a separate category.

6. The Boards should encourage managers to partition cash into operating and financing components.

7. The Boards should partition operating cash flows into short-term (inventory, cash received from sales) and long-term (capital expenditures, investments in subsidiaries) and require a subtotal for each in the statement of cash flows.

8. Classification issues currently not addressed should be addressed prior to an Exposure Draft.

REFERENCES

Ashbaugh, H. and P. Olsson, 2002. An exploratory study of the valuation properties of cross-listed firms' IAS and US GAAP earnings and book values. *The Accounting Review* 77 (1): 107–126.

Ball, R. and P. Brown, 1968. An empirical evaluation of accounting income numbers. *Journal of Accounting Research*, Autumn: 159-178.

Barth, M., J. Elliott and M. Finn. 1999. Market rewards associated with patterns of increasing earnings. *Journal of Accounting Research* 37 (2): 387–413.

Barth, M. E., D. P. Cram, and K. K. Nelson. 2001. Accruals and the prediction of future cash flows. *The Accounting Review* 76 _1_: 27–58.

Barua, A., S. Lin and A. Sbaraglia. 2009. Earnings management using discontinued operations. Working paper, Florida International University.

Berger and R. Hann. 2003. The impact of SFAS No. 131 on information and monitoring. *Journal of Accounting Research* 41: 163–223.

Berger, P. and R. Hann. 2007. Segment profitability and the proprietary and agency costs of disclosure. *The Accounting Review* 82: 969–906.

Bodie, Z., A. Kane and A.J. Marcus. 1989. *Investments*. Third edition, Richard D. Irwin.

Botosan, C., S. McMahon and M. Stanford. 2009. Representationally faithful disclosures, organizational design and managements' segment reporting decisions. Working paper, University of Utah.

Botosan, C. and M. Stanford. 2005. Managers' motives to withhold segment disclosures and the effect of SFAS No. 131 on analysts' information environment. *The Accounting Review* 80: 751–771.

Bowen, R. 1981. The valuation of earnings components in the electric utility industry. *The Accounting Review* 56: 1–22.

Bowen, R., A. Davis and D. Matsumoto. 2005. Emphasis on pro forma versus GAAP earnings in quarterly press releases: Determinants, SEC intervention, and market reactions. *The Accounting Review* 80: 1011–1038.

Bradshaw, M. and R. Sloan. 2002. GAAP versus the Street: An empirical assessment of two alternative definitions of earnings. *Journal of Accounting Research* 40: 41–65.

Burgstahler, D., J. Jiambalvo and T. Shevlin. 2002. Do stock prices fully reflect the implications of special items for future earnings? *Journal of Accounting Research* 40: 585–612.

Damodaran, A. 1996. *Investment Valuation, Tools and Techniques for Determining the Value of Any Asset*. John Wiley & Sons, Inc.

Davis, A. 2002. The value relevance of revenue for internet firms: Does reporting grossed-up or barter revenue make a difference. *Journal of Accounting Research* 40: 445–477.

Dechow, P. 1994. Accounting earnings and cash flows as measures of firm performance – The role of accounting accruals. *Journal of Accounting and Economics* 18: 3–42.

Dechow, P. M., S. P. Kothari, and R. L. Watts. 1998. The relation between earnings and cash flows. *Journal of Accounting and Economics* 25 (2): 133–168.

Dechow, P. and W. Ge. 2006. The persistence of earnings and cash flows and the role of special items: Implications for the accrual anomaly. *Review of Accounting Studies* 11 (2/3).

Dechow, P., S. Richardson and R. Sloan. 2008. The persistence and pricing of the cash component of earnings. *Journal of Accounting Research* 46 (3): 537–566.

Easton, P. and T. Harris, 1991. Earnings as an explanatory variable for returns. *Journal of Accounting Research* 29, No. 1, 19-36.

Easton, P. and J. Pae. 2004. Accounting conservatism and the relation between returns and accounting data. *Review of Accounting Studies* 8 (4): 495–521.

Engel, E., M. Erickson and E. Maydew. 1999. Debt-equity hybrid securities. *Journal of Accounting Research* 37 (2): 249–274.

Fairfield, P., R. Sweeney and T. Yohn. 1996. Accounting classification and the predictive content of earnings. *The Accounting Review* 71: 337–355.

Fairfield, P. and T. Yohn. 2001. Using asset turnover and profit margin to forecast changes in profitability. *Review of Accounting Studies* 6 (4): 371–385.

Financial Accounting Standards Board. 1985. *Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements*. Norwalk, CT: FASB

Ettredge, M., S. Kwon, D. Smith and P. Zarowin. 2005. The impact of SFAS No. 131 business segment data on the market's ability to anticipate future earnings. *The Accounting Review* 80: 773–804.

Harris, M. 1998. The association between competition and manager' business segment reporting choices. *Journal of Accounting Research* 111–128.

Hirst, D., P. Hopkins and J. Wahlen. 2004. Fair values, comprehensive income reporting, and bank analysts' risk and valuation judgments. *The Accounting Review* 79 (2): 455–474.

Hodder, L., P. Hopkins and D. Wood. 2008. The effects of financial statement and informational complexity on analysts' cash flow forecasts. *The Accounting Review* 83 (4): 915–956.

Hopkins, P. 1996. The effect of financial statement classification of hybrid financial instruments on financial analysts' stock price judgments. *Journal of Accounting Research* 34: 33–50.

Kinney, M. and R. Trezevant. 1997. The use of special items to manage earnings and perceptions. *The Journal of Financial Statement Analysis* Fall: 45–53.

Koller, T., M. Goedhart and D. Wessels. 2005. *Valuation: Measuring and Managing the Value of Companies*. Fourth edition, McKinsey and Co., Inc.

Kormendi, R. and R. Lipe. 1987. Earnings innovations, earnings persistence, and stock returns. *The Journal of Business* 60(3): 323–345.

Lipe, R. 1986. The information contained in the components of earnings. *Journal of Accounting Research* 24 (Supplement): 37–64.

Maines, L. and L. McDaniel. 2000. Effects of comprehensive-income characteristics on nonprofessional investors' judgments: The role of financial statement presentation format. *The Accounting Review* 75 (2): 179–208.

Mashruwala, C., S. Rajgopal and T. Shevlin. 2006. Why is the accrual anomaly not arbitraged away? The role of idiosyncratic risk and transaction costs. *Journal of Accounting and Economics* 42: 3–33.

McVay, S. 2006. Earnings management using classification shifting: An examination of core earnings and special items. *The Accounting Review* 81: 501–531.

Moehrle, S. 2002. Do firms use restructuring charge reversals to meet earnings targets? *The Accounting Review* 77 (2): 397–413.

Ohlson, J. and S. Penman. 1992. Disaggregated accounting data as explanatory variables for returns. *Journal of Accounting, Auditing, and Finance* 7 (Fall): 553–573.

Penman, S. 2001. *Financial Statement Analysis and Security Valuation.* McGraw-Hill Irwin, New York, NY.

Plumlee, M. 2003. The effect of information complexity on analysts' use of that information. *The Accounting Review* 78: 275–296.

Schrand, C. and B. Walther. 2000. Strategic benchmarks in earnings announcements: The selective disclosure of prior-period earnings components. *The Accounting Review* 75: 151-177.

Sloan, R. 1996. Do stock prices fully reflect information in accruals and cash flows about future earnings? *The Accounting Review* 71 (3): 289–315.

Street, D., N. Nichols and S. Gray. 2000. Segment disclosures under SFAS No. 131: Has business segment reporting improved? *Accounting Horizons* 14: 259–285.

Wilson, G. 1986. The relative information content of accruals and cash flows: Combined evidence at the earnings announcement and annual report release date. *Journal of Accounting Research* 24 (Autumn): 165–200.