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## Proposal for a New Agenda Project

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### REPORTING INFORMATION ABOUT THE FINANCIAL PERFORMANCE OF BUSINESS ENTERPRISES: Focusing on the Form and Content of Financial Statements

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This Proposal discusses a proposed FASB project to establish standards for the reporting of information in financial statements that is useful in assessing the financial performance of a business enterprise. This Proposal is part of an August 17, 2001 request for comments about the objective and scope of this project as well as a proposed project on disclosure about intangibles.<sup>1</sup> Comments are requested by September 19, 2001.

#### DESCRIPTION OF THE PROPOSED PROJECT

This potential FASB project is referred to in this Proposal as a *project on reporting financial performance*. On August 1, 2001, the Board discussed the project objectives and scope and tentatively agreed that, at a minimum, it should focus on form and content, classification and aggregation, and display of specified items and summarized amounts on the face of all basic financial statements, both interim and annual. The Board directed the staff to issue this Proposal to seek comments on that minimum scope and alternatives for a broader scope.

#### The Problem

The principal reason for the project is to address significant financial reporting concerns raised by constituents of the FASB, including its sponsoring organizations. Those concerns include:

- No common definitions of the elements of financial performance and inconsistent practices regarding the presentation of financial performance
- Increased pro forma reporting and other evidence suggesting that the use of and reliance on net income as an indicator of performance is decreasing
- No consensus or common definitions for the key financial measures or indicators of financial performance that financial statements or financial reporting should provide.

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<sup>1</sup> Further information about that request, including the Proposal for the project on disclosure about intangibles, is available at [www.fasb.org/project/proposals.html](http://www.fasb.org/project/proposals.html).

While all business enterprises report net income, many companies increasingly focus more on alternative measures of performance such as revenue growth, earnings before interest, taxes, depreciation, and amortization (EBITDA), operating cash flow, free cash flow, and countless pro forma results in earnings releases and other investor-related communications. In assessing a company's performance, analysts and other users of financial statements often accept management's lead and emphasize these alternative measures in assessing financial performance.

It has been well recognized that to understand financial performance, one must consider a number of key metrics, not just bottom line net income. In recent years, however, the reporting of alternative and inconsistent financial performance measures has proliferated. This may reflect increased merger and acquisition activity, increased occurrence of gains and losses associated with restructuring transactions and increased gains and losses on financial assets, as well as a somewhat self-serving selection of those indicators that put performance in the best light.

Whatever the reason, the current use of alternative and inconsistent measures is often confusing and sometimes misleading. Addressing that problem is a principal reason for this project, but another reason for such a project at this time is to take advantage of a timely opportunity for a coordinated project with the International Accounting Standards Board (IASB). In July 2001, the IASB added a project on performance reporting to its initial agenda.

### **The Scope**

At its August 1, 2001 meeting, the Board discussed three approaches that could be adopted for a project on reporting financial performance that would address financial metrics. They are:

1. The minimum approach tentatively adopted by the Board and described in this Proposal would explore whether certain line items, subtotals, and totals should be defined in standards and required to be displayed in financial statements, including interim statements. Line items and amounts would include those related to metrics commonly used by investors and creditors in assessing financial performance<sup>2</sup>
2. A broader approach that also involves determining how key financial metrics should be calculated if they are presented, but not requiring them in financial statements
3. A still broader approach that would require business enterprises to provide certain specific financial metrics, including ratios, in financial statements, in notes to financial statements or, perhaps, as supplementary information.

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<sup>2</sup> For example, this project would consider whether to require in financial statements the separate display of specified items such as the amount of expense for depreciation, interest, taxes, or research and development, losses for asset impairments, or gains and losses for holdings of financial instruments. This project also would consider whether to require the display of summarized amounts such as operating income or income from core activities, EBITDA, or operating cash flow.

The minimum approach has an advantage in that it would best align with the scope of the IASB project on performance reporting.<sup>3</sup> That scope would be consistent with the Board's mission and with its goal of promoting the international comparability of accounting standards concurrent with improving the quality of financial reporting.

More specifically, the project will address the classification and display of items, including summarized amounts, in all basic financial statements for annual and interim periods but will exclude reconsideration of segment reporting. The following are among the key issues that the project would consider and answer.

1. What are the *key financial measures* (or indicators) that investors, creditors, and others use to assess and compare the performance of different enterprises in making rational investment decisions?
2. Are changes to existing standards needed to require the classification and display of specified line items, including their summarization or disaggregation, to support the display of new financial measures in financial statements? For example, if EBITDA were identified as a key performance indicator, should companies be required to present EBITDA as a separate line item that is calculated in a consistent manner? If specified items of operating cash inflows or outflows were identified as key performance indicators, should companies be required to use the direct method of reporting operating cash flows?
3. Is it possible and desirable to distinguish between the effects of core (operating) and noncore (nonoperating) activities? If so, how should companies present core and noncore activities? For example, would such a classification scheme require new standards for the disaggregation of the components of net periodic pension expense or to allocate or classify items such as income tax expenses (benefits), holding gains and losses on financial instruments, restructuring charges, asset impairments, and extraordinary and unusual items.
4. Are there key measures of components of earnings that have complementary key measures of components of cash flows, and, if so, should consistent classification schemes be required for income statements and statements of cash flows?
5. If a financial instrument is recognized and measured at fair value, to what extent is the amount of interest or other items of income or expense contributing to the total change in fair value of the instrument a major factor in evaluating financial performance? Should companies separately display certain or all of the components of the change in value in an income statement?

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<sup>3</sup> A July 31, 2001 IASB press release announcing its initial agenda reported that a project on performance reporting, which is one of four "leadership and convergence projects," will:

...address broadly the issues related to the display and presentation in the financial statements of all recognized changes in assets and liabilities from transactions or other events except those related to transactions with owners as owners (comprehensive income). Thus, it will consider items that presently are reported in the income statement, cash flow statement, and statement of changes in equity. Issues addressed in this project include distinguishing revenues and expenses from other sources of comprehensive income or expense, reporting of holding gains and losses, and distinguishing operating and nonoperating items.

6. Do alternative means of presenting a measure of comprehensive income affect a user's understanding of that measure and the weight given to that measure?

The project will not address matters of recognition and measurement of items in financial statements. Moreover, the project will not address nonfinancial measures that might be useful in assessing the performance of a business enterprise.

### **Relevant Research and its Relationship to the Project**

The project scope and approach contemplates consideration of and building on the relevant research and recommendations of others, Board deliberations to develop a proposed Statement, and redeliberations and issuance of a final Statement.

In this project, the Board has the benefit of a significant body of academic research and relevant studies and recommendations of others, including work commissioned by two of its sponsoring organizations, the Association for Investment Management and Research (AIMR) and the American Institute of Certified Public Accountants (AICPA). The project can benefit from constituent comments on those recommendations, which were included in the:

1. November 1993 report of the AIMR, *Financial Reporting in the 1990s and Beyond*
2. December 1994 report of the AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus*
3. January 1998 Special Report, *Reporting Financial Performance: Current Developments and Future Directions*, by L. Todd Johnson and Andrew Lennard, and September 1999 Special Report, *Reporting Financial Performance: A Proposed Approach*, by Kathryn Cearns, published by the members of the former G4+1 standard-setting organizations
4. December 2000 Financial Reporting Exposure Draft (FRED 22), *Reporting Financial Performance*, of the UK's Accounting Standards Board (ASB).

In addition, this project also will benefit from the Board's earlier work on its conceptual framework projects. FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises* (1978), is especially relevant, as well as the discussion in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1984), about financial statements, their objectives, and matters of display in financial statements. The work leading to standards such as APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, FASB Statement No. 95, *Statement of Cash Flows* (1987), and Statement No. 130, *Reporting Comprehensive Income* (1997), also remains relevant. However, many issues about the reporting of comprehensive income remain, including those discussed in paragraphs 30–51 of Concepts Statement 5 about the distinctions among net income, earnings, and comprehensive income, and in paragraph 57 of Statement 130 about (a) whether all items that are or will be recognized under current and future

accounting standards as items of comprehensive income should be reported in a single statement (of financial performance), and (b) how the total amount of comprehensive income should be labeled or described.<sup>4</sup>

The initial phase of the project would use that earlier work and other relevant research that focuses on identifying key financial measures (metrics) that investors, creditors, and others use (or would find useful) in assessing the financial performance of a business enterprise. That contemplates further research and study that will build on and challenge the recommendations of others, primarily through the use of a task force of outside experts to assist the FASB and surveys or direct interviews of users of financial statements.

This major project is expected to result in a final Statement of Financial Accounting Standards. It is likely to raise many controversial issues. Nonetheless, based on the availability of the above relevant research and prior recommendations, we expect to complete the project in approximately three or four years. However, coordination with the Board's project on financial instruments and the similar IASB project may cause us to accelerate or extend that time frame.

### **How Practice Might Change**

It is difficult to predict the extent to which establishing standards for the classification and display of commonly defined financial indicators of performance in financial statements is likely to change in practice. It is conceivable that the minimum scope of the proposed project would do little more than affirm and establish standards to require the display in financial statements of key measures that most business enterprises presently provide, perhaps voluntarily, in financial statements, notes to financial statements, or through other means.

On the other hand, prescribing classification methods and summary measures in financial statements is likely to reduce the degree of flexibility that currently exists in financial statement display, especially for nonpublic companies that are not bound by prescribed regulatory formats. That sacrifice of freedom may be a cause for some constituent resistance. However, as noted in paragraph 16 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, "in return for the sacrifice of some of that freedom, there is a gain from the greater comparability and consistency that adherence to externally imposed standards brings with it. There also is a gain in credibility." Moreover, those standards are likely to lead to changes that improve on prescribed financial statement formats of public enterprises and regulated enterprises.

### **AGENDA CRITERIA**

This Proposal is one of several means by which the Board seeks to obtain advice from its constituents about possible additions to its technical agenda. After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda.

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<sup>4</sup> Further background information is available at [www.fasb.org/project/background.pdf](http://www.fasb.org/project/background.pdf) about relevant academic research, the earlier initiatives and recommendations of the AIMR, AICPA Special Committee, and others and the comments of constituents on those recommendations, as well as related comments of members of the Board's Financial Accounting Standards Advisory Council and others about the problems and issues discussed in this Proposal.

To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics. Those factors, which are more fully discussed in Facts about FASB ([www.fasb.org/facts/fasfact3.html](http://www.fasb.org/facts/fasfact3.html)), include consideration of (a) the pervasiveness of the issue, (b) alternative solutions, (c) technical feasibility, and (d) practical consequences. At this time, the Board believes that this proposed project on reporting financial performance satisfies each of those factors. However, the Board's resources are limited and it is aware of other potential projects suggested by constituents that also satisfy those factors.

In addition, the Board has determined that all topics under consideration for the FASB's agenda should be assessed to determine whether they provide opportunities for cooperative efforts with the IASB. More specifically, that assessment is to include consideration of (a) the possibility that resolution of the issues addressed would increase convergence of standards worldwide, (b) the opportunities the topic presents for cooperation with the IASB or other standard setters, and (c) whether appropriate and sufficient resources are available for a joint project or other cooperative effort.

### **REQUEST FOR COMMENTS**

The Board has not reached any final decisions about whether to add a project on financial performance to its agenda or about the scope of such a project. At this time the Board is seeking comments from its constituents on this Proposal, and is particularly interested in their response to the following major questions.

1. Is there a need for the FASB or others to comprehensively address the reporting of information for assessing the financial performance of a business enterprise? If yes, should the FASB take on such an effort or defer to others? If defer to others, to whom?
2. Is the proposed scope of such a project as described in this Proposal insufficient, appropriate, or too ambitious? Two somewhat broader alternatives are noted on page 2 of this Proposal.
3. Should specific issues identified above be excluded from the scope of the proposed project on reporting financial performance? If yes, for each specific issue, please indicate whether it should be addressed as part of another FASB project, by others, or not at all and why.
4. Should specific issues *not* identified above be addressed as part of the proposed project on reporting financial performance? If yes, please describe the specific issue and indicate why it is sufficiently crucial that it should be addressed as part of the proposed project.