October 17, 2016

Ms. Susan M. Cosper  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

File Reference No. 2016-290

Dear Ms. Cosper:

Connor Group, Inc. is pleased to provide our comments on the FASB Invitation to Comment (ITC), Agenda Consultation. Connor Group was founded in 2005 and is a technical accounting advisory firm built of Big 4 alumni and industry executives. We currently have over 150 accounting professionals and over 500 clients, and specialize in helping our clients solve complex technical accounting issues under both U.S. GAAP and IFRS. Our clients represent industries such as technology, software, internet, cloud services, life sciences and manufacturing, amongst others. Many of our clients are emerging growth mid-cap or small-cap public entities, companies aspiring to become public in the near future, or high-growth private companies.

We have included below our response to each of the “Questions for Respondents” posed in the Proposed ASU.

Comments on Questions for Respondents

OVERVIEW

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.

Response: We have identified the following financial reporting issues that we believe would benefit from additional guidance. In developing this list, we have considered the issues we address in our practice with our clients, as well as whether such issues have a comprehensive, consistent, practical accounting framework that both (a) provides a benchmark that preparers and auditors can apply to make appropriate judgments under GAAP, and (b) results in financial performance reporting that preparers and users of financial statements find meaningful:

- **Aligning business and asset acquisition accounting.** There are significant differences in various accounting aspects (such as acquisition costs, in-process research and development, contingent consideration). We believe it would be beneficial to address and align, where appropriate, the accounting between business and asset acquisitions. We expect this issue to become even more
prominent with the anticipated changes to the definition of a business, which is expected to result in more acquisitions being accounted for as asset acquisitions, and thereby differently from a business acquisition.

- **Collaborations.** There is just limited presentation guidance regarding accounting for collaborations, which leads to inconsistent practice and sometimes counterintuitive results based on analogies to, e.g. revenue recognition accounting models. Although many entities will put their collaborative arrangements through the Topic 606 adoption process, we do not expect Topic 606 to effectively resolve all of the present issues. Therefore, we believe developing a framework that addresses specifically unique aspects of collaborations would be beneficial.

- **Capitalization of assets.** There is limited guidance currently included in Topic 340, mostly limited to specific types of costs such as planned major maintenance activities or costs of contracts with customers. As a result, when practical issues arise, companies analogize directly to the definition of assets in the FASB Concept Statement 6, or other literature. From time to time, practice evolves in ways that may present undesirable surprises. For example, earlier this year one of our clients was required by its Big 4 audit firm to review all of its on-premises time-based software license contracts (often prepaid a year at a time), reclass the amounts from prepaid expenses to intangible assets (or fixed assets) and recognize as an asset the entire value of the contract (less estimated maintenance), as opposed to the prepayment amount, with an offset to a liability. We understand this requirement came as an indirect effect of ASU 2015-05. Notwithstanding the technical merits of either position, neither companies nor auditors benefit from lack of accounting guidance. We believe a comprehensive approach towards recognition, initial and subsequent measurement, and presentation of assets that do not fit into other categories would be helpful.

- **Fixed assets.** This topic may not be for the most part particularly controversial. However, there has historically been very limited accounting guidance (apart from impairment and derecognition aspects). Practical issues do arise that do not have easy solutions. We understand some audit firms tend to use the 2001 exposure draft on property, plant and equipment costs. However, we do not believe it is the best practice to apply a never-approved, non-authoritative exposure draft. Consequently, we believe adding more detailed comprehensive guidance would be helpful. Among other issues, we note there is lack of consistency among entities about classification of certain types of costs, such as software licenses, as fixed assets, intangibles, or other prepaid/deferred charges.

- **Software development capitalization costs.** There are significant differences between internal-use and website development costs under Topics 350-40 and 350-50, and costs of software to be sold etc., under Topic 985-20. With the continuing migration of technology to the cloud, evolution of hybrid models, and agile software development methods, we find the existence of two accounting models that often have a dramatically different impact on results of operations to be confusing and hard to justify. We believe convergence of the two models would be appropriate. In addition, we believe Topic 350-40 (350-50) model requires improvements to address the specifics of agile software development.

- **Financial instruments/investments.** Specific guidance exists for investments in certain debt and equity securities, as well as investments that qualify for the equity method of accounting, those that represent derivatives, and certain others. However, other types of investments (financial instruments) have no specific accounting guidance. It is a common approach to apply the cost
method to account for such investments (subject to certain changes pursuant to ASU 2016-01). This includes, among others, preferred stock investments that do not qualify as in-substance common stock, options and warrants that do not qualify as derivatives, and other types of instruments that do not represent debt securities. In addition, the framework for distinguishing whether the financial instruments are in the scope of Topics 320 and 321 is complex and poorly understood by both preparers and users. This results in challenges in applying the appropriate guidance, counterintuitive conclusions and structuring opportunities. We believe it would be beneficial to address comprehensively the accounting for different types of financial instruments for the holder.

• Noncontrolling interests. There is limited guidance regarding accounting for noncontrolling interests (NCI). In particular, there is a variety of accounting literature that may apply depending on the terms of the NCI. Partially, NCI accounting is also affected by aspects of equity vs. liability framework which is addressed in more detail later in this comment letter, and that adds to the complexities and confusion. Additionally, subsequent measurement of NCI has no accounting guidance when complex allocations may be required to determine investors’ claims to an entity’s assets. Entities often use the Hypothetical Liquidation at Book Value (HLBV) method that was originally developed in a proposed but never adopted SOP on unconsolidated real estate investments. We believe putting a framework on accounting for NCI would be beneficial.

**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.

**Response:** We have categorized our views regarding the importance of addressing the issues identified in this ITS on a scale of 1 to 10 as follows. (1 means there is no need to address an issue; 10 means that it is critically important to address the issue as soon as possible).

- Intangible assets – 3
- Pension and other postretirement benefits – 1
- Distinguishing liabilities from equity – 8
- Reporting performance and cash flows – 4

In addition, we believe many of the issues we have identified in our response to Question 0.1 should have higher priority than any of the issues included in the ITC, with the exception of distinguishing liabilities from equity. Note that certain issues listed under Question 0.1 affect intangibles accounting. In this regard, we favor targeted improvements as opposed to a comprehensive overhaul that is contemplated based on Chapter 1 materials.

In establishing the above priorities, we have considered the following factors. Liability/equity framework is very complex to apply, results in inconsistencies and counterintuitive answers to practical issues, and is poorly understood by preparers, auditors, and users alike. This also leads to errors, material weaknesses and restatements. Thus, we believe it deserves the highest level of attention among the issues noted.
We do not believe there are significant issues that require urgent resolution among the remaining three ITC topics. While the accounting frameworks for intangibles and performance reporting could be improved, they are sufficiently mature and in our observation do not cause significant issues among preparers, auditors, or users. One exception is to address differences in the accounting treatment for in-process research and development acquired in a business combination versus an asset acquisition. Further, we do not believe there is a clear case that any changes to these frameworks would actually represent improvements in financial reporting. As related to pension and other benefits, while we believe the accounting framework is outdated, the number of companies that offer defined benefit plans continues to decline. As such we believe improvements would have limited impact on the overall quality of financial reporting.

Additional considerations regarding priorities of these topics are also included in our responses to the various questions below on these topics.

**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?

**Response:** We do not believe there are dependencies among the ITC topics. Naturally, because performance reporting impacts and is impacted by accounting for any specific types of assets, liabilities, equity, expenses, etc., any changes made to the performance reporting framework should be made in sync with the changes made to the other ITC topics.

**CHAPTER 1 – INTANGIBLE ASSETS**

**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.

**Response:** As noted above in our response to Question 0.2, we do not believe accounting for intangibles is a major financial reporting issue that the FASB should consider for a comprehensive overhaul using either of the Alternatives A through D. This judgment is significantly aligned with the considerations shared by the FASB in ITC 1.8, 1.18, 1.21, 1.27, 1.28, 1.36, 1.42, 1.44, 1.45, etc. In addition, frequently, costs that contribute to generation of intangible assets are not sufficiently separable from other operating activities. For example, a typical company’s CEO may be expected to spend a significant portion of his/her time developing company branding and key customer and other relationships. Costs of these activities conceptually add to the value of the intangibles generated, and thus should be capitalized. However, in our experience neither management nor analysts separately evaluate profitability or expected benefits related to such intangibles. Further, accounting differences, e.g., between acquired vs. internally generated intangibles accounting, are simply
just another factor to take into account when comparing performance of two companies in the same industry. These differences can also be seen as a “price premium” entities pay when they prefer to “buy” instead of “make”.

In summary, while we agree that in an ideal world it would be great to have comparable financial statements with all assets recognized, in our real world getting to reasonable and practical principles and methods of how to make it happen is likely a challenging endeavor. In addition to the many challenges, we also foresee an outcome that many preparers and users would find unsatisfactory, just like what we have today with the equity/liabilities framework.

However, if a project were to be undertaken by the FASB, we would favor Alternative B (specifically, at cost), i.e., recognize research and development (and by extension, technology) intangibles. This is because in today’s emerging technology-based world, for many companies investment in research and development (R&D) is viewed by management and investors as an asset. Specifically, company valuations and ability to raise additional financing are often driven by the size of their R&D efforts. Further, various companies operate with detailed project plans and reasonable cost tracking systems for significant parts of their R&D costs. As such, these companies can evaluate cost and expected return on investment on a project by project basis.

However, we also acknowledge that capitalizing R&D intangibles would bring many challenges. Among these:

- Many companies do not have adequate cost tracking systems, and where such systems exist, they are not “audit-grade”, i.e., do not have supporting documentation or robust IT or manual controls to facilitate either tests of controls or substantive testing by auditor. Further, much of the cost tracking is dependent on time tracking by R&D personnel. These individuals are usually not accustomed to tracking their time in the same manner as, e.g., professional service providers would be. Many companies will likely face significant cultural challenges when implementing more robust time tracking. We encounter these issues on a regular basis with clients who are required to capitalize cloud software development costs under Topic 350-40 (350-50). Many of these companies end up making high-level estimates for lack of any better records.
- Certain R&D costs are not tracked or associated with individual projects even when a company does have adequate cost tracking. Such costs often include any amounts that require allocation to multiple projects. Overall, we believe usually only direct R&D costs have any meaningful cost tracking mechanisms (which are still likely not “audit-grade”).
- Many companies undertake high-risk (i.e. low probability of success) high-reward projects. Such projects are common in the life science industry. Anecdotally, the probability of success for a drug development R&D project in pre-clinical phase is often less than 10%, and would only increase above 50% when the drug advances to Phase III of clinical trials. Even then, it is often assessed at around 60-70%, and thus fails to qualify as probable. Moreover, for many such companies, these projects are the only principal business activity. If such project costs are reported as expenses because success is not probable, while costs related to low risk low reward projects are reported as assets, this would significantly undermine the usefulness of information reported in the financial statements. This
raises a challenge of how to define the capitalization threshold for R&D costs, and whether such threshold can be practically consistent with the definition of an asset.

- Many companies may undertake various R&D projects (perhaps even alternative projects) with an anticipation of failure on some if not most of them. This may be the case in particular when the cost of a project is relatively insignificant. These companies evaluate overall return from a portfolio of projects, even if only one out of every five is eventually successful. While from a management perspective, the return is generated based on the investment in all such projects, an accounting framework is more likely to focus on recognizing the impairment cost of individual projects when those projects fail. Thus, when project portfolios are used, differences are likely to exist between how management and investors look at R&D assets vs. an accounting framework that could be in place.

- Sometimes, companies may choose to suspend an R&D project. Such suspension may or may not signify that the underlying R&D has no value. In particular, in the life sciences industry there are frequent occurrences that a drug candidate that has failed clinical testing for a particular disease can be effective for another treatment, sometimes, in a completely unrelated field. In these circumstances, even with perfect record keeping, companies are not likely to have detailed records that would enable them to split the historical R&D cost and determine how much would have been incurred for this new treatment opportunity regardless. These factors will likely make impairment testing very subjective.

- Last, we find both the existing IAS 38 and Topic 985-20 capitalization frameworks to be unsatisfactory, as the capitalization hurdles are high and additionally subjective to the extent that usually no amounts are capitalized.

As noted above in our response to Question 0.1, we struggle to rationalize different accounting for in-process R&D in business versus assets acquisitions. We do believe the two frameworks should be considered for alignment. Also, in our response to Question 0.1 we have identified certain other target improvement areas that involve intangible assets.

**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.

**Response:** If Alternative B is adopted we believe R&D assets should be recognized at cost, subject to impairment review. In our opinion R&D costs should be capitalized only when the future benefits are expected to exceed costs incurred to date based on the forecasted discounted cash flows related to a specific R&D project or a relevant portfolio of R&D projects. In concept, we also believe that the mere fact that a company chooses to invest in an R&D project should provide a rebuttable presumption that recovery is expected.
We believe capitalizing R&D costs would provide relevant information in relation to the future economic benefit that R&D may generate. Capitalization of such costs communicates to the users of the financial statements the fact that the expected benefits of specific R&D projects are expected to exceed the costs. The impairment review of the capitalized costs will ensure that relevant information about recoverability of such costs is timely provided to the users of the financial statements.

We do not support fair value measurement of R&D assets, since it is not consistent with historical cost accounting for most non-financial assets. Additionally, significant issues would arise regarding how to report the increases in such fair value through the income statement, which we believe cannot be practically resolved in a meaningful manner.

We also believe that annual or more frequent impairment analysis of the capitalized R&D costs is not necessary. The objective of communicating recoverability of such costs can be achieved if impairment review is only triggered by occurrence of specific events. The rationale for this conclusion is that profitability of many R&D projects is binary, i.e., either success or failure to achieve the R&D objectives. We do not believe that a significant change in the recoverability assessment is likely absent reasonably objective triggering events, such as project abandonment, external technological or legal developments, or significant changes in ongoing R&D budgets.

Notwithstanding the above considerations, we believe that not capitalizing R&D costs is still preferable, consistent with our response to questions 0.2 and 1.1-1.2.

**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?

**Response:** As discussed in our response to question 1.3 above, we do not support fair value measurement of intangible assets. This is because we do not believe that presenting those gains and losses in either the income statement, statement of comprehensive income, or other components of equity would result in any meaningful information to the users of the financial statements.

**CHAPTER 2 – PENSION 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.

**Response:** We do not believe accounting for pension and other benefit plans is a major financial reporting issue that needs to be considered for improvement. We completely agree with FASB observations regarding inconsistencies between certain aspects of the current accounting framework and accounting concepts, as summarized in ITC 2.2 through 2.4. However, with the decreasing use of defined benefit plans, we encourage the Board to dedicate its limited resources to other areas that warrant improvement in financial reporting.
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?

Response: If the Board were to engage in the pension and other benefit plans project, we would support Alternative B. We do not believe there is a conceptual basis to leave changes in plan assets and liabilities in other comprehensive income, whether on a smoothed or a perpetual basis. Alternative B would align pension and other postretirement benefit plan accounting with other compensation models currently in place, including cash and share-based compensation. We do not anticipate practical issues with implementation of this accounting model, because entities already have the requisite information based on actuarial valuations being performed.

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.

Response: Not applicable.

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.

Response: As noted above, we support Alternative B.

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)?

Response: With the decreasing use of defined benefit plans, we do not believe the current measurement model requires significant corrections. We expect that any measurement model changes made will likely not be seen as particularly useful or relevant by the financial statement users.

Potential Path Forward

Question 2.6: What approach (that is, targeted or comprehensive reassessment) would you recommend and why?
Response: As noted above, we do not believe this project warrants the Board’s attention. However, if the Board were to undertake such a project, we would favor targeted improvements to address the three aspects of reporting identified in ITC 2.2 through 2.4.

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

Response: Additional guidance and/or examples to help distinguish defined benefit and defined contribution plans could be beneficial. Some plans have features of both, and there is no clear guidance on classification. Counterintuitive answers also exist. For example, the accounting industry appears to have reached a consensus that the social security system in Switzerland represents a defined benefit plan for entities operating in this country, because such entities have a secondary obligation under which they may be required, in a remotely contingent set of circumstances, to provide additional benefits to former employees.

CHAPTER 3 – 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)?

Response: We believe that the liabilities and equity project should be the Board’s highest priority project. As to the reasons, we agree with the observations made in the ITC 3.8 through 3.10. Liabilities and equity is the area of most restatements, because the accounting literature is complex and difficult to apply. Part of that difficulty is related to internal inconsistency of the model as well as form-based rules that are not easily understood. The existing model bears high cost to entities. Most entities and most field audit teams do not have personnel with the skill set to address all complexities of the model. Consequently, these transactions typically require involvement of audit firms’ National Office subject matter experts and third-party technical accounting consulting firms. Consequently, an entity often spends $50,000 to $100,000 in third-party costs (technical accounting consulting, valuation, incremental audit fees) to address accounting for a typical moderate complexity financial instrument transaction. Even then, issues sometimes arise due to impacts on settlement terms of other contractual arrangements the entity may have, or applicable legal regulations.

Further, the resulting accounting has little use to either management or financial statement users and is largely ignored and backed out for any analysis purposes. Public companies often back out the effects through pro forma adjustments; investors prefer their own models for analysis of entities’ debt and equity; and private companies’ Boards and investors usually mentally dismiss these numbers from consideration.

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.
Response: We believe a comprehensive overhaul to replace the current GAAP is the only way to resolve the problems. This is despite the fact that developing a comprehensive framework will likely take another 5-7 years to develop and implement. Although one could argue that making some changes in the near term (2-3 years) would be beneficial, we believe most changes, if they are to be useful, would inherently also require an overhaul of the accounting philosophy underlying current liability vs. equity classification. Specifically, the current philosophy, similar to Alternative B for simple instruments described in ITC 3.24 through 3.28, by and large limits equity instruments to ones that under no circumstances may require the entity to transfer assets to settle them, and also limits settlement amounts to values derived from the entity’s equity. We believe it is this philosophy that leads to a patchwork of complex requirements and outcomes poorly understood by users. Thus, making targeted improvements will inevitably lead to the underlying philosophy changes, which in turn will necessitate broader changes, i.e., a comprehensive overhaul, for the model to retain consistency and integrity.

Our responses to questions 3.3 and 3.4 are included following our response to Question 3.5.

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

Response: As noted in our response to question 3.2, we believe Alternative B is similar to the philosophy that by and large underlies the presently existing accounting guidance for financial instruments. For this very reason, we do not believe Alternative B for simple instruments is viable as a long-term solution. If adopted, this approach is likely to continue to be complex and perpetuate confusion for preparers, auditors, and users. It also inevitably results in financial instruments classified as liabilities when cash settlement can only occur upon a contingency that is highly unlikely to occur. We do not find this presentation to be meaningful or useful. It also obscures the true nature of the instrument.

For some of the same reasons, we also believe Alternative A for simple instruments (ITC 3.20 through 3.23) is somewhat flawed. This is because under this approach, very few instruments will be classified as equity; most financial instruments will end up in liabilities which will be turned into a “dumping ground”. Users will be unable to differentiate between “true” liabilities and complex instruments that may result in equity-based settlement, or where eventual form of settlement is uncertain. Under this approach, liability remeasurement issues will also likely arise and could obscure other amounts reported in the financial statements.

We bring the following illustration of how financial statements may look like under Alternative A. We have recently assisted a Europe-based private client with preparation of its IFRS financial statements. While IFRS does not employ Alternative A for simple instruments, in this particular case the accounting outcome was illustrative of what could transpire in US entities’ financials should Alternative A be adopted. This particular entity had preferred stock redeemable at a future date, in a currency that was not its functional currency. Thus, under IFRS rules, both the debt and the conversion feature components of preferred stock were liabilities, with the conversion feature marked to fair value. During 2015, this entity focused on R&D activities and achieved significant advancements in its clinical trials. Its 2015 statement of operations reflects its operating expenses and operating loss of $194 million. In addition, it also reflects a net finance expense of $524 million largely due to remeasurement of its conversion features. This same entity’s enterprise value
increased during 2015 from less than $1 billion to approximately $7 billion. In other words, recording of net finance expense in the statement of operations added to presenting a picture of financial performance that was completely opposite from what had actually occurred. Of note, shortly after the 2015 year-end, a majority of the entity’s shares were sold to a major pharmaceutical company, with the remaining preferred shares converting into common stock. Thus, the ultimate settlement of preferred stock had nothing to do with how it was accounted for. Further, as the entity had very little common stock outstanding and did not generate any revenues, the only practical manner in which it could ever settle its preferred stock, notwithstanding fixed-date redemption or any other rights, was either through bankruptcy or a liquidity event. In other words, cash settlement of preferred stock was known to be highly unlikely.

In summary, while we support a comprehensive overhaul of the liabilities vs. equity classification framework, we do not believe either Alternative A or Alternative B for simple instruments should be adopted.

We have provided a single response to the following questions in this Chapter.

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

Response: Before we present our thoughts about how the liabilities vs. equity issue could be addressed, we introduce what we believe could be the core underlying principles of any solution. In particular, we believe the principles could be formulated as follows:

- **User-focused.** In pursuing a user-based approach, instead of aiming to classify instruments as liability or equity based on what the Board may perceive the users’ needs would be, we believe a better approach would be to enable users to perform analysis according to their needs based on straightforward presentation and disclosure principles. Based on our experience, users have different and unique needs as related to assessment of financial instruments; there is no “one-size fits all” method that would be satisfactory to most of them. Consequently, we find that users are frustrated when instrument classification is forced based on principles not consistent with users’ needs, and the resulting remeasurement impacts financial results in ways that do not intuitively make sense. From the users’ perspective, this just means there is an extra step in performing their own analysis, to back out the accounting entries related to financial instruments.
• **Simple and practical.** This is important to both preparers and auditors to reduce the risk, cost and complexity involved in preparing the financial statements. It is also important to users, as stated above, because complexity does not add to improvements in the financial reporting; usually it has an opposite effect.

• **Lead to reasonable outcomes.** The new framework should avoid circumstances where counter-intuitive conclusions are expected to result. We do not believe users will benefit from such conclusions. To achieve reasonableness, we might suggest to contemplate classification and measurement models for specific instruments that would be most useful to the users of the financial statements. In particular, we would start with complex, rather than simple, instruments, because this would allow to flush out how to deal with uncertainties of settlement that eventually would need to be addressed. If a model is instead built on raw principles applied to simple instruments, with complex instruments falling “where they may”, we fear the outcome will be as unsatisfactory as the current model. Example instruments to start with might include (a) convertible debt; (b) redeemable convertible preferred stock, and (c) an option which can have its settlement value change based on various triggers unrelated to counterparty’s performance.

We believe it is unlikely that a model can be designed that would meet the above core principles and at the same time sustain the currently existing dichotomy of equity vs. liability. In other words, we believe the above principles likely require introduction of a third classification category, similar to the presently existing mezzanine for public companies. What we contemplate is the following framework:

• The “right side” of the balance sheet would comprise of three separate sections: (i) liabilities, further split into current and long-term as appropriate, (ii) equity claims (mezzanine), and (iii) residual interests.

• Residual interests would include primarily what is referred to in ITC 3.17(a) as perpetual instruments. Residual interests would also include additional paid-in capital and retained earnings (accumulated deficit) amounts. Liabilities would include claims against the entity that are required to be settled with cash or other assets. Equity claims would comprise of any instruments that do not represent liabilities or residual amounts. In other words, this category would include instruments that contain equity or liability settlement features, with the eventual method of settlement uncertain, such as convertible debt, options, warrants, and certain preferred stock and noncontrolling interests.

• No instruments would be bifurcated unless an instrument contains two or more freestanding instruments (as currently defined). Thus, in response to question 3.6, we favor Alternative B (ITC 3.31, i.e., no bifurcation) model for complex instruments. This is because we believe bifurcation obscures users’ understanding of the financial statements and the entity’s performance. Even if users favored bifurcation, there is likely a diversity of models in use many of which would differ from the one the Board might mandate. Bifurcation also adds complexity for preparers and auditors that we do not believe would translate into benefits for users of financial statements.

• Liabilities and equity claims would be measured at anticipated settlement value. In other words, this is the value for the entity to settle the claim based on the manner of settlement anticipated as of the measurement date. If settlement is anticipated via issuance of new residual interests, the value is
not changed after initial issuance. If settlement is anticipated via cash or issuance of new equity claims, the value is remeasured if the underlying means of settlement require such remeasurement.

- If the expected settlement manner changes, the entity would remeasure the instrument consistent with the new settlement manner. For example, an option may entitle holder to receive either 1,000 or 2,000 shares of common stock depending on a contingency. Upon a change in the expected outcome of the contingency, the instrument’s measurement would change. This approach is similar to present accounting for performance based stock compensation awards under ASC 718 with multiple possible performance-based outcomes.

- For liabilities, this approach results in the same amounts as the accreted cost method currently used to measure debt, payables, accruals, etc. Discounting would be optional if the settlement period does not exceed one year.

- All changes in the carrying value of liabilities and equity claims would be reflected in the income statement.

- Robust disclosures regarding potential settlement methods would be required in the footnotes to the financial statements. For example, if an instrument provides for multiple settlement alternatives, the footnotes would disclose pertinent details of such alternatives, including potential impact on the entity’s financial position and results of operations. Also, the entity would be required to disclose its assumptions and estimates regarding the expected settlement manner.

- EPS calculations would be aligned with the anticipated manner of settlement.

We would be happy to further elaborate our thoughts in a round table discussion or in a separate meeting with the FASB staff.

We believe a framework such as this would be more useful to the investors due to the following reasons aligned with the principles we formulated above:

- **It is user-focused.** It does not bifurcate any instruments and reports all instruments at the value at which settlement of the instrument is expected, and in a manner consistent with the form of such settlement. In particular, settlement with residual interests is recorded at the issuance date value and is not subsequently remeasured, reflecting the nature of the counterparty investment. Settlement with cash is remeasured to align with the ultimate cash settlement amount. Investors also have access to disclosures about alternative settlement mechanisms to enable them to perform their analyses.

- **It can be made simple and practical.** By and large, it does not require sophisticated calculations other than what an entity would have to perform anyway to calculate the actual settlement amounts. It also eliminates a lot of the current complexity in the financial statements by presenting all instruments with multiple settlement alternatives in one “equity claims” category, which reduces the risk of errors and restatements.

- **It leads to reasonable outcomes.** It presents various instruments based on their anticipated settlement manner, which would align their classification and measurement with management’s expectations. It would also communicate those expectations to the users. Consequently, this method is meant to result in accounting for various instruments consistent with their substance.
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.

Response: Consistent with our response to the preceding questions, we favor remeasurement based on changes in the expected settlement value over either intrinsic or fair value. We believe there are inherent flaws in both intrinsic and fair value methods. Specifically, the intrinsic value method does not associate any value with at- or out-of-the-money options. The fair value method results in amounts that investors often find to be of little value. However, if we were to choose, we would favor the fair value method.

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?

Response: We believe there are instances where remeasurement of instruments at each reporting period is not useful. If the expected settlement manner of the instrument has not changed, we would not anticipate that investors would benefit from recording of the remeasurement, other than as related to the recognition of the time value of money, if relevant. Our proposed method above contemplates remeasurement of instruments classified as equity claims only to the extent it is consistent with the anticipated amount and method of settlement.

CHAPTER 4 – REPORTING PERFORMANCE AND CASH FLOWS

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?

Response: Consistent with our response to question 0.2, we do not believe that income statement presentation is a major financial reporting issue that needs to be addressed. We considered the improvements being contemplated by the Board in ITC 4.15 through 4.24. While we agree that improvements in reporting and ability to evaluate performance would arise from some of the contemplated changes, we do not believe making such changes is a critical area of improvement compared to other financial reporting improvement needs.

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?

Response: If the Board were to engage in a project on income statement presentation, we believe defining operating and non-operating income categories would be helpful in the income statement. Further, we would support aligning categories and definitions between the income statement and the cash flow statement. There is currently a lack of guidance as related to the income statement and therefore, diversity;
in addition, issues arise from time to time that preparers and auditors find hard to resolve without having a benchmark of authoritative literature. Examples of items where diversity exists are (i) gains/losses from disposition of businesses; (ii) gains/losses from disposition of assets; (iii) reclassifications of cumulative translation adjustment upon disposition of foreign subsidiaries; and (iv) foreign currency gains/losses. Last, confusion tends to arise due to differences between operating activities and operating cash flows; these differences may also hinder the analysis of the financial statements. We do not believe, however, that income statement classification issues would usually have a significant impact on the users’ ability to evaluate the entity’s performance.

With respect to the three alternatives proposed in ITC 4.15 through 4.19, we believe the most expedient approach would be to describe (not define) both operating and non-operating activities, similar to the approach taken in ASC 605-45 where indicators for both gross and net reporting are described. We expect this approach would allow sufficient latitude for management to take into account all relevant company and transaction-specific facts and circumstances while introducing a comprehensive framework that applies to all industries or types of transactions. Further, it would also allow to consider not just why a transaction should be categorized into one category but also why it should not be categorized into the other.

In addition, it will be beneficial if the Board provides illustrative examples of applying the framework to various industries and contrasting the reasoning as to why for certain transactions categorization as operating is appropriate for some entities but not others.

**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)?

**Response:** Yes, we believe it is possible to describe operating and non-operating activity categories in a way that all types of reporting entities would find effective, following the approach in our response to Question 4.2.

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

**Response:** We believe it will be challenging to provide a standardized definition statement to accommodate differences between various industries and transaction types. Also, even with a standardized definition, management judgment could not be avoided completely. Therefore, we believe an indicator based approach described above, combined with appropriate management judgment, would be most appropriate. This would balance the needs for comparability among various entities, consistency in application to various types of transactions, flexibility based on entity facts and circumstances, as well as implementation cost efficiency.

**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?
Response: We do not support any of Alternatives A, B or C for income statement presentation purposes. We observe that all three alternatives are meant to customize income statement to enable users to derive information from which they could perform more extensive analysis of financial performance. However, we believe performance analysis-focused presentation is better served in a report such as Management Discussion & Analysis (MD&A) included in periodic SEC reports. Alternatively, certain information could also be presented in a footnote to the financial statements. Conversely, we believe separate identification of infrequent items, remeasurement amounts, or functional items on the face of the income statement would clutter the income statement and lead to inconsistencies in presentation. For example, remeasurement as defined in ITC 4.22 would encompass items of both non-operating and operating nature, such as changes in the value of contingent consideration arising out of business combinations, and certain changes in bad debt allowances and provisions; all such items may also be recurring or non-recurring. Ultimately, we expect such changes would fail to accomplish the objective of enabling deeper performance analysis for users, because these items only represent a fragment of the information users might desire to see for analysis purposes. Finally, we do not expect such line items will resolve the issue of companies focusing on non-GAAP measures as indicators of performance.

As to the information that could be included in MD&A and/or footnotes, we believe the following could be useful:

- Identification and discussion of significant items that do not occur on a regular basis, or where the amounts may differ significantly from period to period, and their impact on financial performance (this would also capture items subject to remeasurement);
- Identification of the significant components (by nature) within functional line items, as well as significant fluctuations in these components and the key drivers that account for a majority of the fluctuation in such line items from period to period;
- Disclosure of the amounts associated with the above factors.
- At a minimum, entities could be required to disclose employee compensation and depreciation and amortization expenses included in various functional line items, consistent with the requirements of IAS 1.

We do not believe these requirements will trigger significant costs because entities already perform fluctuation analysis of line items in the income statements as part of MD&A preparation.

In line with the overall direction of the above comments, we believe it may also be expedient to have entities present a separate statement of management performance. Such statement would aim to replace and, in effect, legitimate non-GAAP (pro forma) reporting. It would enable entities to present management view of the entity’s performance using performance measures that management considers to be most relevant for the entity. Unlike current non-GAAP information, such statement could encompass all transactions in the income statement (and not just individual line items), and could use any measure management finds useful and relevant for measuring its performance. Of course, any measure used would need to be explained and reconciled to the GAAP income statement. While this proposal may appear too radical, we believe it would benefit users by enabling them to look at the business in the same way management does. We do not believe
there would be a significant risk of management performance measures supplanting net income as reported under GAAP. Of course, an entity could also choose to report management performance using GAAP measures.

Certain of the above information is better suited for MD&A than financial statement footnotes, as it may not easily lend itself to being audited. As such, we acknowledge that such changes may have to be promulgated by the SEC instead of the FASB.

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

**Response:** We believe it would be helpful to introduce guidance with respect to classification of income as revenue vs. gain, and correspondingly as expense vs. loss. This should also be aligned with any evolution of how operating vs. non-operating activities are defined. Based on our experience, due to a lack of formal guidance, companies are looking to paragraphs in Statement of Financial Accounting Concepts No.5 and No.6 when making this determination. The guidance there is limited. In addition, the assessment is particularly challenging in cases where entities receive income from monetization of their productive assets that are also used in revenue-generating activities, through transactions that are not one-time but do differ from the usual sales transactions of the entity. For example, a technology entity which typically generates revenue from product sales may enter into a long-term licensing arrangement with a third party for its proprietary technology, upon which the entity’s main products are based. The entity will receive an upfront payment, milestone payments and recurring royalties in the future under the licensing arrangement. It would be helpful if the Board could provide guidance that addresses classification of such income.

**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?

**Response:** Overall, we believe segment reporting is a financial reporting area where there are improvement opportunities that could be implemented without significant increase in preparation costs. We have further elaborated this view through responses to questions below. In reaching this conclusion, we considered that the current reporting structures provide fairly limited disclosures of segment performance, as various key income statement line items are not reported at the segment level. Further, information can be difficult to reconcile to the consolidated financial statements. These observations are consistent with the Board observations in ITC 4.32 through 4.34.

**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?

**Response:** We believe Alternative B, which embeds Alternative A, represents the right balance to enhance the users’ ability to predict future segment performance and understand the interrelation between segment
information and the primary financial statements. This is because we believe gross margin, operating cash flow, and working capital are commonly used in analysts’ valuation models and can provide accurate and meaningful historical trends. Additionally, we believe disclosure of operating expenses by category would also be useful to users.

We agree that additional measures should only be required to be disclosed if they are used in the segment resource allocation and performance assessment. We recommend for clarity purposes that such measures, if they are not reported regularly to the CODM, be marked as “N/R” (“not reported”), instead of as nil amounts.

We caution that in some cases segment gross margin, operating cash flow, working capital amounts or operating expenses may be reported to management on a non-GAAP basis. For example, a segment may benefit from services provided by another segment or a service center, which are not charged to such segment in management reporting. Likewise, an entity may include investing or financing cash flows in its definition of segment operating cash flows. Also, classification of intra-segment cash flows as operating, investing or financing, and of intercompany accounts receivable or payable as current or noncurrent, can be subjective, challenging and often difficult to compile. Sometimes we also see intercompany accounts in one entity offset with equity balances in another entity. Thus, certain aspects of segment reporting, including a reconciliation to the financial statements, may be challenging and/or not meaningful. To the extent such measures are reported, we believe it would be appropriate to mitigate the impact of these factors as follows:

- By including qualitative and/or quantitative information about lack of comparability among segments and with the consolidated totals
- By explaining whether and how segment performance measures used differ from the corresponding GAAP measures (or reconciling to such GAAP measures)

For these same reasons, we believe Alternative B provides a better balance of additional segment information to be disclosed than Alternative C. This is because Alternative B (with the suggested enhancement related to operating expenses) limits the required disclosures to what, in our opinion, is most useful to users. In contrast, we expect that Alternative C likely would not result in incremental meaningful information, because many entities do not track segment balance sheet, cash flow statement and non-operating gain/loss information at a segment level. Even when such information is tracked, it is likely not used to make decisions about resource allocation and performance assessment.

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?

Response: (a) With respect to the aggregation criteria, we do not believe a bright quantitative threshold and additional aggregation tests would be effective. Different financial measures may be appropriate to represent economic characteristics for different types of business. In addition, a 10% margin difference could be significant for a thin-margin e-commerce reseller; but might not be meaningful for a high-margin
technology consumer product maker who dominates the market. We believe it would be consistent with the objectives of ASC 280 for management to decide how to compare economic characteristics of two segments.

We also believe clarifications and additional examples will be helpful with respect to the aggregation criteria. In particular, the current standard only introduces one indicator, average long-term gross margin. We believe preparers will benefit from various industry examples with different indicators used to assess economic similarities. Other examples could relate to businesses managed by geography instead of by product and service lines.

ASC 280-10-55-7A and 7B provide that similarity of economic characteristics should be evaluated based on future prospects and not necessarily on current indicators only. Thus, one could interpret that future prospects are a more determinative factor than the current indicators. However, the SEC through speeches and/or comment letters has conveyed that an expectation that operating segments will have similar economic characteristics (e.g., long-term average gross margins) in the future does not take precedence over the lack of similarity in current and past performance. Clarification regarding this point will be helpful. A potential resolution could be to require disclosure when an entity combines two operating segments based on future prospects, including the basis for management’s prediction.

(b) With respect to management vs. governance perspective, we acknowledge observations in ITC 4.33 that with the advancement of technology, the CODM receives substantially more information about the entity, and further, that the information packages regularly reviewed by the CODM can be used to restrict the individual items that are disclosed by segment. These observations are also consistent with our experience from client engagements. However, we believe the root cause is that the current guidance and therefore the entities’ practices place too much emphasis on what information is made available and is reviewed by the CODM. Instead, we believe segment information analysis should focus on the disaggregated level at which the CODM uses information to make operational decisions to allocate resources and assess performance. Thus, while we believe management perspective continues to be important, reports provided to the Board of Directors may often provide insight about how management uses the information to make decisions about segment performance. This is because the CODM reports to the Board which assesses his/her performance. Additionally, Board members hold fiduciary duties and are usually informed at a sufficiently detailed level for investors to make investment decisions. Therefore, reviewing Board (not management) reports could be a practical first step toward identifying the entity’s segments. As additional steps, to emphasize the usage-focused approach, entities would also consider other factors, including organization charts, budgeting process, compensation structure, management meeting minutes, earnings calls, investor presentations, and footnote disclosures. Lastly, entities should also consider if important operational decisions have been made based on information that is not included in the CODM or governance reports. This will help ensure completeness of the consideration as well as avoid structuring of reporting packages to limit disclosures.

We believe this proposed segment process revision will not increase entities’ costs significantly, if at all, as we believe the information is already available and used by organizations for decision making processes.
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?

Response: We observe that certain disaggregated revenue information will be required to be reported under ASC 606 when companies adopt this standard. We believe such information will provide additional enhancements to segment information and will facilitate performance analysis by users. We have no additional observations regarding segment disclosures.

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?

Response: Overall, in our experience, both preparers and users attribute no value to any amounts reported in OCI, including any reclassification adjustments to net income. Consequently, we do not believe this is a financial reporting area that requires urgent attention from the Board. However, as noted in ITC 4.57, OCI has no conceptual basis and was not defined to be applied consistently to transactions with similar characteristics. Therefore, we believe any narrow-scoped incremental improvement efforts will result in nothing but continued confusion and perceived utter lack of value among preparers and users. This applies to all alternatives described in ITC 4.60 through 4.65.

Our recommendation is to eliminate OCI altogether. For example, we do not believe there is any reason unrealized gains and losses on available for sale securities are included in OCI while those on trading securities are recorded in net income. Similarly, unrealized gains and losses on available for sale securities are “recycled” when those securities are sold. However, gains and losses on translation of monetary assets held in foreign entities are not “recycled” until the entities themselves are liquidated, which often results in those gains and losses remaining in OCI for a very long time.

We understand that more volatility will be introduced into income statement with this approach. However, volatility should be viewed relatively. In other words, when volatility is increased for all entities, the relative difference provides a perspective in assessing whether a particular entity has effectively managed its exposure to gains/losses driven by external factors.

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?

Response: We do not believe either of the two alternatives could result in meaningful improvement of financial reporting.
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?

Response: We do not believe either (a) or (b) will improve even marginally the relevance of information contained in OCI components because of the issues pointed out in our response to Question 4.11 above. We do not believe there is anything whatsoever that can be done to OCI components in their current status to be of any relevance to any preparers or users.

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?

Response: Please refer to our proposed approaches in response to Question 4.11 above.

Statement of Cash Flows

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?

Response: While we do not believe improvements in the cash flow statement are urgently required, we believe there are opportunities to make it more meaningful to users without exposing entities to a significant incremental cost. Additionally, as currently defined, preparation of the cash flow statement already requires a significant level of effort from preparers. Thus, we do not expect a significant incremental effort to result from the improvements. We have further elaborated on our views through responses to questions below.

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?

Response: If the Board takes on this project, we recommend that the Board reconsider the three-category structure after the operating vs. non-operating categorization project on the income statement is complete. Specifically, we support a blend of Alternatives A and C in ITC 4.84 and 4.86. In particular, we recommend to align operating items in the income statement and operating cash flows in the cash flow statement, such that the same transactions are presented on a consistent basis between the two statements. Either direct or indirect method could be used. The direct method would allow presentation as proposed in the Alternative C. The indirect method would start with operating income instead of net income.

In addition to the cash flows from operating activities, we recommend to have just one additional cash flow statement category. It could be called “other cash flows” and would incorporate all non-operating cash flows (defined consistent with non-operating items in the income statement), investing and financing cash flows. These cash flows would be presented on a gross basis. In our experience, users benefit from reporting of individual investing and financing cash flows at a detailed level, not from the amounts reported as totals for
these categories. This approach would significantly reduce the complexity of cash flow statement preparation, eliminate potential for errors and restatements, and result in more meaningful information. This is because most transactions will not be split between categories following arbitrary (even if reasonable) rules. In this regard, we observe the recent EITF Issue 15-F that aims to add guidance regarding cash flow statement classifications for certain types of transactions. With the existing cash flow statement structure the consensus is bound to follow, this simply adds to the existing pattern that makes the cash flow statements prone to error, increases complexity, and reduces, not improves, the usefulness of the information reported in the cash flow statement, by requiring split presentation of certain transaction types.

We do not believe order of precedence in which the cash receipts and payments should be classified among categories as proposed in Alternative A is necessary. This is because of the proposed alignment between income and cash flow statements and the definitions of operating and non-operating activities within the income statement. We also believe companies should use judgment to classify cash flows into the most appropriate category when there is no clear guidance as to which category might apply to a particular transaction.

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?

**Response:** Refer to our response to Question 4.22.

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

**Response:** Refer to our response to Question 4.22.

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?

**Response:** Please refer to our response to Question 4.16.

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

**Response:** We believe the proposed framework in our response to Question 4.16 would help alleviate this question. It would align the cash flow statement structure to the income statement structure, and further limit cash flow statement to just two categories. This would enable users to perform their analysis at a disaggregated level with respect to both operating and other activities of the entity and help remove the
focus from total cash flows from various activities which, we believe, are not particularly used for analysis purposes.

We note also that the aligned cash flow and income statements frameworks we proposed are based on management definition of what represents operating activities using the indicator-based approach similar to what is provided in Topic 605-45 (as we discussed in our response to Question 4.2). Thus, we believe this approach inevitably requires management’s judgment and analysis.

Conversely, we believe Alternative B is likely to result in significant loss of comparability to other companies such that performance analysis and valuation by users will be hindered.

**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?

**Response:** Please refer to our response to Question 4.16.

**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?

**Response:** We have identified the following improvement opportunities.

- **Working capital disclosures.** Some entities aggregate changes in working capital into fewer lines in the cash flow statement. Also, sometimes entities aggregate changes in current and noncurrent assets or liabilities (e.g. other current and other noncurrent assets). In our experience, usually this is done because amounts in the individual line items are immaterial. However, we understand that changes in working capital are among the key assumptions in analysts’ modeling processes and provide incremental information if they are presented in a more disaggregated manner. Accordingly, we support a narrow-scoped improvement to align cash flow statement (under indirect method) and balance sheet presentation in relation to working capital accounts. We believe most entities have the data required for such alignment readily available. However, we also caution that in some cases, following the balance sheet presentation may not be meaningful. This is because the same balance may be split on the balance sheet into two or more categories. This in particular relates to liabilities and deferred taxes, but could also apply to noncurrent inventories and other items.

- **Cash received from customers and paid to vendors.** We understand cost is seen as a major impediment for companies to use the direct cash flow method. However, we believe investors would ascribe value primarily to certain types of information within a direct cash flow statement and not necessarily to the entire statement. We believe such information includes cash received from customers and cash paid to vendors, which is routinely tracked by entities to manage their cash positions. Accordingly, we suggest entities using the indirect cash flow method could disclose supplementally cash received from customers and cash paid to vendors. We also encourage the
Board to reach out to users to determine if other direct cash flow items could be beneficial and available without significant incremental cost.

- **Distinguishing between operating and investing cash flows.** We recommend adding guidance to help separate noncash charges in the income statement (e.g., depreciation and amortization) that follow cash-based acquisitions of fixed assets and intangibles from cash-based items such as recognition of prepaid expenses and deferred costs. As noted earlier in this letter, classification issues do arise as to what is a fixed asset vs. an intangible vs. a prepaid/deferred cost. Also, items in the latter category could be current or long-term, further adding to the challenges. Similar issues also arise with respect to classification of cash flows from sales of available for sale securities where practice varies with respect to what portion should be classified as operating vs. investing cash flows. We believe clarification is desirable whether the existing cash flow statement structure is retained (to help separate operating and investing cash flows) or the new structure is adopted per our response to Question 4.16 (to help separate operating and other cash flows).

- **Capital expenditures.** We believe it would be challenging for many companies to practically segregate “maintenance” and “expansionary” cash flows related to fixed asset acquisitions. This is because GAAP does not define these concepts, and adding definitions would create unnecessary complexities. Also, many practical challenges will arise, as many companies operate today in a non-industrialized environment. For example, office leasehold improvements may be the largest fixed asset for many technology companies. From time to time, a company may relocate to a new facility. We do not expect it would be productive to try to devise measures of how much of the leasehold improvement expenditure may be for capacity expansion and how much for replacement of the original facility. Even if the number of employees in the facility is exactly the same, one could argue that a better office environment would increase employees’ productivity.

Instead, we believe MD&A could be used for qualitative (or quantitative if relevant) discussions about capital expenditures. Such discussions could, among others, specifically focus on the objectives (e.g., capacity expansion, useful life extension, replacement due to new technologies, etc.). We believe this approach will largely address users’ needs. In addition, location in the MD&A alleviates the burden of high level of confidence and auditability required for primary statements or footnotes.

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

**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?

and

**Question 4.24:** What issues and solutions should be addressed within those projects? Please consider the priority of pursuing the issues and were solutions?
Response: We do not believe any of the proposed projects in this chapter represent the most urgent issues that require immediate attention from the Board. If the Board does undertake them, we recommend that operating vs. non-operating presentation of income statement items be addressed simultaneously with categorization of cash flows, because we believe these two projects should be aligned. This is because simultaneous deliberations on both items are more likely to expose challenging areas while allowing to retain a consistent approach to classification between the two statements.

We believe the project on other comprehensive income could be accomplished either before or after the work is done on the income and cash flow statements.

The remaining income statement, cash flow statement and segment disclosure projects can be undertaken in any sequence.

From benefits to the users perspective, we believe the following projects (listed in no particular order) should be the highest priorities:

- Segregation of operating vs. non-operating (other) activities in the income and cash flow statements
- Additional disaggregated information in the cash flow statement
- Segment disclosure improvements

We would be pleased to respond to any questions the FASB or its staff may have concerning our comments.

Sincerely,

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