**Financial Accounting and Reporting Section
of the American Accounting Association**

Financial Reporting Policy Committee

**Response to the FASB Exposure Draft:
Presentation of Financial Statements (Topic 205) – Reporting Discontinued Operations**

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The Financial Reporting Policy Committee (the Committee) is charged by the Financial Accounting and Reporting Section (FARS) of the American Accounting Association (AAA) to provide comments on discussion papers, exposure drafts, and accounting standard updates related to financial accounting and reporting issues. The Committee bases their comments on academic analyses and research findings. The Committee is pleased to provide the Financial Accounting Standards Board (the Board) comments on the Proposed Accounting Standards Update, "*Presentation of Financial Statements (Topic 205) – Reporting Discontinued Operations*" (the Exposure Draft). The comments in this letter reflect the views of the individuals on the Committee and do not represent an official position of either FARS or the AAA.

General Comments

The main provisions of the Exposure Draft narrow the definition of items qualifying as discontinued operations and increase disclosures for those items. The FASB proposes these rule changes because: (1) certain stakeholders suggest that too many disposals of assets qualify for presentation as discontinued operations, potentially leading to diminished decision usefulness of this information; (2) the over-inclusion of disposals categorized as discontinued operations also leads to unnecessarily high financial statement preparation costs to comply with existing requirements; and (3) the new criteria would enhance convergence of the FASB's and the IASB's reporting requirements for discontinued operations (particularly under IFRS 5).

Regarding the potentially diminished decision usefulness of this information, two streams of research are relevant. First, the academic literature provides no substantial evidence that current reporting of discontinued operations lacks decision usefulness, and only limited evidence that it is being manipulated by management. Rather, the preponderance of evidence suggests that the reporting of discontinued operations is useful in distinguishing firms' recurring and nonrecurring performance. Second, more general research on the aggregation versus disaggregation of reported data suggests that although managers can use this reporting decision to enhance the informativeness of financial reports, incentives (such as capital markets benefits to achieving certain earnings targets) can also lead to distortions in how these items are reported.

Regarding potentially high preparation costs, the academic literature provides no evidence on whether the expanded number of items included in discontinued operations under SFAS 144 had caused these costs to be prohibitively high. This likely reflects more broad challenges within the academic literature to identify clear measures of such preparation costs. However, as a practical matter, it seems likely that management currently tracks this information for internal purposes. Thus, it is not clear from the Exposure Draft how the revised definition would significantly reduce preparation costs.

Regarding increased convergence, the proposed changes can provide related benefits to the extent they more closely align U.S. GAAP and IFRS. Although there is no direct academic evidence of costs/benefits attributable to convergence between U.S. GAAP and IFRS, a broad literature does provide evidence of capital market benefits attributable to convergence in non-

U.S. settings, such as increased liquidity (Daske, Hail, Leuz, and Verdi 2008), increased mutual fund flows (Defond, Hu, Hung, and Li 2011), and reduced ability of insiders to exploit private information (Brochet, Jagolinzer, and Riedl 2013)

Below, we respond to the individual questions posed within the Exposure Draft.

Question 1: *Do you agree with the proposed definition of discontinued operations? Is it understandable and operable?*

Yes, but with the following reservation: the proposed narrower definition of discontinued operations may better signal managers' intended long-term strategic plans, but it may inhibit the clear and full disaggregation of reporting of items expected not to recur in the following year.

The academic literature consistently documents the benefits of disaggregation of recurring and nonrecurring items within the income statement: greater earnings predictability (e.g., Fairfield, Sweeney, and Yohn 1996; Herrman, Inoue, and Thomas 2000), clearer signals about managerial performance for compensation contracting (Saito 2012), and more efficient market valuation (Lipe 1986; Bradshaw and Sloan 2002; Burgstahler, Jiambalvo, and Shevlin 2002; Gu and Chen 2004). The usefulness of this distinction hinges on identifying the more persistent nature of recurring items, thus providing a clearer signal to financial statement users about managerial performance and expected future cash flows. Relatedly, there is some academic evidence that managers use available discretion over the presentation of accounting information (specifically, special items) within the financial statements to help users better identify recurring versus non-recurring income statement components (Riedl and Srinivasan 2010).

However, the proposed narrower definition of discontinued operations would result in fewer items being classified as discontinued operations (i.e., less disaggregation). Although this narrower definition is consistent with addressing stakeholders' stated concern of too many items being classified as discontinued operations, it does raise a potential concern that nonrecurring items could be included in income from continuing operations. Consistent with this concern, Curtis, McVay, and Wolfe (2013) demonstrate that the broader definition of discontinued operations under SFAS 144 (compared to APB 30, which is closer to IFRS 5) allows better prediction of one-year-ahead earnings. This suggests the proposed narrower definition could render financial statements less useful by overly restricting the inclusion of (economically) non-recurring items that qualify for discontinued operations treatment. To address this issue, the standard should maintain required separate disclosure of material revenue and expense streams not expected to recur in the future and also not qualifying for discontinued operations treatment.

One potential advantage of the proposed narrower definition is that it could reduce manipulative reporting. Barua, Lin, and Sbaraglia (2010) find that firms shift recurring operating expenses to income-decreasing discontinued operations to increase core earnings. This type of classification shifting offers management the potential to distort the reporting of continuing performance, which in turn helps firms meet certain core earnings benchmarks in the current period (e.g., analysts' forecasts). The proposed narrower definition could make this type of manipulative reporting behavior more difficult by reducing the frequency with which discontinued operations are reported. Note, however, that Curtis, McVay, and Wolfe (2013) find no evidence of differential opportunistic reporting of discontinued operations under SFAS 144 versus APB 30.

Another potential advantage of the proposed definition is its ability to provide a clearer signal of management's strategic intent, which would affect longer-term performance (i.e., performance beyond one year). We could find no literature which directly addresses this point.

Indirectly related research shows that SFAS 131's "management approach" to reporting operating segments based on the internal structure of the firm better reflects management's major strategic initiatives (Berger and Hann 2003, 2007; Ettredge, Kwon, Smith, and Zarowin 2005). It appears from the proposed changes that two firms could have similar disposals but for only one firm would this constitute discontinued operations. If this is the case, the proposed definition seems conceptually closer to the intent of SFAS 131 to reflect management's longer-term strategic intent.

Question 2: *Do you agree that the continuing involvement criterion in the existing definition should be eliminated? Why or why not?*

Yes. Although there is no direct academic evidence regarding this, we base our response on the following intuition. This proposed elimination would broaden the definition of items included in discontinued operations, in contrast to the other aspects of the proposed definition of discontinued operations discussed in Question 1 above. To the extent enhanced disclosures allow users to further distinguish recurring and nonrecurring income, the inclusion of these items in discontinued operations may better reflect management's strategic intent.

Question 3: *Do you agree with the scope of the amendments in this proposed Update? Do you agree that disposals of equity method investments and oil and gas properties that are accounted for using the full-cost method of accounting should be eligible for discontinued operations presentation if they meet the criteria to be reported in discontinued operations?*

Yes, as we believe that the proposed criteria can be applied for a wide range of economic phenomena and settings, including disposals of equity method investment as well as oil and gas properties. As indicated in our response above, the broader definition of discontinued operations to include equity method investments, along with enhanced disclosures, should improve the predictability of earnings and better signal management's strategic intent.[1]

Question 4: *U.S. GAAP and the amendments in this proposed Update do not specify whether an entity should reclassify the assets and liabilities of a discontinued operation classified as held for sale in the statement of financial position for periods before reclassification. Should an entity be required to reclassify the assets and liabilities of a discontinued operation classified as held for sale in the statement of financial position for periods before reclassification? Why or why not?*

Yes. Although there is no direct academic evidence on this issue related to discontinued operations, conceptually this will enhance inter-period comparability across all financial statements (including the statement of financial position), which is shown in accounting research to improve decision usefulness (De Franco, Kothari, and Verdi 2011).

Question 5: *Do you agree with the disclosures required for disposals of individually material components of an entity? If not, which disclosure or disclosures would you eliminate or add and why?*

Yes. Related to the response in Question 1, separate disclosure for individually material components would help users assess the recurring versus nonrecurring portion of current performance. To the extent the proposed narrower definition prevents these disposals from being reported as part of discontinued operations, additional disclosures should clarify their nonrecurring nature.

The tax consequences associated with these material disposals are not separately disclosed. This could be problematic as recurring versus nonrecurring taxes (or tax benefits)

[1] We note that the spirit of this notion is consistent with the Boards' thinking underlying the Revenue Recognition project's objective of having a single set (or at least a minimum number) of guidelines for handling transactions rather than unique approaches for each industry's particular transactions and circumstances. To the extent that is a primary objective generally in standard-setting, it follows that disclosures for oil and gas discontinued operations should be treated the same as other discontinued operations.

affect predictions of future cash flows. To the extent that the tax consequences associated with these individually material components are significantly different than those for normal profits, separate disclosure could be provided.

Question 6: *Do you agree that businesses held for sale on acquisition should be excluded from certain disclosure requirements? Why or why not?*

In general, material information that helps users forecast future cash flows and their riskiness is valuable to users. From that standpoint, if a business held for sale on acquisition represents a material component of the acquisition or of the acquirer's business, disclosures would seemingly be relevant and should not be excluded from disclosure requirements. It is not clear from the exposure draft what rationale supports differential disclosure for such situations. There may be research findings that are relevant to this question, but without an articulated rationale, we are not aware of academic research findings that are directly on point.

Question 7: *Do you agree with the prospective application transition method? Why or why not?*

No. The academic literature provides considerable evidence that firms' financial performance patterns over time are important for predicting future performance (e.g., O'Hanlon 1995). This literature would suggest retroactive application to assess the performance trend of continuing operations. However, we recognize the potential costs of separately identifying such effects (e.g., the past tax consequences of these operations). One possibility is for the firm to provide disclosure of retroactive pre-tax profits. Such information should be readily available to management, especially considering the narrower definition of discontinued operations. These data were likely used by management to decide to discontinue these operations, so they should be readily available and preparation costs should be minimal.

Question 8: *How much time do you think will be needed to prepare for and implement the amendments in this proposed Update?*

The academic literature offers no guidance on this issue. A timeframe similar to implementation of SFAS 131 seems reasonable, given similarities in the underlying economic rationale (e.g., both use a management perspective) and operating data needed for the financial reporting (e.g., the segment performance data).

Question 9: *Do the modified disclosures for nonpublic entities provide the right level of disclosure? If not, how should the proposed Update be modified for nonpublic entities?*

Yes. We understand the concerns expressed by private firms that certain accounting standards applicable for public firms seem overly burdensome, often do not apply to them, and may not be relevant to their external constituents (Blue Ribbon Panel Report on Standard Setting for Private Companies 2011). Recent research provides evidence that public firms' financial reporting reflects greater demand for financial information (Hope, Thomas, and Vyas 2013). Private firms often communicate through private channels. We find no literature suggesting that the proposed exclusions for nonpublic entities would materially affect their information environment.

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