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COMMENTARY

Response to the Financial Accounting Standards Board's and the International Accounting Standard Board's Joint Discussion Paper Entitled *Preliminary Views on Financial Statement Presentation*

American Accounting Association's Financial Accounting Standards Committee (AAA FASC)

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SYNOPSIS: The Financial Accounting Standards Board (hereafter, FASB) and the International Accounting Standard Board (hereafter, IASB) issued a joint discussion paper titled *Preliminary Views on Financial Statement Presentation*. The Boards are seeking comments on whether their proposed model for financial statement presentation would improve the usefulness of the financial statement information for financial decision makers. This paper sets forth the American Accounting Association Financial Accounting Standards Committee (hereafter, the committee) summary comments as well as responses to several of the FASB's and IASB's (hereafter, jointly mentioned, the Boards) specific objectives and principles-related questions. Overall, the committee believes that the model has several appealing features, but also has several potential problems. Many of the problems discussed related to potential learning impediments for users to adapt to the new presentation format.

Keywords: Financial Accounting Standards Board; International Accounting Standards Board; exposure draft; financial statement presentation.

This comment was developed by the Financial Accounting Standards Committee of the American Accounting Association and does not represent an official position of the American Accounting Association.

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INTRODUCTION

The committee is charged with responding to requests for comments from standard setters on issues related to financial reporting. The committee appreciates the opportunity to respond to the FASB's and the IASB's joint discussion paper entitled *Preliminary Views on Financial Statement Presentation* (hereafter, *Preliminary Views*). The comments in this paper reflect the views of the individuals on the committee and are not necessarily those of the American Accounting Association.

The Boards are seeking comments on whether their proposed model for financial statement presentation would improve the usefulness of the financial statement information for financial decision makers. Overall, we support the Boards' efforts to improve financial statement presentation and believe the proposed model offers several appealing features. There are potential problems with the model as well. In the remainder of this paper, we indicate several views and offer general questions and additional considerations about the model within the context of certain of the objective and principles-related questions posed by the Boards. Our concerns generally fall into the following categories: (1) timing and concurrent changes; (2) user learning issues and impediments to this learning; (3) objectives and terminology; (4) categorizing activities: operating (business) and financing; and (5) categorizing assets and liabilities—the management approach.

ANALYSIS

Timing and Concurrent Changes

We begin by questioning the timing of the proposals on two grounds. First, an implicit conceptual framework is woven into the document. Prudence suggests completion of the conceptual framework itself first to ensure that the views in the financial statement presentation standard are entirely consistent with the ultimate conceptual framework. Second, the reporting technology is changing rapidly at this time given the momentum in user and preparer circles for emerging reporting technologies such as XBRL and "data tagging." We implore the Boards to deliberate this issue within the context of the current environment as well as future expectations.

Regarding the current environment, user decision models often rely on databases that have a matrix of data items with standardized definitions. We believe it is important to consider the impact of proposed changes on sophisticated users' computer models that access and process machine-readable versions of company reports to make financial decisions. Finally, any proposed standard should not sidestep important questions concerning the display of items of other comprehensive income and recycling for the sake of expediency; for example, just to get a converged financial statement presentation standard on the books to pave the way for adoption of IFRS in the U.S. under an arbitrary timetable. The disposition of price changes under the asset and liability recognition approach has emerged as a high-profile topic in contemporary reporting. Thus, renewed consideration of guidance regarding financial statement presentation of short-term price fluctuations (reported as unrealized gains and losses) would be especially timely.

User Learning Issues and Impediments to this Learning

The Boards' proposed revision of financial statement presentation would require start-up costs for users to adapt to the new presentation format. Since the proposal concerns presentations of financial reports designed to be more useful to the readers, we begin by suggesting that, as an intermediate step, the Boards first ask companies to provide electronic worksheets of interlinked financial statements on their websites on a trial basis, a process that would involve little additional cost. Learning issues will also be implicit in several of our objectives, terminology, and categorization-related comments that follow.

The Objectives and Terminology

In Chapter 2 of the *Preliminary Views*, the Boards offer that the objective of financial reporting is "to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers" (*Preliminary Views*, paragraph 2.1a). To this end, the Boards propose that information should be presented in financial statements in a manner that: (1) portrays a cohesive financial picture of an entity's activities; (2) disaggregates information so that it is useful in assessing the amount, timing, and uncertainty of an entity's future cash flows; and (3) helps users to assess an entity's ability to meet its financial commitments as they become due and to invest in business opportunities (*Preliminary Views*, paragraph 2.4).

The Boards pose the following questions about these objectives:

> Would the objectives of financial statement presentation … improve the usefulness of the information provided in an entity's financial statements and help users make better decisions in their capacity as capital providers? Why or why not? Should the Boards consider any other objectives of financial statement presentation in addition to or instead of the objectives proposed in this discussion paper? If so, please describe and explain.

Cohesiveness Objective

The abstract definition provided for the cohesiveness objective in paragraph 2.5 of the *Preliminary Views* raises many issues. That definition is as follows:

> A cohesive financial picture means that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible.

While the inconsistencies in financial statement presentation identified in paragraphs 1.11–1.13 of the *Preliminary Views* are well known, we are not aware of user complaints phrased in terms of cohesiveness. We recommend that the Boards not appropriate new terms or coin new phrases when simpler, more familiar ones would work. During earlier deliberations by the Boards and project staff, the cohesiveness concept was identified simply as "linkage" or "articulation" between financial statements.[1]

As an operational definition of cohesiveness, paragraph 2.15 of the *Preliminary Views* refers to aligning line items, their descriptions, and their order across financial statements. Paragraph 2.16 then cites the Boards' preference for cohesiveness at the line item level but backs away from this preference significantly by qualifying this statement with the observation that "an entity should comply with the spirit of that goal." Such a qualification may be necessary and appropriate on cost-benefit grounds if cohesiveness at the line item level is costly and difficult to achieve by reconciling successive statements of financial position via traditional flow statements such as the income statement and statement of cash flows, or by summarized transaction data as proposed in the July 2007 CFA Institute white paper, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*.[2] Nonetheless, in response to rather straightforward requests by the CFA institute and others for alignment and linkage of financial statements at the line item level, creating an abstract notion of cohesiveness and elevating it to the level of financial statement objective without delivering it at the line item level risks ignoring legitimate concerns of financial statement users. Simply put, while reconciliations of successive balance sheets at the line item level may be

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[1] In the minutes of the September 17, 2008 Joint International [Advisory] Group/Financial Institutions Advisory Group meeting, the cohesiveness principle is explained in the following way: "Some think about this cohesiveness principle in terms of *articulation or linkage*—a cohesive financial picture will clarify the relationships between related items in the financial statements." Merriam Webster's Online Dictionary defines cohesiveness as "exhibiting or producing cohesion or coherence" and coherence as "the act or state of sticking together tightly."

[2] Available at http://www.cfapubs.org/doi/abs/10.2469/ccb.v2007.n6.4818.

a costly disclosure, if sufficient numbers of users find reconciliations of at least certain line items useful enough that they would attempt to create such reconciliations on their own, it may be less costly overall for firms to provide the disclosures. Such a demand also might be satisfied by footnote or other disclosures that are less comprehensive than the reconciliation schedules in the proposed reporting model.

Disaggregation Objective

Similarly, the disaggregation objective is too abstract to be a useful principle. The Boards' original version of the disaggregation "working principle" (in, for example, the July 17, 2006 FASB Board meeting handout) instructs financial statement preparers to:

> Disaggregate items into groups that respond similarly to changes in the same economic condition and present subtotals and totals where appropriate.

This is a more succinct and concrete statement of the disaggregation objective than that found in paragraph 2.7 of the *Preliminary Views*:

> An entity should disaggregate information in the financial statements in a manner that makes it useful in assessing the amount, timing, and uncertainty of the future cash flows.

While the current statement of the objective picks up the language of the conceptual framework, we recommend that the Boards and staff present their views in terms of principles (even "working" principles) rather than vaguely defined objectives.

Other Objectives

Because the excessive use of financial leverage has been cited as a key factor leading to failures of financial firms in 2008 that has stressed financial markets, we propose that the Boards also consider an additional objective: (d) Helps users assess the extent to which an entity employs financial leverage. We would like to see this objective be presented as a separate objective of financial statement presentation on the same level as objective (c), "Helps users assess an entity's liquidity and financial flexibility" (*Preliminary Views*, paragraph 2.4). Alternatively, objective (c) might be revised to incorporate an assessment of financial leverage alongside assessments of liquidity and financial flexibility. It is possible that assessing financial leverage may already be implicit in objective (c). However, given its paramount importance, we would at least like to see this objective made explicit.

One reason for segregating financing activities from other activities is to focus attention on the non-financial (business or operating) activities by which an enterprise creates value. A parallel objective is to indicate how financial leverage is employed to enhance shareholder returns. A key attribute of the proposed reporting model is that it helps clarify the extent to which net financial liabilities lever a firm's operating (or business) activities.

Categorizing Activities: Financing and Business

The *Preliminary Views* propose separating the entity's activities into financing activities and business activities. Business activities are further separated into operating and investing activities. Regarding this categorization, the Boards pose several questions:

> Would the separation of business activities from financing activities provide information that is more decision useful than that provided in the financial statement formats used today (see paragraph 2.19)? Why or why not?
>
> Are the business section and the operating and investing categories within that section defined appropriately (see paragraphs 2.31–2.33 and 2.63–2.67)? Why or why not?

The separation of operating activities from financing activities provides information that is decision useful, but we would define operating activities as what the *Preliminary Views* labels business activities. Contemporary finance theory relies on a dichotomy between operating and financing activities, where on an *ex ante* basis, operating activities encompass the firm's value-creating activities while financing activities are viewed, at least at first approximation, as zero net present value activities. Accordingly, financial statement analysis based on this view of contemporary finance theory would split a firm's operating activities from its financing activities, but treat these categories as not only mutually exclusive but exhaustive.

Attaching the label business activities to what finance theorists and practitioners identify as operating activities detracts from many of the benefits offered by embracing this basic dichotomy. Consequently, some of the proposed categorizations in the *Preliminary Views* and the concepts underlying them are rendered unduly complex, and others lack a clear focus. Such difficulties are largely unnecessary as they could be avoided by reverting to the basic dichotomy of operating versus financing as used in the contemporary finance theory.

While the Boards intend that the business section proposed in the *Preliminary Views* encompass two subsections or categories labeled and defined in the document as operating and investing, in contemporary finance theory, operating activities is the label generally applied to all of the firm's activities other than those designated as financing activities. If the label investing activities is used, it is usually identified with investments in operating assets, particularly capital expenditures, which the *Preliminary Views* appropriately classifies within operating activities.

While coupling the two categories in the business section (operating activities and investing activities as defined in the *Preliminary Views*) with the financing section would appear to lead to balance sheets and income statements that parallel the three sections in today's statement of cash flows, this apparent correspondence actually has the potential to mislead. As paragraph 2.65 of the *Preliminary Views* correctly points out, while the captions for the categories used in the statement of cash flows today (under IAS 7 and FASB Statement No. 95) are the same as the categories in the proposed presentation model of the *Preliminary Views*, what is included in the respective categories is distinctly different. In particular, some cash flows that would be classified as investing in today's statement of cash flows would be classified as operating cash flows in the proposed model (for example, acquisitions and divestitures of property, plant, and equipment also known as net capital expenditures), while other flows presently classified as investing in the contemporary statement of cash flows (for example, purchases or sales of certain marketable securities) would be classified as financing cash flows under the approach set forth in the *Preliminary Views*.

When one thinks of ways to dichotomize a firm's activities, business is not the label with which one would naturally start. The category that most naturally comes to mind as the complement to business activities is non-business activities, not financing activities. Moreover, operating activities are distinguished from investing activities in the business section in the *Preliminary Views* essentially by using notions of core activities and non-core activities. If core versus non-core activities captures the essence of the distinction the Boards are trying to draw, it would be more straightforward to simply label the categories as core activities and non-core activities, rather than business and investing activities. Relabeling the business category as operating and labeling the categories within this section as core and non-core (instead of operating and investing) would be a simple yet powerful way of implementing the concepts the Boards have in mind without creating unnecessary confusion.

Attributes other than core and non-core may also characterize what the Boards and others have in mind for the contents of the investing activities category. Core operating activities would generally involve multiple line items beginning with sales revenue followed by expenses. In contrast, items cited as candidates for the investing activities category are often reported net, such as (equity method) income from subsidiaries, income from available for sale securities, income from real estate holdings, and so on. An income statement label that could properly be attached to the subtotal representing core operating income items would be "income from sales." This label might even be appropriate for a subtotal within core operating income if management wishes to distinguish core sales profit margins from other items of core income that are reported net (for example, rent income) for which profit margins are not typically calculated.

While some might view labeling as pedantic or excessively focused on terminology, terminology is important, especially in accounting. The caption "business" has been attached to what we would prefer to see labeled the operating section in most of the discussions that the Boards have had with the project staff and with various advisory groups (for example, the Financial Accounting Standards Advisory Group, the Joint International Group, and the Financial Institutions Advisory Group). Hence, the Boards might be reluctant to change this label at this juncture because individuals who have been closely involved in the financial statement presentation project (including those who are now commenting on the *Preliminary Views*) are familiar with the label and what it represents. However, the task of reorienting the thinking of those closest to the project is minor compared to the potential for confusion if the financial statement presentation model goes forward as proposed. Indeed, a massive education effort might be required to reorient the thinking of financial statement users surrounding the use of the term investing activities, especially users who are less sophisticated. A better approach would be to not reuse the term investing because operating, investing, and financing will be, at least for the current generation of financial statement preparers and users, inextricably linked to the captions for the sections in the current cash flow statement. In contrast, generations of business students, many with limited exposure to accounting, should appreciate the basic dichotomy between financing activities and operating activities, at least at a conceptual level.[3]

Regarding financing categorization, the Boards pose the following question:

> Should equity be presented as a section separate from the financing section or should it be included as a category in the financing section (see paragraphs 2.19(b), 2.36, and 2.52–2.55)? Why or why not?

We feel that it is appropriate to present common equity in a section separate from the financing section. The *Preliminary Views* did not specifically address the classification of preferred stock as financing or equity. Accordingly, we wondered if treatment of preferred stock as equity was implicit in the document or, alternatively, if classification as either financing or equity would be acceptable under a management approach to classification. Many analysis models treat preferred stock as interchangeable with debt as a source of financing. Also, if the Boards choose to revisit the definition of equity in other standard-setting projects, such an equity section would be consistent with the notion of basic equity (lowest priority claims of the current shareholders).

Finally, the Boards pose the following question regarding the placement of discontinued operations:

> In the proposed presentation model, an entity would present its discontinued operations in a separate section (see paragraphs 2.20, 2.37, and 2.71–2.73). Does this presentation provide decision-useful information? Instead of presenting this information in a separate section, should an entity present information about its discontinued operations in the relevant categories (operating, investing, financing assets, and financing liabilities)? Why or why not?

Congruent with the notion of operating activities and financing activities as both mutually exclusive and exhaustive, we would prefer to see discontinued operations presented in the relevant categories. Discontinued operations logically should be viewed as part of operating activities, more in the nature of special items that warrant separate disclosure. The emphasis on its presentation in a separate section in the *Preliminary Views* appears to reflect a desire to continue report-

[3] Regarding the investing terminology, whether in a section labeled investing activities or in one of the other sections, we view it as important to specify the object of all investments in the statement presentation (i.e., investments in marketable securities or investments in affiliated companies), as we believe that the term "investments" has come to mean little in contemporary reporting without appropriate modification.

ing certain familiar subtotals on the income statement (income from continuing operations and net income). However, we believe that the desire to present the familiar subtotal "Income from Continuing Operations" should not drive the reporting model for display of assets and liabilities of discontinued operations. While backward compatibility with existing reporting models is desirable in order to continue providing familiar inputs to user decision models and a reasonable objective on which to seek compromise, reporting discontinued operations in a completely separate section on par with operating (business) and financing sections potentially moves financial reporting in the wrong direction and may set a dangerous precedent. Reporting the financing liabilities of a held-for-disposal group outside the financing section of the balance sheet before the disposal takes place seems questionable to us because the reported total for financing liabilities affects key measures of financial leverage. Debt of a disposal group ordinarily is not extinguished until the disposal takes place.

The conventional way to organize an income statement capturing the familiar subtotal for income from continuing operations in the proposed reporting model is to present operating (business) income first (pretax), followed by income taxes on operating (business) income (that is, income taxes not otherwise allocated to discontinued operations, other comprehensive income, or equity). Adding income from discontinued operations (net of tax) yields profit or loss (in IFRSs) or net income (in U.S. GAAP). Adding other comprehensive income (net of tax) yields comprehensive income. But, while this is a conventional income statement format, if preserving backward compatibility with the extant reporting model by reporting the familiar subtotal for income from continuing operations is the only goal, it does not necessarily require preserving the current income statement format, where income from continuing operations and net income are the focal points. Instead, to attain backward compatibility, the new reporting format could simply require that income from continuing operations be calculated (using reporting rules currently in effect) and separately reported as supplementary information. In fact, the *Preliminary Views* (paragraph 2.22) specifically states that:

> An entity may present the sections and categories within a section in a different order as long as the order is the same in each statement.

In order for this statement not to be an empty promise, the reporting model should contemplate providing line items that are specifically intended to provide backward compatibility as supplemental information, perhaps as footnote disclosures, similar to what is proposed for the disclosures of total assets, total liabilities and subtotals for short-term assets, short-term liabilities, long-term assets, and long-term liabilities.[4]

Categorizing Assets and Liabilities: The Management Approach

The Boards propose that classification of assets and liabilities in the business and financing sections be done "in a manner that best reflects the way the asset or liability is used within the entity" (Chapter 2, paragraph 27). This is called the management approach to classification. Regarding the management approach, the Boards pose several questions. The two questions we chose to address were as follows:

> Would a management approach provide the most useful view of an entity to users of its financial statements?

and:

[4] Paragraph 3.22 of the *Preliminary Views* states the following: "An entity should disclose total assets and total liabilities either in the statement of financial position or in the notes to financial statements. An entity that presents its assets and liabilities in short-term and long-term subcategories also should disclose subtotals for short-term assets, short-term liabilities, long-term assets, and long-term liabilities either in the statement of financial position or in the notes."

Would the potential for reduced comparability of financial statements resulting from a management approach to classification outweigh the benefits of that approach? Why or why not?

Both these questions revolve around the issue of accounting choice, which the academic accounting literature has studied extensively, with mixed evidence: Accounting choice can be a net positive or a net negative depending upon facts and circumstances in the particular case. For example, if the incentives of the firm's management are aligned with those of the shareholders, then accounting choices are more likely to convey incremental valuable information to financial statement users (Dye and Verrecchia 1995; Warfield et al. 1995). Conversely, if management's incentives are not aligned with those of the shareholders, then it is more likely that accounting choices will be made for opportunistic reasons (for example, earnings management) (Healy 1985; Guidry et al. 1999; Gaver and Gaver 1998; Chen and Lee 1995; Burgstahler and Dichev 1997; DeFond and Park 1997; Kasznik 1999; among others).[5] Overall, we feel that the management approach could convey valuable information at the cost of potential opportunistic classification. It is difficult to assess and quantify these costs in the current reporting environment.

While the management approach to classification has the potential to convey additional information about what management sees as the core value-creating activities within an enterprise versus a more prescriptive classification scheme, the choices therein also present the potential for opportunistic classification. For example, we would expect that most likely management would make the case that capital (finance) lease liabilities recorded under current U.S. GAAP (IFRS) are interchangeable with other sources of financing, and thus should be classified in the financing section. Consistent with that view, paragraphs 2.34 and 2.58 of the *Preliminary Views* suggest that lease financing would be indeed interchangeable with other sources of financing and would properly belong in the financing section. Yet in the Toolco illustration in Appendix A, lease liabilities are classified in the operating section. If this is an illustration of the latitude that a management approach to classification would allow, perhaps a more prescriptive approach to classification would be preferable. (We recognize that the Toolco illustration may have a narrow intent to capture classification of an expanded set of capital or finance lease liabilities that would arise under a revised lease accounting standard.)

Categorizing Capital (or Finance) Lease Liabilities as Financing or Operating

Categorizing capital (or finance) lease liabilities as financing or operating is bound to be problematic, especially under a management approach to capitalization. This classification issue is bound to become more acute under any expanded lease capitalization standard, which means that standard setters will eventually have to establish additional guidance.

Paragraph 2.27 proposes that both assets and liabilities should be presented in the business section and in the financing section of the statement of financial position. Would this change in presentation coupled with the separation of business and financing activities in the statements of comprehensive income and cash flows make it easier for users to calculate some key financial ratios for an entity's business activities or its financing activities? Why or why not?

This is an inherently difficult question to answer with any precision because the range of user decision models and key financial ratios is broad. In general, segregation of activities that are clearly financing does move in the direction reflected in common user decision models that focus attention on the aspect of the firm that generates value-core operations. Whether the reporting model matches a user decision model is highly dependent on the management approach to clas-

[5] Such opportunism was the subject of concerns expressed by then SEC Chairman Arthur Levitt in an often-quoted 1998 Speech (Levitt 1998).

sification. Line item cohesiveness as the operational standard would facilitate adjusting for differences between the reporting model and user decision models. However, if the concept of cohesiveness is interpreted as only requiring linkage between financial statements only within broad financial statement categories, and line-by-line reconciliations of specific financial statement line items are not provided, this greatly diminishes the ability of users to adjust for the cross firm reporting differences that are inherent in the management approach.

Viewing financial statements prepared according to the *Preliminary Views* as an “off the shelf” reporting model, the failure to allocate income taxes within sections and categories within sections will inhibit the ability of users to readily calculate ratios that require after-tax income numbers in the numerator. For example, enterprise level ratios such as the rate of return on net operating assets (or, equivalently, the rate of return on invested capital) are often calculated on an after-tax basis, using operating income after tax in the numerator. This requires income tax allocations between, at a minimum, the operating (business) and financing sections.[6] While users need to understand that any allocation of income taxes is arbitrary, the important question is who would be in a better position to make a reasoned allocation-financial statement: preparers or financial statement users.

Issues Related to Classification of Preferred Stock as Financing (that is, as Equivalent to Debt)

Allocating income taxes to sections becomes more desirable if preferred stock is viewed as interchangeable with debt and, accordingly, classified as financing, because under U.S. tax law interest on debt is tax deductible while dividends on preferred stock generally are not.

> Paragraphs 2.27, 2.76, and 2.77 discuss classification of assets and liabilities by entities that have more than one reportable segment for segment reporting purposes. Should those entities classify assets and liabilities (and related changes) at the reportable segment level as proposed instead of at the entity level? Please explain.

We agree with classification at the reportable segment level. We are not at all certain that classification at the entity level (one policy for all of an entity’s business) would automatically be “less complex” than classification at the reportable segment level (a separate policy for each reportable segment) as asserted in paragraph 2.76. It may be more difficult for management to establish one entity-wide approach to classification than a disciplined approach applied repetitively to individual segments.

> Are the financing section and the financing assets and financing liabilities categories within that section defined appropriately (see paragraphs 2.34 and 2.56–2.62)? Should the financing section be restricted to financial assets and financial liabilities as defined in IFRSs and U.S. GAAP as proposed? Why or why not?

Restricting the financing section to financial assets and financial liabilities precludes the possibility of preferred stock being classified as financing, an outcome that runs counter to a new standard that would define equity as common equity or more narrowly (for example, as basic equity). Of course, no conflict with the definitions would arise if preferred stock were to be redefined as a financial liability in a revised standard on liabilities and equity.

CONCLUSION

Overall, we believe that the Boards’ discussion paper entitled *Preliminary Views on Financial Statement Presentation* offers several appealing proposals, but has potential problems as well. We

[6] An equivalent way to view the calculation of the numerator of an enterprise level ratio such as the rate of return on net operating assets is to begin with net income or comprehensive income and add back the net financing expenses, after tax.

began by questioning the timing of the proposal since the document seems to contain an implicit conceptual framework at the same time that a comprehensive conceptual framework is being developed by the FASB. Also, we note that the proposed format changes would complicate the learning process around access and use of XBRL and data tag-based reports. Finally, we provide responses to several specific objectives and principles-related questions posed by the Boards. These responses relate to (1) timing and concurrent changes; (2) user learning issues and impediments to this learning; (3) objectives and terminology; (4) categorizing activities—operating (business) and financing; and (5) categorizing assets and liabilities—the management approach. Overall, we view the financial statement presentation project as having great potential to improve the usefulness of financial statements. We look forward to continuing progress on this important project and hope that our views serve to inform their deliberations.

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