A Revised Model for Presentation in the Statement(s) of Financial Performance: Potential Implications for Measurement

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I thank Ron Lott for his comments and suggestions. The views expressed in this paper are those of the author and any errors and faulty thinking are solely my responsibility. Official positions of the FASB are reached only after extensive due process and deliberations. My colleagues on the Board have not provided any input to this paper and may disavow themselves from these views.

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The purpose of this paper is to propose a revised financial performance reporting model and to explore its potential implications for measurement. The content of this paper originally was presented as part of a lecture at Baruch College in New York City in November of 2012. It, therefore, predates the issuance of the IASB's Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting*, in July 2013, and should be viewed as a separate document. The objective of exposing this thinking to the ASAF and IFASS communities is to provide an opportunity for participants to discuss the perspectives shared in this paper and to consider whether any are worth exploring further in future deliberations on the presentation and measurement chapters of the conceptual framework.

Financial Performance Reporting

Current financial performance reporting has three areas of focus that drove my considerations in proposing revisions to the financial performance reporting model to better meet users' needs: (1) other comprehensive income (OCI) and recycling, (2) earnings per share (EPS), and (3) non-GAAP measures.

OCI and recycling

In considering the reporting of financial performance, the primary focus of our constituents has been on determining which components of income should be reported in OCI and whether, and in what circumstances, OCI items should be recycled to net income (NI). Solutions to these issues require: (1) developing a definition of OCI items that differentiates them from items in NI and (2) identifying what we are trying to achieve with the reporting of NI that suggests OCI items should be reported twice within different measures of financial performance by recycling OCI amounts to NI.

Conceptual Framework Definitions. Let's first explore whether the current FASB conceptual framework provides a basis for differentiating OCI items from items in NI. Paragraph 70 of Concept Statement No. 6 (FASB 1985)[1], defines comprehensive income as "… the change in equity of a business during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners." In addition, Concepts Statement No. 5 (FASB 1984)[2], describes earnings (a synonym for NI) as "…a measure of performance for a period…" (para. 34) that "focuses on what the entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices to produce and distribute that output (expenses). Earnings also include results of the entity's

[1] FASB 1985. Concepts Statement No. 6, *Elements of Financial Statements,* FASB: Norwalk, CT.

[2] FASB 1984. Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* FASB: Norwalk, CT.

incidental or peripheral transactions and some events and circumstances stemming from the environment (gains and losses)" (para.38). Finally, paragraph 42 of Concept Statement No. 5, defines other comprehensive income as "…certain classes of gains and losses are included in comprehensive income but are excluded from earnings".

Because the definition of other comprehensive income fails to define the characteristics of the gains or losses excluded from earnings and because earnings is described to include the results of incidental or peripheral transactions, I conclude that current Conceptual Framework definitions are not useful in (1) differentiating OCI items from NI items and (2) indicating why items should be reported twice in CI and NI.

Are There Consistent Characteristics that Differentiate OCI Items from NI? Another potential means for developing a definition of OCI that differentiates OCI items from items in NI is to evaluate whether there are unique characteristics that can be associated with current OCI items in U.S. GAAP or IFRS. Potential characteristics that may form a basis for differentiating OCI items from items in NI include:

- Degree of persistence or sustainability of income
- Core vs. non-core activities
- Degree of management control
- One-time non-recurring remeasurements vs. recurring items
- Degree of measurement uncertainty
- Time horizon until realization
- Operating vs. Investing and Financing

FASB and the IASB co-sponsored a conference in December 2011 entitled, “Other comprehensive income and the presentation of earnings”. The conference is attended annually by members of the FASB and IASB and our staffs and about sixty individuals from our key constituents, including academics, regulators, users, auditors, and preparers. The first case used at the conference asked participants to identify the key characteristics of every OCI item required to be reported under US GAAP or IFRS. Once those characteristics were identified, the case then asked conference participants whether they could identify items with the same characteristics reported in NI. For every OCI item examined, conference participants identified at least one income component with the same economic characteristics within NI

Conclusion: There is no differentiating set of characteristics to define what items are included in OCI rather than NI other than that standard setters decided for political reasons to present those items below the line net income. This also means it will be very challenging to provide a consistent basis for identifying what we are trying to achieve with the separate reporting of NI. Query: Is this approach working in serving financial statement users’ needs relating to the reporting of financial performance?

EPS

The effort to differentiate OCI items from items in NI has the primary outcome of defining the earnings amount reflected in numerator of the single most important income statistic derived from US GAAP or IFRS reports: EPS. Financial statement users pay significant attention to EPS. However, some users also pay even more attention to non-GAAP measures provided by management and the numbers and types of these measures are proliferating. This suggests EPS (and NI reporting) increasingly may not be serving all users' needs. Query: Could examining the primary types of non-GAAP measures provide insights into what users primarily are seeking from reporting financial performance?

Non-GAAP Measures

At the FASB's October 2012 Financial Accounting Standards Advisory Council (FASAC) meeting seven reports made by preparers, users and auditors indicate that non-GAAP measures generally serve the purpose of reporting financial performance through the eyes of management. Overall the reports indicate that there primarily are two types of non-GAAP measures:

- *Non-financial* measures that most often provide volume information (# of clicks, # of tweets, # of barrels of oil etc.)
- *Financial* measures that exclude from net income items that are distortive of operations and/or one-time (non-recurring) items

These latter financial measures primarily result in a number that better depicts the results of core, recurring operations and suggest that that is the primary financial performance number of interest to financial statement users.

Observations about Current Income Statement Reporting

Most income statements are quite abbreviated, often presenting less than 12-15 line items, including 4-5 totals and subtotals. This abbreviated reporting causes the user to focus primarily on the one single bottom line number – NI. Standard setting efforts in the US (and many other parts of the world), therefore, primarily have taken a bottom up approach that concentrates on getting the bottom line summary number right by (1) excluding certain purportedly irrelevant OCI items from NI and (2) recycling items reported in OCI to NI because if reporting financial performance is about getting one number right, performance reporting requires that all changes in equity be reported in NI, except those resulting from investments by owners and distributions to owners.

A Proposed Revised Model for Reporting Financial Performance

Does the current approach to reporting financial performance serve users well? The proliferation of the Non-GAAP measures suggests to me that the answer is no. To understand why, I think about the primary reasons I invest in certain entities and not others. I primarily invest in an entity because I believe its core business activities have the potential to provide a persistent (sustainable) positive expected return that compensates me for the risk taken. This view suggests that the primary income number in which I am interested is operating income. In addition, to help me in determining whether that number will recur, it also suggests that recurring operating items should be presented separately from non-recurring (one-time) operating items. Note this multi-layered, top down approach to highlighting operating income and separately presenting recurring and non-recurring operating items is perfectly consistent with financial non-GAAP measures provided to and/or demanded by current users of financial reports.[3]

However, is operating income the only financial performance information needed by users? In examining my investment decisions, the answer again is no because the additional changes in equity for the period (exclusive of transactions with owners) also affect the total amount of net assets available for dividends. This suggests that I also am interested in the outcomes for the period of the investing, financing, tax and discontinued operations activities of the entity. In addition, it suggests that I am most interested in two key subtotals: operating income (my primary interest) and comprehensive income with separate reporting of recurring and non-recurring items within each subtotal. Also, because non-operating items never become operating, I am not interested in recycling between those two income categories. Finally, because non-recurring items are presented separately from recurring items within both operating income and comprehensive income, it leaves open the question whether and, if so in what circumstances, decision-usefulness would be enhanced by differentiating some income items from others (as OCI) within either operating income or comprehensive income.

This proposed performance reporting model could be operationalized by requiring presentation of one statement of comprehensive income with one required

[3] To operationalize such an approach requires developing definitions that distinguish (a) operating income items from other items of income and (b) recurring income items from non-recurring income items. A starting point is provided in the July 2010 staff draft of a joint financial statement presentation standard that is available on the IASB and FASB websites.

intermediate operating income subtotal and EPS based on the bottom line CI number. However, there may be two key concerns with such presentation. First, the most important subtotal is buried in the middle of the single statement of comprehensive income, which might cause users to focus more on the bottom line CI number (on which EPS is based) rather than operating income. Second, assuming continuing demand for the reporting of an EPS number, on which income number(s) should EPS be based?

I propose two potential solutions to those issues. First, to require presentation of the most important income number as a bottom-line amount I would consider requiring presentation of two statements of financial performance instead of one. The first statement would be a Statement of Operating Income and the second would be a Statement of Comprehensive Income that begins with operating income and presents all nonoperating income items that yield comprehensive income for the period. To give a complete picture in one location of all items affecting CI for the period, these statements would be required to be presented consecutively in financial reports. Second, I either would (1) require an EPS number for both operating income and CI or (2) provide users with the weighted average number of common shares outstanding for the period (i.e., the denominator of the EPS number) and let them calculate the income amounts per share that they believe are most relevant to their decisions.

Potential Implications of the Proposed Performance Reporting Model for the Measurement Phase of the Conceptual Framework

Joint work on the measurement phase of the Conceptual Framework project was suspended in May 2011 to concentrate board efforts on higher priority projects. In addition, progress was slow because the task is so challenging. The work completed by May 2011 on the project focused moreso on identifying measurement methods to be used in the balance sheet (initial measurement) rather than the income statement (subsequent measurement). Preliminary decisions were that future financial reporting should incorporate both historical cost (HC) and fair value measures (FV). The challenge was developing a framework for when each should be used.

According to Concepts Statement No. 8 (FASB 2010)[4], the objective of financial reporting is to provide decision-useful information to help resource providers make buy, hold or sell decisions based on prospects for future cash flows to them from the entity by facilitating assessments of (1) the amount, timing and uncertainty of net cash inflows to the entity and (2) how efficiently and effectively management has discharged its responsibility to use the entity's resources. The income statement when compared to the balance sheet can provide the most useful information in making those assessments because accrual accounting is designed to best reflect the magnitude (and variability) of the economic effects of transactions and events occurring in specific periods. Query: Would an income statement focus based on the

[4] FASB 2010. Concepts Statement No. 8, *Conceptual Framework for Financial Reporting: Chapter 1,* The Objective of General Purpose Financial Reporting**,** *and Chapter 3,* Qualitative Characteristics of Useful Financial Information (a replacement of FASB Concepts Statements No. 1 and No. 2), FASB: Norwalk, CT.

performance reporting model proposed in this paper facilitate identification of when FV vs. HC measures should be used?

Under a HC measurement system, the income statement information that typically is provided includes (1) recurring income and expenses, (2) impairment losses on assets, and (3) realized gains or losses on sales or settlements not already recognized in (1). In contrast, under an FV measurement system, the income statement information that can be provided includes all of the income items reported under a HC system (if reported separately, which is not always the case) plus incremental unrealized gains/losses that need to be recognized to reflect the full change in FV for the period. Thus, from an income statement perspective, the choice of FV versus HC can be framed as a decision about the potential decision-usefulness of providing information about unrealized gains/losses in addition to the common income statement information that could be reported under both measurement attributes.

I also note that recurring income and expense amounts often are persistent. As an example, the reported interest income on an investment in a fixed-rate debt security is persistent for all periods the financial asset is held because both the quantity of the security (i.e., its principal amount) and its rate of return (the fixed interest rate) remain unchanged from period to period. Thus, if these recurring amounts are reported separately in the income statement in an FV model, not all reported changes in FV will follow a random walk. Therefore, counter to the view espoused in some academic research, the income statement need not be redundant to the balance sheet in a FV model.

Selection of HC and FV measurements commonly is viewed to be based on an evaluation of the relevance and reliability (degree of estimation uncertainty) [5] of the alternative measures. There are two common perspectives in most *academic* research about FV and HC that have led to the following common (erroneous) assertions about HC and FV:

- HC always is assumed to be more reliable (have less estimation uncertainty) than FV because the original HC transaction price is observable.
- FV always is assumed to be more relevant than HC.

Note these conclusions are derived from a balance sheet focus that primarily evaluates the relevance and reliability (estimation uncertainty) of alternative measures at initial measurement. In contrast, the proposed financial performance model takes an income statement focus concentrating on the implications for subsequent measurement. Therefore, its application to the measurement phase of the conceptual framework may result in different conclusions about the importance

[5] FASB (2010) replaces the term “reliability” with the term “faithful representation” to avoid confusion about what the term “reliability” means, which is not estimation uncertainty. Because many still believe the selection of FV or HC primarily involves a tradeoff between relevance and reliability with reliability primarily focused on the degree of estimation uncertainty, I continue to reference reliability (as well as estimation or measurement uncertainty) in the remainder of this paper.

of relevance and reliability (or estimation uncertainty) in the selection between HC and FV measures.

From an income statement perspective, does HC always have less estimation uncertainty than FV? The relative degree of measurement uncertainty of alternative measurements is based, in part, on the nature and amount of judgments and estimates required to implement each measure. The more judgments or estimates necessary to apply a measure the greater the measurement uncertainty is likely to be. Judgments and estimates can occur at both initial measurement and subsequent measurement.

Under an HC model, the judgments and estimates at initial measurement of an asset or liability are quite limited because the initial transaction price usually is observable with the primary judgments and estimates pertaining only to whether any costs incurred at acquisition of an asset or fees incurred at issuance of a liability should be capitalized as part of the carrying value of the asset or liability.

Under an HC model, the nature and amount of judgments and estimates relating to subsequent measurement of assets/liabilities can vary significantly depending on the income statement line item to which they pertain. For recurring income and expenses, the nature and amount of judgments and estimates depend on the type of asset/liability: financial or nonfinancial. For financial assets and liabilities, the judgments and estimates relating to measuring recurring items often are few because there is little difficulty in measuring interest or dividends. In contrast, for nonfinancial assets, the judgments and estimates relating to measuring recurring income or expenses often are many, including but not limited to determining patterns of benefit, useful lives, and salvage values. Most challenging under an HC model is subsequent measurement relating to asset impairment. These judgments and estimates are many, including the evaluation of whether impairment triggers have been met and estimation or measurement of one or more of the following items in determining the impairment amount: expected cash flows, discount rates, fair value and/or value-in-use. Finally, under an HC model, judgments and estimates relating to the determination of realized gains or losses on the sale of an asset or settlement of a liability are few, if any.

If all of the HC income components for assets/liabilities described above are presented separately in the income statement under the FV model, the nature of judgments and estimates under an FV model generally will be similar to those under an HC model. The primary difference is that certain estimates and measurements must be made on a recurring basis under an FV model at perhaps both initial and subsequent measurement rather than generally being required only when assets are impaired under an HC model.[6] However, because the nature of the judgments and estimates across the two systems do not vary significantly, I make the following assertion.

[6] Another less significant difference is that under a FV model no acquisition costs or issuance fees would be capitalized as part of the asset or liability; these costs would be expensed as incurred.

Assertion: From an income statement perspective, estimation uncertainty (reliability) cannot be the primary factor driving the selection of FV versus HC because neither has a demonstrably lower level of estimation uncertainty.

Thus, from an income statement perspective, HC cannot always be considered to have less estimation uncertainty than FV.

From an income statement perspective, is FV always more relevant than HC? As described above, from an income statement perspective, the only additional information provided by an FV model, with full income component reporting, is the recognition in income of unrealized gains/losses. Do unrealized gains/losses always provide useful information in assessing either the future cash flow prospects to the entity or management's stewardship? The answer generally is yes if it is likely management will sell the asset or transfer the liability before maturity or the end of its useful life. In such circumstances, unrealized gains/losses provide useful information about the potential change in wealth the entity will experience if an asset is sold or the liability is transferred before its maturity or the end of its useful life. This information is useful in assessing both cash flow prospects to the entity and the value realized by the entity from management deciding to sell (transfer) rather than hold the asset (liability).

Unrealized gains/losses reverse (i.e., are remeasured to zero) if an asset or liability is held to maturity or the end of its useful life and, if an asset or liability is unlikely to be sold or transferred before maturity or the end of its useful life, unrealized gains/losses therefore only provide very limited information about the likely amount, timing, and uncertainty of cash flows prospects that could be realized by the entity. When the asset or liability is unlikely to be sold or transferred before maturity or the end of its useful life, unrealized gains/losses mostly provide relevant information about the opportunity cost of management holding rather than selling (transferring) the asset (liability). However, users of financial statements have indicated a preference for opportunity cost information to be provided in the notes to the statements; information in the statements themselves should be limited to reflecting the outcomes of management decisions.

Thus, whether unrealized gains/losses information is decision-useful (i.e., relevant) primarily depends on whether the asset is likely to be sold or liability likely to be transferred before maturity or the end of its useful life. The likelihood an asset or liability will be sold or transferred before maturity or the end of its useful life depends on (1) whether or not management has a disincentive to sell the asset or settle the liability before the end of its useful life or maturity and (2) whether or not there are impediments preventing management from being able to sell the asset or transfer the liability. Factors that cause management to have a disincentive and/or in ability to sell an asset before maturity or the end of its useful life include (1) whether the asset is being used internally in a manner that makes it economically unwise to sell (i.e., the asset is being used together (synergistically) with other assets to create value to the business or if the asset is being used alone the asset it is so hard to replace that the entity would be out of business without it and (2) whether the asset can be readily sold or exchanged (e.g., a market exists on which it can be transferred). Factors that cause management to have a disincentive and/or inability to transfer a liability before maturity is whether there is legal restriction against transfer and, if not, whether there is a market available on which the liability can be transferred.

Because these factors can vary significantly for different types of assets (e.g., financial versus many nonfinancial assets) and liabilities, I have arrived at the following assertion that drives my standard-setting decision-making.

Assertion: From an income statement perspective, relevance of FV information depends on the nature of the asset or liability and how it is being used or able to be used within the business. Relevance should be the driving factor for voluntary or mandatory selection of FV or HC.

Thus, from an income statement perspective, FV should not always be considered more relevant than HC.

Outcomes of Proposed Performance Reporting Model for Measurement. Property, plant, and equipment (PP&E) and intangible assets often (1) are used synergistically with other assets in the business and thus are more costly to extract and sell and (2) do not have secondary markets on which they can be sold. Financial liabilities often are restricted from being transferred and, therefore, do not have secondary markets on which they can be transferred. These characteristics make it less likely that management will have the incentive and/or ability to sell these assets or transfer these liabilities before maturity or the end of its useful life. This suggests that reporting of unrealized gains/losses on these nonfinancial assets and financial liabilities in income is less likely to provide relevant information; unrealized gains/losses would merely reverse if the asset or liability is held to maturity or the end of its useful life.

In contrast, financial assets and investment properties often (1) are not hard to replace and are not used synergistically with other assets in the business and thus are not as difficult to sell without hindering other business activities and (2) have secondary markets on which they are sold. These characteristics make it more likely that management will have the internal incentive and the external ability to sell these assets before the end of their useful lives. This generally suggests for financial assets and investment properties that FV accounting and reporting of unrealized gains/losses in income is more likely to provide relevant information to users of the financial statements.

Additional Thoughts on Measurement

The prior section was developed under the presumption that the primary (if not only) issue that needs to be addressed in the measurement chapter of the conceptual framework is the basis for selecting between HC and FV measurements. However, the recent paper, “Profit or Loss/OCI and Measurement”, prepared by Ikuo Nishikawa of the Accounting Standards Board of Japan (ASBJ) for discussion at the December 2013 ASAF meeting caused me to expand that view.

The ASBJ paper reminded me that we do three distinct things when we subsequently account for the original transaction price within the HC system and, therefore, the conceptual framework also could serve standard setting by developing a basis for deciding when the original transaction price/ carrying value of an asset or liability should be

- Allocated without remeasurement to income of different periods (e.g., by allocating the original transaction price to different periods when recognizing depreciation and cost of goods)
- Remeasured downwards and perhaps sometimes upwards for changes in cash flows but without remeasuring the discount rate, if any (e.g, by remeasuring accounts receivable cash flows downwards through impairment and remeasuring warranty and contingent liability cash flows both upwards and downwards without remeasuring the discount rate, if any)
- Remeasured for changes in cash flows and discount rates, that is remeasured to FV or another current value measure (e.g., when impairing nonfinancial assets)

From this perspective, FV measurements can be viewed as providing the opportunity to recognize changes in both upward and downward cash flow expectations as well as changes in market discount rates in income in the current period. As argued in the prior section such remeasurements can be viewed as providing decision-useful information on a recurring basis when (1) management does not have a disincentive to sell the asset or settle the liability before the end of its useful life or maturity and (2) there are no impediments preventing management from being able to sell the asset or transfer the liability.

However, within an HC system we do not require FV remeasurements on a recurring basis. Sometimes we only require assets to be written down but not written up to FV or another current value measure (e.g., when we impair inventory). Other times, we only require remeasurement of assets' cash flows downward without requiring remeasurement of the discount rate (e.g., when we impair financial assets).

We have no conceptual basis for making such decisions and to develop such a framework requires answers to the following questions:

- When does remeasuring cash flows and not the discount rate meet the objective of financial reporting?
- How and when does discounting and remeasurements of the discount rate meet the objective of financial reporting?
- When and why does remeasurement downwards and not upwards meet the objective of financial reporting?

These observations have caused me to conclude that the measurement chapter of the conceptual framework should provide a basis for determining:

- When to use the following subsequent measurement methods (a) allocated HC, (b) HC with remeasurements of cash flows and not the discount rate, if any, and (3) fair value or another current value measure.
- When we should discount and at what amount

- Whether, and if so when and how, measurement uncertainty should have an effect on subsequent measurement.

Finally, with regard to the last issue, would not the development of a basis for when writedowns (and not writeups) should be required provide an opportunity for selectively identifying when a prudent approach to dealing with measurement uncertainty meets the objective of financial reporting without requiring that all measurements be prudent as many advocates for selectively including prudence in the conceptual framework have argued?

Conclusion

The current reporting model for net income and comprehensive income is broken:

- Concentrating on separate reporting of OCI items from NI
- Failing to provide a clean measure of operating income, and
- Failing to separate recurring income items from non-recurring (one-time) changes in wealth.

Users of financial statements have indicated that in their analyses that they first attempt to separate operating income from other income and then to distinguish in both categories recurring items from non-recurring items. These observations have caused me to suggest a new model for reporting financial performance that facilitates such analyses.

This model also has the potential to provide new perspectives on resolving some vexatious accounting issues, including measurement. Taking an income statement perspective on measurement based on the proposed performance reporting model provides an alternative perspective that could be considered in developing the measurement chapter of the conceptual framework. Of course, this analysis may have errors and can be improved based on the insights of thoughtful individuals like you. I look forward to hearing your views.