Convergence of Financial Performance Reporting

History

The debate on how to measure and present the performance of a business entity has been ongoing for the past 30 years (Mechelli, 2008; Hageman, 2011). The reason for the debate is based on the perception that net income does not adequately provide to the reader a basis to determine performance. In 2001, the International Accounting Standards Board (IASB) increased the scope of developing International Accounting Standard (IAS) Number 1 to include performance reporting in the project (Mechelli, 2008). In 2004 the Financial Accounting Standards Board (FASB) and the IASB, in the interest of convergence (Deloitte, 2010), coordinated their efforts by creating a joint project on performance reporting with the IASB expanding the effort to include a complete review of the financial statements and changing the name of the project to financial statement presentation (Mechelli, 2008). The primary focus of the IASB in this project was to bring IAS 1 in line with FASB’s Statement of Financial Accounting Standards (SFAS) No. 130 regarding comprehensive income (Mechelli, 2008). The FASB/IASB effort would be done in three segments (FASB Update, 2011; IFRS, 2013):

1. Segment A would address the statements that represent a complete set of financial statements with reissue of IAS 1
2. Segment B would address performance reporting including aggregation and disaggregation of information on the financial statements, use of subtotal and totals, the use of direct versus indirect method of cash flows, and development of a common definition of discontinued operations
3. Segment C would address the presentation of interim financial statements

The use of the capital maintenance rule for income determination is the basis of the FASB and IASB rule making efforts. The idea of using capital maintenance as a performance measurement is embedded in Financial Accounting Standards Concept (FASC) No. 5 and has been in existence for years (Mechelli, 2008). Historically, financial statements presented performance by noting the amount of income realized during the accounting period. As accounting standards evolved, the rule making bodies shifted away from realization concepts to recognition of unrealized gains and losses through fair value and current value assessment of assets and liabilities (Mechelli, 2008). As such, historical performance measures had to evolve as well resulting in confusion at the user level (Mechelli, 2008).

In 2008 the two Boards issued a joint discussion paper titled “Preliminary Views on Financial Statement Presentation” (Hageman, 2011). In this non-authoritative publication, the two Boards reviewed their progress and identified their approach to addressing the question on comprehensive income and concluded that a single all-inclusive income statement would be appropriate (Hageman, 2011). However, the Boards announced that they would postpone their joint efforts on the project because of capacity issues and not publish a formal standard until such time as the two Boards could return to the project. However, progress would continue through an outreach program by staffs of both Boards to meet with users, practitioners, investors, and others to accumulate data and gain an understanding of the needs of the preparers and users of financial statements (Whitehouse, 2010). In 2010, the Boards issued an Exposure Draft proposing
the single statement approach which placed other comprehensive income (OCI) on the income statement, removing it from the equity section of the balance sheet. Several objections, as noted by Henry (2011), were received including the following:

- Net income would be a sub-total and therefore de-emphasizing its importance
- Confusion would result as to which income number was used for earnings per share calculations
- Components of OCI (items outside the control of management) would be emphasized

The two Boards reviewed the input on the exposure draft and concluded that the two statement approach would be appropriate:

1. Show a continuous statement of comprehensive income
2. Provide two separate but consecutive income statements

The new treatment became effective with Accounting Standards Update (ASU) 2011-05 issued in second quarter 2011 to be effective for fiscal periods after December 15, 2011. This action brought U.S. GAAP into convergence with IAS.

Issues

Earnings is a concept of performance measurement that does not include non-operating, nonrecurring, or events outside of the control of management (Barker, 2004). However, Barker (2004) finds the concept of earnings difficult or impossible to define for purposes of developing accounting standards. The balance sheet measures the change in assets and liabilities resulting from transactions with owners and through results of operations. Profit represents the result of operations under the all-inclusive concept and arises from the realized transactions that include income, expenses, gains and losses which is called clean surplus (Barker, 2004). Basically clean surplus includes those transactions that change the equity balance other than transactions with owners (van Cauwenberge & de Beelde, 2010). Both FASB and the IASB recognize this concept. Under U.S. GAAP, the concept is called comprehensive income. Under international standards, IASB refers to the concept as profit or loss (Barker, 2004). However, some items are allowed to bypass the income statement and are treated as increases and decreases to equity as in international standards or in a separate financial statement in U.S. GAAP. These items are classified as other comprehensive income and have been labeled as dirty equity (van Cauwenberge & de Beelde, 2010). The issue here is that there is not a precise definition of earnings or net income in either FASB or IASB standards (Barker, 2004). The lack of conceptual guidance results in confusion especially as the standard setters move toward a fair value focus, creating an environment with lack of clarity as to what is exactly included in earnings and how performance should be measured (Barker, 2004).

Research conducted by FASB, as noted by Munter (2003), discovered that users:

- Prefer more disclosure of information that is predictive in nature
- There is not widespread need for a change in the format of the financial statements including adding, deleting, or changing statements
- Important financial measures include operating cash flows, return on invested capital, operating earnings
- Net income is an important performance measure but not absolute
Minimal support exists for a statement of comprehensive income nor is there any significant opposition for such a statement.

Statement of cash flows is considered an important statement for predicative capabilities and disclosures as to sources and uses of components of operating cash flows is more valuable than the reconciliation approach used in the indirect method.

Additional disclosures on capital asset transactions is preferable noting potential direction the company is moving.

The above comments provide insight as to the needs of the user of the financial statements and the investor.

Adding to the confusion is the concept of OCI. OCI is composed of certain transactions deemed out of the control of management and therefore segregated from the income statement and placed in the equity section of the balance sheet. Such items include foreign exchange translation adjustments, unrealized gains or losses on available-for-sale securities, actuarial gains or losses on pension obligations, gains or losses on hedging instruments, and for international standards, revaluation of property, plant, and equipment, and revaluation of intangible assets (Pronobis & Zülch, 2011). In a study by Andersson & Karlsson (2011), it was found that producers of financial statements did not consider items in OCI as part of performance measurement activities. Rather, net income was the primary focus of performance. In the same study it was found that users regard OCI a little higher but rely more heavily on net income as a performance indicator (Andersson & Karlsson, 2011). It was also found in studies conducted by (Hageman, 2011) that net income is the dominate factor in decision metrics and that comprehensive income is more associated with return than net income. In a study conducted by Pronobis & Zülch (2011) it was also found that comprehensive income was not a primary provider of performance measurements nor did it have any predictive qualities over net income.

In the joint project, the FASB/IASB boards determined that two statements showing comprehensive income and OCI would be useful (Andersson & Karlsson, 2011), therefore addressing the needs of both the business entity and the user.

Though significant effort has been made towards convergence, differences still remain especially in the area of aggregation/disaggregation of information reported on the financial statements (Libby & Brown, 2011). IAS requires significant disaggregation of income statement items as compared to U.S. GAAP income statements (Libby & Brown, 2011). For example, U.S. GAAP requires that operating expenses be shown as one of two categories: cost of sales or general, selling, and administrative whereas IAS requires a more detailed breakdown of selling, marketing and administrative costs separately and further disaggregation in the notes to the financial statements as sub-categories (Libby & Brown, 2011). Studies indicate that increased disaggregation reduces errors and improves the quality of financial statements but the question still remains as to the type of disaggregation. Should it be by function or by nature? In a study conducted by the SEC in 2011, half of international companies disaggregate financial information by nature and the other half present by function (Libby & Brown, 2011).

**Conclusion**
Convergence continues with both Boards agreeing to jointly consider ways to align their research and standard setting models more closely (Hoogervorst & Seidman, 2012). Accounting for the same transactions differently can produce different economic outcomes (Andersson & Karlsson, 2011). We see this continually in the literature. By continuing to work together, the differences will slowly fade and be replaced by coordinated, consistent, and aligned approaches to accounting for the world’s financial transactions.
References


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