



FINANCIAL ACCOUNTING STANDARDS BOARD

---

**Background Paper to a  
Proposal for a New Agenda Project**

---

REPORTING INFORMATION ABOUT  
THE FINANCIAL PERFORMANCE OF BUSINESS ENTERPRISES:  
Focusing on the Form and Content of Financial Statements

---

by Ronald J. Bossio<sup>1</sup>  
August 17, 2001

## **INTRODUCTION**

This paper provides additional background information for those who are interested in and are considering responding to the Board's August 17, 2001 request for comments on a proposed project on reporting financial performance. That project Proposal is available at <http://www.fasb.org/project/performance.pdf>.

## **BACKGROUND**

In 1991, the American Institute of Certified Public Accountants (AICPA) formed the Special Committee on Financial Reporting to address concerns about the relevance and usefulness of business reporting, many of which are related to issues about the quality of reporting and disclosure of information in financial statements. The Special Committee, in its December 1994 report, *Improving Business Reporting—A Customer Focus*, offered its recommendations for consideration by the FASB and others interested in furthering the quality of business reporting.

The Association for Investment Management and Research (AIMR) in its November 1993 report, *Financial Reporting in the 1990s and Beyond*, also identified several major issues and concerns about the quality of financial reporting. They include, among others, concerns about the quality and frequency with which disaggregated financial statement information is disseminated, the need for FASB to develop its concept of comprehensive income, and the quality of information in statements of cash flow.

---

<sup>1</sup> This Paper was prepared by Ronald J. Bossio, a senior project manager on the research and technical activities staff of the FASB. The findings and views expressed in this background paper are those of the author. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.

Many of the concerns identified by the Special Committee and the AIMR persist and are heightened by the increased and diverse reporting of alternative measures of performance such as revenue growth, earnings before interest and taxes (EBIT), earnings before interest, taxes, depreciation, and amortization (EBITDA), operating cash flow, free cash flow, and a myriad of pro forma earnings presentations. The press is raising serious questions about that diversity and the credibility of business reporting,<sup>2</sup> which also raises concerns about the adequacy of accounting standards.

### **Plan to Consider a Project to Address Constituent Concerns**

During the fourth quarter of 2001, the Board plans to consider whether to add a project to its agenda on reporting financial performance. At its August 1, 2001 meeting, the Board discussed three approaches that could be adopted for a project on reporting financial performance that would address financial metrics. They are:

1. The minimum approach tentatively adopted by the Board and described in this Proposal would explore whether certain line items, subtotals, and totals should be defined in standards and required to be displayed in financial statements, including interim statements. Line items and amounts would include those related to metrics commonly used by investors and creditors in assessing financial performance<sup>3</sup>
2. A broader approach that also involves determining how key financial metrics should be calculated if they are presented, but not require them in financial statements
3. A still broader approach that would require business enterprises to provide certain specific financial metrics, including ratios, in financial statements, in notes to financial statements or, perhaps, as supplementary information.

Under the minimum approach, the project would explore whether certain line items, subtotals, and totals should be defined in standards and required to be displayed in financial statements, including interim statements. Line items and amounts that would be considered include those related to metrics commonly used by investors and creditors in assessing financial performance. For example, this project would consider whether to require in financial statements the separate display of specified items such as the amount of expense for depreciation, interest, taxes, or research and development, losses for asset impairments, or gains and losses for holdings of financial instruments. This project also would consider whether to require the display of summarized amounts such as operating income or income from core activities, EBITDA, or operating cash flow.

---

<sup>2</sup>Reporting about such concerns include, among numerous others, the May 14, 2001, *Business Week* cover story, "The Numbers Game: Companies Use Every Trick to Pump Earnings and Fool Investors. The Latest Abuse: 'Pro Forma' Reporting"; the April 16–May 6 *Accounting Today* commentary, "EBITDA; Freedom of Speech or Freedom to Confuse?"; the April 29, 2001 *Washington Post* article, "Hypothetically, Pro Forma May Be a Mirage"; the April 4, 2001 *Wall Street Journal* article, "P&G's One-Time Charges Make Critics Look Twice at Earnings"; and the February 13, 2001 *American Banker* article, "NetBank Plays Hide-and-Seek With Its Earnings Information."

<sup>3</sup> For example, this project would consider whether to require in financial statements the separate display of specified items such as the amount of expense for depreciation, interest, taxes, or research and development, losses for asset impairments, or gains and losses for holdings of financial instruments. This project also would consider whether to require the display of summarized amounts such as operating income or income from core activities, comprehensive income, EBITDA, or operating cash flow.

The project approach contemplates consideration of and building on the relevant research and recommendations of others, including constituent comments on the following:

1. AIMR November 1993 report, *Financial Reporting in the 1990s and Beyond*
2. AICPA Special Committee on Financial Reporting December 1994 report, *Improving Business Reporting—A Customer Focus*
3. FASB 1996 Invitation to Comment, *Recommendations of the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research*
4. Members of the former G4+1 standard-setting organizations January 1998 Special Report, *Reporting Financial Performance: Current Developments and Future Directions*, by L. Todd Johnson and Andrew Lennard, and September 1999 Special Report, *Reporting Financial Performance: A Proposed Approach*, by Kathryn Cearns
5. UK’s Accounting Standards Board (ASB) December 2000 Financial Reporting Exposure Draft (FRED 22), *Reporting Financial Performance*.

### Research and Recommendations of Others

The remainder of this Paper discusses the research and recommendations of those earlier initiatives, including certain comments of constituents that supported and challenged those recommendations, related research efforts of others, and related comments of members of the Board’s Financial Accounting Standards Advisory Council and others about the problems and issues discussed in the Proposal.

### AIMR

Among other things, a project on reporting financial performance would consider the AIMR report and its suggestion that “financial statement users need in one place all the data reporting an enterprise’s economic activity, which they then may sort out to suit their own purposes [and that the] income statement format needs codification of its structure to ensure that like items are classified similarly by different companies” (pages 64 and 65). That paper also said that “cash flow statements that have appeared in published financial reports have been much less useful in analysis than we might have expected” (page 65). It also noted two significant deficiencies: (1) failure of companies to present their cash flows from operations using the preferred direct method<sup>4</sup> and (2) many detectable errors of imprecise application of FASB Statement No. 95, *Statement of Cash Flows*.

<sup>4</sup> Table 6-3 (Method of Reporting Cash Flows from Operating Activities) of the AICPA’s *Accounting Trends & Techniques—2000*, provides the following information for 600 companies in its survey.

	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Indirect method	593	593	590	589
Direct method	7	7	10	11
Total Companies	<u>600</u>	<u>600</u>	<u>600</u>	<u>600</u>

### **AICPA Special Committee**

The project also would consider the AICPA Special Committee's recommendations for improving the content of financial statements and notes to financial statements (Chapter 6), which include suggestions that companies:

- Provide a summary of key financial (and nonfinancial) data on a consolidated basis as well as for each business segment
- Distinguish between the effects of core and non-core activities and events on the face of financial statements (income statement, statement of cash flows, and balance sheet) with the goal of presenting the best possible information with which to analyze trends in a company's business
- Increase the amount of detail in financial statements, particularly in the income statement, as a means of helping users understand the business, the linkage between the financial statements and actual events, and the opportunities and risks
- Restate or reclassify information in more circumstances than currently allowed when that is reasonably possible and is necessary for a better and more complete understanding of the business.

The project also will consider the Special Committee's 1994 decision to not recommend the use of the direct method of reporting cash flows from operations. On page 99 of its Report, the Special Committee said:

The Committee does not recommend the direct method for three reasons. First, a substantial minority of users believes that the indirect method in current practice is acceptable or preferable. Second, the Committee's recommendations should provide most of the information that users who support the direct method seek. For example, many of the Committee's recommendations help users understand a company's business and the recommendations related to display help users predict core income and core cash flows. Third, the costs of reporting under the direct method could be significant because most companies do not currently capture the information required. Converting information systems to provide the information or determining the information from existing reporting systems could be costly.

This project will determine the extent to which those reasons continue to exist today and degree to which users' assessment of financial performance of a business enterprise depends on or would be improved by the majority of users' preference for the direct method of reporting information about an enterprise's cash flows from operations.

### **Members of G4+1**

In the late 1990s, members of the former G4+1 standard-setting organizations undertook efforts to study how the reporting of financial performance might be improved. Those efforts led to the issuance of Special Reports in January 1998 and September 1999. Both Special Reports proposed a single performance statement showing all changes in equity from all sources other than transactions with owners that would show a full analysis of financial performance with three main components: (1) the results of operating (or

trading) activities, (2) the results of financial and other treasury activities, and (3) other gains and losses. The G4+1 member standard-setting organizations also invited comments on those proposals.

While several respondents expressed strong support for a project on reporting financial performance, some also disagreed with the limited scope suggested by the G4+1 Special Reports. For example, the Global Financial Reporting Advocacy Committee (GFRAC) of the AIMR said:

The GFRAC is pleased to see the G4+1 standard setters addressing the important issue of reporting financial performance. Unfortunately, we are disappointed that the position paper focuses solely on the income statement. We believe that a comprehensive discussion of financial performance must address all of the financial statements: income statement, balance sheet and cash flow statement. Failure to do so merely reinforces undue reliance on “bottom line” earnings. All three statements are interrelated and any discussion of financial performance must address this interrelationship. [Letter No. 7, pages 1 and 2]

The minimum approach tentatively adopted by the Board for a project on reporting financial performance would address all basic financial statements, both annual and interim. PricewaterhouseCoopers LLP suggested a similarly broad scope project that would also include *nonfinancial* measures of performance. They said:

We strongly believe that the issue of reporting financial performance should be addressed by standard setters throughout the world. It appears, however, that the Paper discusses issues associated with the format of a Statement of Financial Performance but does not address the larger issue of performance reporting. While we recognize that there are significant challenges in developing a model that faithfully reflects a company’s performance, we also believe that pervasive changes in the modern economy and the changing needs of investors demand that such a project be undertaken. We believe that either the G4+1 or, preferably, the Financial Accounting Standards Board should take up that challenge.

It is clear to us that investors in the United States are becoming increasingly dissatisfied with the measures of performance used in the current accounting model. As a result, alternative measures, such as EBITDA, “cash earnings,” and cash flow per share are becoming increasingly popular with financial analysts and other users of financial statements. We are also cognizant of the fact that investors are increasingly basing investment decisions on nonfinancial information, especially so-called Value Drivers. We commend the FASB on its initiative to study these alternative measures as a part of its Business Reporting Research Project, however it is clear to us that more is required. We advocate a project that would encompass further investigation of the needs of investors and the financial and nonfinancial information they use to make investment decisions. . . . [Letter No. 6, page 1]

The minimum approach tentatively adopted by the Board does not contemplate addressing nonfinancial data and metrics. It is generally acknowledged, however, that voluntary disclosures of the broad range of nonfinancial data may provide investors and creditors with information that is useful in assessing the performance of a business enterprise.<sup>5</sup>

### **UK's ASB**

More recently, the UK's ASB issued FRED 22, which solicited comments on a proposed standard that substantially adopts the recommendations of the 1999 Special Report. FRED 22 includes the following proposed definition of financial performance:

The financial performance of an entity comprises the return it obtains on the resources it controls, the components of that return and the characteristics of those components, insofar as they can be captured by the accounting model.

The project Proposal acknowledges that in the US, there also is no common definition of financial performance and no consensus or common definitions for the key financial measures or indicators of financial performance that financial statements should provide. The project can benefit from the definition of financial performance proposed in FRED 22 and the comments of the ASB's constituents that support and challenge that proposed definition and its other proposed standards.

FRED 22 notes that the objective of the proposed Financial Reporting Standard (FRS) "is to require reporting entities falling within its scope: (a) to report all recognised gains and

---

<sup>5</sup> The January 2001 Special Committee Report of the Business Reporting Research Project, *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, made several key recommendations about voluntary disclosures that include nonfinancial data. It noted that companies can markedly improve their business reporting by voluntarily disclosing more available information about which the investment community and shareholders have a keen interest. These matters include identifying factors important to the financial success of the company, delineating management's plans and strategies for managing those factors in the past and future, and specifying measurements used by management to assess its effectiveness in implementing those plans and strategies. These recommendations resulted from a two-year project supervised by a 14-member Steering Committee of FASB constituents. The Steering Committee guided and directed the activities of a group of more than 50 professionals representing the preparer, financial statement user, auditing, and academic communities who worked on the project. The report also noted that voluntary disclosures related to matters that are important to the success of individual companies are very useful, particularly disclosures of management's view of the company's "critical success factors" and trends surrounding those factors, and that the metrics used by companies to manage their operations and drive their business strategies often are very useful voluntary disclosures.

In May 2001, a task force chaired by Jeffrey E. Garten of the Yale School of Management, issued a report entitled *Strengthening Financial Markets: Do Investors Have the Information They Need?* That report also encourages the promotion of voluntary efforts to improve measures, including nonfinancial measures, that would be useful in assessing the performance of a business enterprise, especially forward-looking measures. In the Executive Summary of that report, the task force said:

We recommend that the SEC pull together the considerable work that has already been done by academics, the accounting firms and projects sponsored by organizations such as the Financial Accounting Standards Board (FASB) in order to move forward with a framework for voluntary supplemental reporting for intangible assets, operating performance measures and other information that would help investors assess a company's *future performance*. [Emphasis added.]

losses in a single performance statement; and (b) to highlight a range of important components of financial performance to help users to understand the performance achieved by an entity in a period and assess future results and cash flows” (paragraph 1). Among other things, FRED 22 proposes that “an entity should divide its performance statement into the following three sections: (a) operating; (b) financing and treasury; and (c) other gains and losses” (paragraph 14, footnote omitted). FRED 22 is available at [www.asb.org.uk/publications/publicationproject.cfm?upid=66](http://www.asb.org.uk/publications/publicationproject.cfm?upid=66).

A potential FASB project on reporting financial performance would consider many of the same issues addressed in FRED 22 and the G4+1 Special Reports but its scope would not be limited to a single statement. Rather, the minimum scope of such a project would consider how the full set of financial statements of business enterprises might be improved to facilitate the reporting of key financial information—line items, subtotals, and totals—that investors, creditors, and others use (or desire) in assessing the financial performance of a business enterprise.

Moreover, the project approach does not take as a given that a single financial statement is capable of providing the key financial information for assessing performance or that any single summarized amount is *the* key measure of performance. Some constituents may still cling to or wish for one simple measure of performance, such as earnings or earnings per share. However, Johnson and Lennard observe that no one measure can hope to satisfy the different needs of different users.<sup>6</sup> Moreover, there is considerable evidence that the relevance of earnings as a measure of financial performance is declining and that users of financial statements are increasingly seeking many complementary financial measures, including measures of components of earnings and cash flows.<sup>7</sup>

---

<sup>6</sup> Johnson and Lennard, in the 1998 G4+1 Special Report, noted:

The difficulty in prescribing simple performance measures is not only, or even mainly, one of deriving suitable definitions, but rather it is that different users have different needs for different purposes and that they need to be informed about all of an enterprise’s financial performance. Thus, the most important question is not what measures of profitability should be presented in financial statements, but rather what components of financial performance should be presented to make the information as useful as possible.

No single performance measure is likely to serve unambiguously for the wide variety of purposes for which financial statements are used, including those performance measures that are familiar in current practice. Accordingly, the reporting of financial performance should not be constrained by an overriding need to preserve the measures that are currently presented. . . . [paragraphs 1.6 and 1.7]

<sup>7</sup> Jennifer Francis and Katherine Schipper, in their autumn 1999 *Journal of Accounting Research* article “Have Financial Statements Lost Their Relevance?” noted that:

the results of [their] tests show a decline in the relevance of earnings information, and an increase in the relevance of balance sheet and book value information, over our sample period [1952-94]. These results are broadly consistent with other research examining the value relevance of financial information (e.g., Collins, Maydew, and Weiss [1997], Ely and Waymire [1999], Lew and Zarowin [1999], and Chang [1999]).<sup>5</sup>

<sup>5</sup> An exception is Chang’s finding of a decrease in the value relevance of earnings and book values.

## IASB

The International Accounting Standards Committee, predecessor of the IASB, previously expressed concern about the lack of a definition in the 1999 G4+1 Special Report of what constituted “financial performance” and appointed a steering committee in March 2000 to undertake work on reporting financial performance. Subsequently the IASB was reconstituted and in July 2001 it added to its agenda a major project on reporting financial performance that would include considering the form and content of a statement of cash flows as well as a statement of income (statement of revenues and expenses, comprehensive income, or similarly titled statement).

## CONCLUSION

As a result of the more recent G4+1 Special Reports and FRED 22, both the IASB and the FASB have useful commentary for acting upon the recommendations of the AIMR, AICPA Special Committee, and others. Such an effort seems especially timely in the United States as increased reporting of alternative (pro forma) performance measures is raising concerns about investor confusion. That practice has been heightening calls for the FASB to issue standards or guidelines for the comparable and consistent reporting of key measures that are used in assessing financial performance.<sup>8</sup>

Nonetheless, although there are several useful recommendations for improving the form and content of financial statements in ways that could facilitate the consistent reporting of highly relevant and understandable key financial measures that are useful in assessing financial performance, consensus may not come easily.<sup>9</sup> Moreover, as suggested by the

---

<sup>8</sup> For example, as noted in the September 2000 Summary of Responses to the Annual FASAC Survey, Mr. Monson of KPMG said that “the increased attention being given by analysts, investment bankers, and other users of financial statements to ‘cash earnings per share’ and ‘EBDITA’ as measures of performance suggests that more and better information relating to an entity’s cash flows is being demanded by the marketplace. The Board should get out in front of this issue” (page 65). Similarly, Ms. Parrs of International Paper said that “unless the FASB or the EITF issue guidelines on definition of cash flow per share, investors are going to be confused by a plethora of definitions” (page 67) and Mr. Herz of PricewaterhouseCoopers said that “we believe that the financial reporting model, particularly reporting financial performance, should be addressed comprehensively. We also see cash flow as a component of financial performance, rather than a separate project” (page 72).

<sup>9</sup> For example, Mr. Oelkers of Texaco, responding to a potential project on performance reporting, as noted in the September 2000 Summary of Responses to the Annual FASAC Survey, said that “a performance reporting project will face difficult hurdles. Most nonprofessional readers focus on traditional performance measures, such as net income, earnings per share, revenues, etc., that are reported by the financial media. Professionals use their own modeling techniques to gauge performance. Until the mindset of these users is changed, there will likely be resistance to new measures. Users will still demand the traditional measures. Comprehensive income is an example. Though companies are required to report that figure, it is ignored by the financial media” (page 67).

Oscar S. Gellein’s article, “Periodic Earnings: Income? Or Indicator?” published by *Accounting Horizons* in June 1987, provides another useful reminder of the long-standing controversy surrounding whether “periodic earnings should be an indicator of enterprise performance or a measure of periodic income representing enterprise wealth enhancement during the period, or whether it can fill both roles” (page 61).

recent comments of Mr. Boggs of Microsoft Corporation,<sup>10</sup> whether a single financial statement format or classification scheme is appropriate for all or certain companies remains an open issue for consideration. For example, reporting by mutual funds, pension plans, and perhaps, financial institutions for which investing activities are core activities may require a different classification scheme than for companies for which investing and financing activities are incidental or peripheral to their core activities.

As previously noted, the Board plans to consider whether to add to its agenda a project on reporting financial performance and it has requested comments by September 19, 2001. However, the Board has not reached a final decision about the project scope. Moreover, distribution of a proposal for comment does not necessarily establish the eventual scope of a potential project. Nor does it mean the proposed issue will be added to the Board's agenda.

---

<sup>10</sup> Mr. Boggs, responding to a potential project on performance reporting, as noted in the September 2000 Summary of Responses to the Annual FASAC Survey, said that "while we are very cautious about what the outcome of this potential project may be, with all the discussions of items such as pro forma reporting and so-called cash earnings, we believe an examination of this issue is warranted. However, we do not believe a one-size-fits-all answer is obtainable or desirable, but do believe an in-depth examination of this issue will be useful" (page 71).