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Thank-you for the opportunity to comment on this Exposure Draft. Our primary reaction is that the continued focus on assets and liabilities as having conceptual primacy is inconsistent with the objective of providing useful information to investors and creditors. Given the broad nature of our feedback, we have respectfully chosen not to answer the specific questions raised in the Exposure Draft. Instead, we encourage The Board to consider whether an 'income statement' approach to defining the elements of financial statements would result in financial statements that are more useful to investors and creditors.

Investors and creditors are primarily interested in the current earnings capacity of a reporting entity. Investors' primary interest in earnings capacity has long been established, and continues to this day. The current proliferation of management-provided non-GAAP measures is a direct consequence of investor demand for measures of current earnings capacity. The Exposure Draft asserts that assets and liabilities have conceptual and definitional primacy and that this primacy is axiomatic. Yet one could alternatively assign primacy to revenues, expenses, gains and losses. Equity can be defined in terms of either assets and liabilities or in terms of cumulative past revenues, expenses, gains, losses and capital transactions. Investors' focus on earnings capacity suggests that the latter set of elements provide a foundation for information that is more relevant to the objective of financial reporting.

The measurement of current earnings capacity involves a determination of the net periodic income generated by the reporting entity through exchange transactions. This leads to a focus on whether current or anticipated receipts generated by exchange transactions have been earned (i.e., performance obligations satisfied) and on the measurement of past and anticipated future costs incurred in the process of generating earnings. We don't find the proposed definitions of assets and liabilities to be appropriate for making such determinations. Moreover, we feel that information provided in the balance sheet is more useful to investors when it is derived from an income statement approach to defining the elements of financial statements.

We expand on these points below.

Provision of Financial Statement Information that is Useful

It has long been established that users of financial statements are primarily interested in the earnings capacity of reporting entities. These entities are generally 'going concerns.' As such, their value to investors and creditors hinges on their future cash flows, which are primarily determined by their future earnings capacity. Current earnings capacity is the starting point for investors in forecasting future earnings capacity and future cash flows. The primacy of earnings capacity can be traced back at least as far as the inception of US GAAP by the 'Special Committee' in 1937.[1] Two of the four principal objects identified by The Committee are:

1. To bring about a better recognition by the investing public of the fact that the balance-sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

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[1] See *Audits of Corporate Accounts: Correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934.* New York: American Institute of Accountants, 1934. [Reprinted, New York: American Institute of Certified Public Accountants, 1963.]

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2. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the year to which it relates."

The primacy of earnings was also expressed in leading investment texts of the day. For example, in their classic text on security analysis, Graham and Dodd (1934, p. 17) state in Chapter 1 that:

> "Some time ago intrinsic value (in the case of a common stock) was thought to be about the same thing as 'book value', i.e., it was equal to the net assets of the business, fairly priced. This view of intrinsic value was quite definite, but it proved almost worthless as a practical matter because neither the average earnings nor the average market price evinced any tendency to be governed by book value…Hence, this idea was superseded by a newer view, viz., that the intrinsic value of a business was determined by its earnings power."

The primacy of earnings capacity to financial statement users has been reiterated many times since. One notable exception is Sprouse (1966). This exception is notable in that Sprouse was subsequently appointed as a founding board member of the FASB and the views expressed in Sprouse (1966) align closely with the FASB's primary focus on the assets and liabilities. Sprouse (1966) supports the assertion that financial statement users are concerned with assets and liabilities by reference to a quotation from Graham, Dodd and Cottle (1962). As has subsequently been pointed out (see, Basu and Waymire 2010), this quote was taken out of context and the overriding theme of Graham, Dodd and Cottle is that users are primarily interested in earnings power.

The focus of financial statement users on the earnings capacity of reporting entities has been corroborated in numerous subsequent surveys. For example, a recent survey of CFA Institute members with equity analysis responsibilities reveals a predominant focus on earnings (see Pinto, Robinson and Stowe, 2019). The most popular valuation approach is a market multiples approach, the most popular multiple is price to some measure of earnings and the most popular

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measure of earnings is forecasted net income. A second example is provided by Liu (2020), which provides an analysis of the fairness opinions in corporate acquisitions. The most common method of valuation is "public company multiple analysis," which employs multiples of price to measures of current earnings capacity, including EBITDA, net income and free cash flow.

Financial statement user demand for measures of earnings capacity is also evidenced by the ongoing proliferation of non-GAAP metrics. The rise of non-GAAP metrics has closely paralleled the FASB's shift to a balance sheet emphasis in accounting standards. The balance sheet approach has caused income to be affected by adjustments to assets and liabilities that are not directly related to the current earnings capacity of the entity (see Dichev, 2008). Managers have responded to user demand for measures of earnings capacity by reporting non-GAAP numbers that attempt to eliminate such adjustments. Thus, we have an equilibrium in which financial measures prepared according to GAAP lack usefulness and managers are left to develop their own non-GAAP measures in an effort to provide more useful information. This equilibrium undermines the role of the mandated audited financial statements and provides the opportunity for unscrupulous managers to develop non-GAAP measures that artificially inflate earnings capacity. Nevertheless, available evidence indicates that the primary purpose of managers non-GAAP metrics is to produce more informative and useful measures of periodic performance for investors (see Black and Christensen, Ciesielski and Whipple, 2018).

Conceptual Primacy

The key justification in the Exposure Draft for the focus on identifying and measuring assets and liabilities is the assertion that they have conceptual primacy. Yet the accounting identities referred to in the Exposure Draft also allow for revenues, expenses, gains and losses to have conceptual primacy:

The key identity (often referred to as the clean surplus relation) is:

Comprehensive Income = Change in Equity – Net Owner Contributions

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Given any two of these variables, we can infer the third. The Exposure Draft advocates for a focus on identifying and measuring the components of Equity in order to recover Comprehensive Income. Alternatively, one could focus on identifying and measuring the components of Comprehensive Income to recover the Change in Equity.

Regardless of which alternative is selected, comprehensive income and equity must still be decomposed into their underlying components:

Equity=Assets-Liabilities

Comprehensive Income=Revenues – Expenses + Gains - Losses

It is a matter of choice as to which alternative is selected. Given that earnings capacity is the primary focus of financial statement users, the selection of components of income seems more appropriate. Dichev (2017) provides a more complete case for the conceptual primacy of the income statement approach and identifies other popular accounting systems adopting this approach.

Finally, we appreciate the inclusion of Appendix A on "Accrual Accounting and Related Concepts" in the Exposure Draft. However, we find that the procedures discussed in Appendix A are more consistent with an income statement approach and do not follow naturally from the definitions of assets and liabilities provided in the Exposure Draft. These procedures include revenue recognition, cost matching, allocation and amortization.

The Role of the Balance Sheet

Financial statement users are primarily interested in earnings capacity, leading to a natural focus on the income statement. Yet the balance sheet also provides information that helps users to evaluate current earnings capacity and forecast future earnings power. Here, we briefly summarize two common ways in which information in the balance sheet is used and explain why

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an income approach to defining the elements of financial statements facilitates the provision of useful balance sheet information.

(i) Measuring Return on Investment

Return on investment (return on equity, in the case of an equity investment) is a key factor in forecasting the future earnings power of an entity. Return on investment is measured as periodic income divided by invested capital. Entities that have both a return on equity exceeding their cost of equity and the potential to grow the scale of their business operations have valuable growth opportunities. In order for return on equity to be useful in identifying such growth opportunities, it is critical that equity be a good measure of invested capital.

Unfortunately, the balance sheet approach to financial reporting has failed in this respect. Some costs that are clearly incurred with the intent of generating future earnings are not recorded as investments (e.g., R&D expenditures). Other investments are subject to fair value adjustments that can cause the carrying value of the investment to understate invested capital (e.g., reported goodwill after taking a fair value impairment charge). In both cases, the effect is to distort return on equity, thus making it difficult for investors to assess whether an entity is generating a healthy return on invested capital.

In contrast, the income statement approach has a clear focus on defining and measuring assets as unexpired costs, thus providing an appropriate measure of invested capital. The key distinction between the two approaches is that the balance sheet approach defines assets as economic benefits, while the income statement approach defines investments that are made with the intent of generating future earnings to be assets.

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(ii) Evaluation of Quality of Earnings

Under the income statement approach, assets and liabilities arise from accruals and deferrals resulting from the measurement of income. By studying accruals and deferrals on the balance sheet, financial statement users can evaluate earnings quality and make their own adjustments to earnings. Examples include the identification of bloated inventory accounts, excessive cost deferrals and excessive revenue deferrals. Users that disagree with management's assumptions can substitute their own assumptions to recompute periodic income.

The balance sheet approach confounds this type of analysis. The focus on assets as economic benefits and liabilities as economic obligations results in recognition and measurement rules that distort current earnings power. For example, some assets are subject to fair value adjustments that are based on changes in anticipated future earnings power (e.g., goodwill). In addition, some unexpired costs are not recognized as assets (e.g., R&D expenditures), thus requiring users to make their own expense deferrals, without any management guidance as to the appropriate assumptions.

In summary, we believe that a primary focus on the definition and measurement of the components of comprehensive income will provide financial statements that are more useful to investors. We hope that you find these comments useful as you continue your deliberations. Please feel free to contact us if you would like to discuss these comments further.

Yours Faithfully,

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