UNIVERSITY OF GOTHENBURG
SCHOOL OF BUSINESS, ECONOMICS AND LAW

Department of Business Administration
Jan Marton
Associate Professor
jan.marton@gu.se

Financial Accounting Standards Board
Technical Director
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
USA

Response to Invitation to Comment, File Reference No. 2021-004

This is a response to the Invitation to Comment (ITC), File Reference No. 2021-004. The response is based on recent academic research, including research that utilizes new machine-learning methods.

Research is often focused on aggregate measures of performance, such as earnings or cash flows, while each financial reporting standard often covers one specific financial statement item or issue. Still, this response highlights what we can learn about specific issues mentioned in the ITC from research on aggregate measures.

Detailed comments are provided in the Appendix. In summary, research shows that the usefulness of reported net income relative to cash flows has decreased over the last few decades. A suggested explanation for the decline is that the importance of intangible assets in the economy has increased, and that the current accounting model for such assets is insufficient. Research identifies economic characteristics of intangible assets that create challenges for standard setters. A separate finding in research is that some summary measures of earnings—for example EBITDA and gross profit—are consistently more useful than cash flows, even for firms with high intangible asset intensity. This points to the importance of consistent definitions of such measures.

In the ITC, the Board has specific questions for respondents. In the Appendix, answers are provided to those questions that are relevant in relation to research referred to. Consequently, some questions are left unanswered in this response.

All views expressed herein are my own and do not represent official policy of the University of Gothenburg.

Sincerely yours,

Jan Marton

Appendix

This appendix gives responses to some of the questions posed by the Board. After a response to Question 1, there is an overview of recent research on the usefulness of reported earnings, followed by responses to questions that relate to this research.

> ***Question 1:*** *Please describe what type of stakeholder you (or your organization) are from the list below, including a discussion of your background and what your point of view is when responding to this ITC.*

I am an academic ('a' from the list). While I have experience from several Big 4 accounting firms, both as a CPA and a financial reporting specialist, the point of view taken here is to provide input based on academic research.

Research overview

The main function of accounting is to turn cash flows into earnings through accruals. Consequently, much of US GAAP—and FASB's Agenda—relate to accruals. Producing accruals-based financial statements is a costly activity, which is motivated by a superior usefulness of accrual accounting over cash accounting.

Research shows that over the last 50 years, the usefulness of earnings for stock market investors has declined relative to the usefulness of cash flows (e.g., Adame et al., 2019). The decline coincides with a decrease in the ability of accruals to smooth temporary timing fluctuations in operating cash flows (Bushman et al., 2016). Recent research focuses on more detailed data to identify which types of accruals contribute to the relative decline in earnings usefulness. Lewellen and Resutek (2016) distinguish between accruals directly related to within period transactions and non-transaction accruals. The latter include, for example, changes in value of existing assets and liabilities. They find that non-transaction accruals do not contribute to the usefulness of earnings. These findings are confirmed by Ball and Nikolaev (2021), who show that earnings excluding non-operating and non-transaction items outperform operating cash flows.

Both Lewellen and Resutek (2016) and Ball and Nikolaev (2021) define quality of performance measures as their ability to predict next year's earnings or cash flows. Based on recent advances in machine learning, Starica and Marton (2021) develop a method to obtain an unbiased measure of the relation between stock prices and earnings or cash flows (a comprehensive measure of their usefulness for stock market investors). Using the method, Marton and Starica (2021) investigate the usefulness of different earnings numbers. They show that while the usefulness of bottom-line earnings relative to cash flows declines over time (consistent with prior research), EBITDA and gross profit consistently outperform operating cash flows.

The implication for the Board is that, for example, accruals related to changes in value of assets and liabilities (including depreciation and amortization, which is excluded from EBITDA) do not render earnings more useful. This effect is gradually increasing in importance over time, especially for high-tech firms. This relates to Question 2 in the ITC:

> ***Question 2****: Which topics in this ITC should be a top priority for the Board? Please explain your rationale, including the following.*

A suggestion is that the Board initiates a research project to bring clarity into the overall usefulness of accruals resulting from US GAAP, and which standards increase the usefulness of earnings. Ultimately, US GAAP will only be successful if they are useful for intended users, such as equity investors. While each individual standard may be well motivated, in aggregate standards can generate less useful earnings numbers.

Implications for specific agenda items
Based on the research referred above some items should have increased importance. This relates to Questions 5 and 6 in the ITC:

> ***Question 5***: *The objective of this ITC and the related 2021 Agenda Consultation process is to ensure that the FASB continues to allocate its finite resources to standard-setting activities that fulfill its primary mission of improving financial accounting and reporting standards and that are of the highest priority to its stakeholders. Therefore, feedback on the prioritization of projects on the FASB's technical agenda (see Appendix A) would be helpful. Do you have any feedback on the FASB's technical agenda, including the following?*

> ***Question 6:*** *Greater disaggregation and granularity of the types of financial reporting information described in Chapter 1 have been identified as decision useful to investors. The following insights would be helpful to the FASB when considering this area.*

First, the currently ongoing project on Financial Performance Reporting—Disaggregation of Performance Information is important, in particular relating to the presentation of subtotals in the income statement. As research indicates, some of these subtotals are potentially much more useful than bottom-line earnings. This could relate to the issue of Other Comprehensive Income, which could be important as it constitutes a vehicle for presenting accruals that are not useful outside the income statement.

Relating to Questions 14 and 15 in the ITC, I make the following reflection.

> ***Question 14***: *Are there common financial KPIs or metrics—either widely applicable to all companies or industry specific—that would provide decision-useful information if they were defined by the FASB? Please explain.*

> ***Question 15***: *If the FASB were to define certain financial KPIs or metrics, should all companies be required to provide those metrics or should providing those metrics be optional?*

Research suggests that EBITDA is especially useful for stock market investors, and it could therefore be helpful to have a standardized definition of this KPI. Meanwhile, it is especially useful for high tech firms. More detailed research could determine for which industries EBITDA is particularly helpful.

Based on the research, there is also a response to Question 7 in the ITC:

> ***Question 7***: *Investors and other financial statement users—What cash flow information, if any, required for your analysis is missing in a statement of cash flows prepared using the indirect method? How would this information influence your decisions and behavior? Please explain.*

The project on Targeted Improvements to the Statement of Cash Flows is important to the extent that investors rely on cash flow information for equity investment decisions. Currently, it is often not possible to use the statement of cash flows to identify two measures deemed important to investors: cash from operations and free cash flows.

Intangible assets
Research suggests intangible assets as an explanation for a gradual decline in the usefulness of earnings. Over the last few decades, the importance of intangible assets has increased in the economy. Kahle and Stulz (2017) show that investments in intangible assets have increased over time in relation to investments in tangible assets, and recently the former surpassed the latter in absolute numbers. Research indicates that this has both led to a decrease in earnings quality (Srivastava, 2014) and a

decline in the number of listed firms (Stulz, 2020). The discussion here relates to Question 18 in the ITC, even if no direct answer is provided.

> ***Question 18**: The FASB has encountered challenges in identifying a project scope that can be sufficiently described for intangible assets. If the Board were to pursue a project on intangible assets, what types of intangible assets should be included within the scope and why? Within that scope, should a project on intangible assets be primarily focused on improvements to recognition and measurement or to disclosure?*

Relating to the Board's project Accounting for and Disclosure of Intantibles, it is important to be aware of some economic characteristics of such assets that cannot be easily remedied through financial reporting. First, compared to tangible assets, some intangible assets are easily replicated as their use by one firm does not preclude the simultaneous use by another firm (Kahle & Stulz, 2017). Second, intangible assets are often complementary, in that their value is highly dependent on their joint use with other resources.

Additional considerations

The referred research focuses on using financial statements for valuation purposes on an equity market. In its standard setting, the Board needs to take a broader perspective, and consider, for example, lenders and the stewardship function of financial statements. Such additional users are not considered in the discussion in this response.

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