

Memo to FASB and IASB: How to Repair Statements

What is wrong with the existing model for reporting financial statements? **Gordon E. Goodman** examines the temporal problems plaguing the incumbent system, urges the major accounting regulators to adopt a new reporting standard and explains the logic behind alternative initiatives like remeasurement.

The current system of financial performance reporting is broken, and it is incumbent upon US and international organizations charged with protecting our financial markets to fix it. Moreover, we must do so quickly.

The problem with the current system arises from a failure of regulatory organizations — such as the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB) in the European Union — to maintain certain logical and temporal distinctions within standard financial performance reports. Currently, these reports do not properly account for the timing and sequence of financial events in the marketplace.

Financial performance reporting is the primary means by

which public corporations, government entities, financial institutions and charitable organizations communicate their financial status to the broad community of investors and creditors. The basic purpose of financial performance reporting should be to provide useful but discrete information about an entity's results in the past, present and future. Unfortunately, these critical temporal elements have long been confused and mismatched through the historical use of a "mixed attribute model," described later in this story.

In order to fix the current financial performance reporting system, it is first necessary to deconstruct this system's organizing elements. The existing broken reporting model is composed of three primary financial performance reports: the income statement (which is a hybrid repository



for both present and future results); the balance sheet (which is a hybrid repository for both past and future results); and the cash flow statement (which is an interstitial report that fits between and reconciles the income statement with the balance sheet).

To repair the temporal imbalances in this model, the FASB and IASB need to adopt a fourth standard financial performance report: a fair value statement. This new statement should provide useful information only about future or “realizable” results.

In earlier *GARP Risk Review*¹ articles, I have discussed the logical distinction between realized and realizable earnings. As an extension of this argument, I now propose that the new fair value statement should become the natural temporal repository for all realizable future earnings; the income statement should become the natural temporal repository for all realized present earnings; and the balance sheet should become the natural temporal repository for all past results.

The new fair value statement should be the report into which entities record changes in the valuation of all items subject to fair value measurement. If the FASB and IASB adopt this recommendation, the new fair value statement would quickly become the financial report closest to the hearts of all risk managers, risk controllers and quantitative risk analysts.

Problems, Problems

The first major problem with the existing system of financial performance reporting is that the income statement (also called the statement of operations) is now a hybrid repository for both (1) accruals and cash earnings, which reflect present results, and (2) changes in the fair value of derivatives not designated as cash flow hedges, which reflect future results. The second major problem with our existing system is that the balance sheet is also a hybrid repository for both (1) assets, liabilities, and shareholders' equity, which reflect past results, and (2) changes in the fair value of derivatives designated as cash flow hedges, which reflect future results.

In addition, changes in the fair value of derivatives designated as cash flow hedges now appear within the balance sheet under the heading “other comprehensive income” (OCI).

Apart from the income statement and balance sheet problems, there is also a “Who’s on first” issue that needs to be resolved as part of a financial performance reporting restructuring. The existing financial hierarchy is comprised of a variety of elements, including concept statements that serve as the primary statements of underlying financial principles; financial accounting standards, which synthesize various concept statements and apply them to many real-life situations; and several forms of interpretation and imple-

mentation guidance.

Financial performance reporting should accurately reflect all of these elements. However, at this time, it is difficult to undertake major revisions to financial reporting, because there are so many proposed changes to the underlying “financial accounting standards.”

Now that we have identified the problems, we need to probe further. For example, what are some additional flaws of the incumbent mixed attribute model for financial performance reporting? Aside from implementing a fair value statement, are there any other approaches — such as recycling or remeasurement — that make sense? And how can the FASB and IASB rebuild investor confidence in financial statements?

The Mixed Attribute Model

The aforementioned mixed attribute model really began to take shape back in 2000. The Statement of Financial Accounting Standards No. 133 (FAS 133), titled “Accounting for Derivative Instruments and Hedging Activities,” was issued in June 1998 and became effective for fiscal years beginning after June 15, 1999. Both before and after implementation of this derivatives standard, it was clear that the inclusion of fair value measurements in the existing financial performance reports would lead to temporal confusion about results.



Gordon Goodman

During December 2000, Jackson M. Day, then deputy chief accountant of the US Securities & Exchange Commission, gave a speech titled “Difficulties with a Mixed Attribute Model.” In this speech, Mr. Day noted that the

“current [financial performance reporting] model is referred to as a mixed attribute model ... because some financial instruments are measured based on historical cost, some at the lower of cost or market, and some at fair value. To add to the mix, for those instruments measured at fair value, sometimes the changes in fair value are recognized in earnings and other times in comprehensive income. In certain instances, financial instruments are not even recognized in the financial statements until settlement date.”

Moreover, despite what he called the “growing pains” associated with expanding use of financial derivatives, Mr. Day concluded that FASB should “continue to move forward with its project on measuring all financial instruments at fair value.”

Due to the increasing complexity of the global marketplace, there will inevitably be further uses of derivative instruments subject to fair value measurement, and FASB’s current effort to adopt a more comprehensive financial standard gov-

erning fair value is an obvious example of this trend.

The mixed attribute model was the result of good faith efforts during the adoption of the derivative standard (FAS 133) to incorporate these new fair value measurements into

Remeasurement: A Flawed Approach

In a well-researched article published in the June 2004 issue of Accounting Horizons magazine, Professor Richard Barker of the University of Cambridge argues in favor of a major modification to financial performance reporting. His article, titled "Reporting Financial Performance," contends that the FASB and IASB should abandon the traditional concept of "earnings" in favor of a new concept dubbed "remeasurement."

Barker defines remeasurement as the measure of income resulting from revisions to the carrying amounts of assets and liabilities. One alleged benefit of this approach — which is favored by many of the more academically oriented members of the FASB and IASB — is that it avoids the current distinction between operating earnings versus other items of comprehensive income.

But this approach to financial performance reporting is flawed. The primary problem with remeasurement is that it ignores the necessary temporal distinctions. Based on my own observations in the marketplace, investors and creditors appear to be more confused over the timing of events and transactions than they are over the meaning of familiar financial terms like "earnings" and "operations."

Professor Barker presents a list of attributes ascribed to the term "earnings," including the concepts of operations, recurrence and control. For each of these attributes, he identifies the shortcomings and/or the potential inconsistencies that could result from differing companies taking conflicting positions; these positions are based on whether an event is "recurring," as well as on each company's definition of operations.

Barker's solution to these problems is to jettison the concept of earnings in favor of his alternative reporting of remeasurement. He also asserts that adoption of the remeasurement approach to financial performance reporting would facilitate improvements in the development of future financial standards.

Though I admire Barker's boldness in proposing to make a wholesale revision in the structure of financial performance reporting, I am concerned that his advice could stimulate a leap into the financial unknown. Adoption of Barker's approach would likely lead to significant disruption of the existing reporting system — especially as it applies to users of financial statements — without providing any significant increase in useful information. Despite these concerns, I offer my compliments to Barker for his interesting approach to these difficult issues.

the existing reporting model — which then, as now, only included the income statement, the balance sheet and the cash flow statement.

But rather than address the need to create a new financial performance report at that time, FASB instructed preparers to record both realized and realizable earnings in a single financial performance report — the income statement. Given the confusion that has resulted from this initial determination, the critical question for today is where best to record and report these fair value measurements in the future.

Recycling: The Elephant in the Room

The temporal confusion caused by combining present and future results into a single income statement — and mixing past and future results in the balance sheet — fueled a need to cycle (or "recycle" in FASB terminology) earnings.

This is due to the ordinary temporal sequence by which transactions start out as future realizable events, become realized events in the present and ultimately reside in the past. This confusion is inherent in the current mixed attribute model, under which certain realizable future events (specifically cash flow hedges that currently reside on the balance sheet) evolve over time into realized present events (on the income statement) and then must be re-entered as past events on the balance sheet.

At the March 31, 2004, meeting of FASB, there was a discussion of this "recycling" issue, which led to a comment by Chairman Robert Herz that recycling was the "elephant in the room" with respect to the FASB's Financial Performance Reporting (FPR) project.

A specific example of the recycling phenomenon is hedge accounting treatment for cash flow hedges under FAS 133. When a transaction qualifies as a cash flow hedge under FAS 133, the change in the fair value of the hedging instruments appears first under OCI on the balance sheet. These changes in fair value do not initially appear as income in the statement of operations. At such time as the hedged items are ultimately realized (i.e., the cash flows are accrued), the cumulative changes in the fair value of the hedging instruments are then recycled from OCI — first through the statement of operations, which in turn leads to a final reentry into the balance sheet.

There are also other items that go through this same form of recycling, including foreign exchange gains and losses (FAS 52 and IAS 21) and unrealized gains and losses on available-for-sale financial instruments (FAS 115 and IAS 39).

For some members of FASB, allowing the deferral of income recognition for these specific items — via the use of the OCI category as a "holding" position on the balance sheet — is contrary to their sense of accounting order. For most consumers of financial reports, however, the use of hedge accounting seems both logical and reasonable — at least until the cre-

ation of the new proposed fair value statement as a natural repository for all future results (including cash flow hedges).

This recycling mechanism is the only current means to match the timing of income recognition for certain hedged items (which cannot be marked at fair value) with the timing of income recognition for their related hedging instruments (which must be marked at fair value as derivatives).

At the April 22, 2004, joint meeting of FASB and IASB, the recycling issue was included in the Segment "B" (or secondary) group of issues within the FPR project. Issues that will be addressed at the beginning of the FPR project have now been identified as Segment "A" (or primary) issues, while other issues that will be addressed later in the FPR project have been labeled Segment "B" issues.

To the extent that FASB considers the "realized versus realizable" distinction to be part of the "recycling" issue (though I do not think it logically falls within this category based on my current understanding), then I would object to its inclusion in the Segment "B" group.² I encourage both FASB and IASB to address both the "realized versus realizable" distinction and the proposal to create a new fair value statement as Segment "A" issues.

Rebuilding Investor Confidence

In order to rebuild investor and creditor confidence in financial statements, it is essential to provide users with additional relevant information — especially with respect to the timing of results. For example, showing the distinction between realized versus realizable earnings in the statement of operations would provide a significant improvement to understanding differences in the quality of earnings reported by differing groups of companies. But it would be even more effective to introduce a fair value statement.

Some companies receive a large percentage of their total income from realized earnings, while other companies receive a large percentage of their total income from realizable earnings. (Ultimately, all realizable earnings should evolve into realized earnings.) The question is whether an investor can easily identify companies that fall in one or the other of these important categories based on the informa-

tion provided by their current financial statements.

Unfortunately, the answer to that question today is "no." It is very difficult even for sophisticated investors to extract this information by carefully comparing and contrasting the statement of operations, the balance sheet and the statement of cash flows. In fact, for many individual investors, and for most practical purposes, it is impossible.

How could FASB and IASB present this distinction between realized and realizable income in a revised statement of operations (the income statement)? The first step would be to show the two primary temporal components of earnings separately: i.e., a new financial performance report, the fair value statement, for fair value earnings (which include changes in the value of derivatives) and a separate financial performance report, the income statement, for actual earnings (which include accruals and cash).

If this simple, pragmatic distinction between realized and realizable earnings had been implemented in the past — through the creation of a new fair value statement separate from the income statement — it might have highlighted the lack of quality in the earnings reported by a company like Enron. Moreover, in the future, this distinction arguably could provide more useable information to investors and creditors than any of the other proposed changes that have been identified in the FPR project.

Lamentably, this relatively simple change does not explicitly appear on either the Segment "A" or the Segment "B" lists of the FASB's proposed changes to financial statements. And it was also not mentioned in the IASB's recent press release.

I urge FASB and IASB to refocus their proposed changes to financial statements on more significant issues like the realized versus realizable distinction — a change that would be immediately useful to many members of the user communities. What's more, the FASB and IASB should also consider introduction of a new fair value statement to serve as the natural temporal repository for all future results. Finally, FASB and IASB should institute these more relevant changes in financial performance reporting before turning to address recycling and remeasurement — academically interesting but troublesome issues. ■

FOOTNOTES:

1) For further discussion of the significant benefits that users of financial statements would derive from clearly showing the distinction between realized versus realizable income, I direct readers to my two earlier articles in *GRR*. Specifically, please see *Differences in the Quality of Earnings* (Nov/Dec 2003 *GRR*) and *Transparency Quest* (May/June 2004). This proposed change (i.e., distinguishing between realized and realizable income) is an example of a relatively small change in the statement of operations that would provide a significant improvement in useful information.

2) For a complete list of Segment A and Segment B issues, please go to http://www.fasb.org/project/fin_reporting.shtml#board_meeting_dates.

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