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November 1, 2016

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116

Re: Proposed Invitation to Comment, *Agenda Consultation*

Dear Mr. Golden,

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2] is pleased to provide you with our perspectives on areas for consideration in connection with the Financial Accounting Standards Board's (FASB's or Board's) agenda consultation invitation to comment (hereafter referred to as the "Proposal" or "ITC").

General Comments

The ITC seeks stakeholder views on whether FASB should undertake standard setting activities on the following topics:

- Intangible assets
- Pensions and other post-retirement benefits
- Distinguishing liabilities and equity
- Financial statement presentation including income statement, cash flow statement, and OCI
- Segment reporting.

We laud the FASB for undertaking a targeted agenda consultation approach by presenting a preliminary view on its agenda priorities. The targeted approach, which also presents alternatives for standards development within each of the identified topics, facilitates stakeholders'

[1] CFA Institute is a global, not-for-profit professional association of more than 137,000 investment analysts, advisers, portfolio managers, and other investment professionals in 157 countries, of more than 131,400 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 73 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

comprehensive consideration and effective prioritization of these topics. We envision standard setting efficiency benefits can be derived from a targeted approach as it is likely going to be easier to transition from a phase of stakeholder feedback on preliminary agenda proposals including on the proposed standard setting alternatives to a phase of detailed specific standards development.

We recognize that different stakeholders including investors are likely to identify additional topics for possible inclusion in the agenda. That being said, rather than considering additional topics, we would encourage FASB to focus its agenda selection from the ITC sample - as these include three of the most important topics for investors. We observe that all the selected topics have broad applicability across different sectors and therefore are worthy candidates for inclusion in the FASB agenda. Completing any or all of these designated topics will be a major undertaking and can certainly result in significant improvements in financial reporting.

Top three priorities – The ITC provides varied reasons for considering each of these five topics including: enhancing the usefulness of financial reporting information; reducing complexity; and lowering incidences of restatements. Notwithstanding the well-articulated merits for focusing on the identified topics contained within the ITC, we recommend that FASB should prioritize three topics:

1. Enhancing the presentation of primary financial statements,
2. Segment reporting, and
3. Intangible assets.

Improving the requirements for these three topics is likely to have the highest marginal impact on the overall usefulness of financial reporting information. These topics are likely to significantly enhance the overall usefulness (i.e. economic relevance and understandability) of financial reporting information.

Specific Comments

In our specific comments, we elaborate on the top three priority topics (enhancing the presentation of primary financial statements, segment reporting, and intangible assets) and at the end have some comments on those that we consider lower priority (pensions and other postemployment benefits; and distinguishing liabilities and equity).

Our Top 3 priorities

Priority #1: Enhancing Presentation of Primary Financial Statements

Importance of Enhancing Presentation of Primary Financial Statements

Improving the presentation of financial statement line items has been a long-standing investor priority for the overall improvement of financial reporting information as it can help investors to better assess the performance, liquidity and financial condition of reporting entities. Over the years, we have consistently reiterated the importance of Financial Statement Presentation ("FSP") through various commentary. Our 2007 publication- Comprehensive Business Reporting Model (CBRM) put forward several proposals for enhancing the presentation of the main financial statements. In subsequent commentary (2009 comment letter on the Financial

Statement Presentation discussion paper, 2011 IASB agenda consultation letter, 2013 "Financial Reporting Disclosures" report, 2014 comment letter on disclosure Initiative: Amendments to IAS 1, 2014 comment letter on IFRS conceptual framework presentation and disclosure, 2015 "Analyzing Bank Performance: Role of Comprehensive Income" report; 2016 IASB agenda consultation letter), we affirmed the importance of this topic. For instance, the 2013 "Financial Reporting Disclosures" report highlighted that 82% of member survey respondents (**Figure 1**) considered improved financial statement presentation to be very important in enhancing the use of financial statements. Similarly, a 2010 member survey (**Figure 2**), with a relative ranking of projects at the time, showed that investors consider the financial statement presentation project to be one of the top two priority projects.

Figure 1: Responses to survey reported in "Financial Reporting Disclosures" report

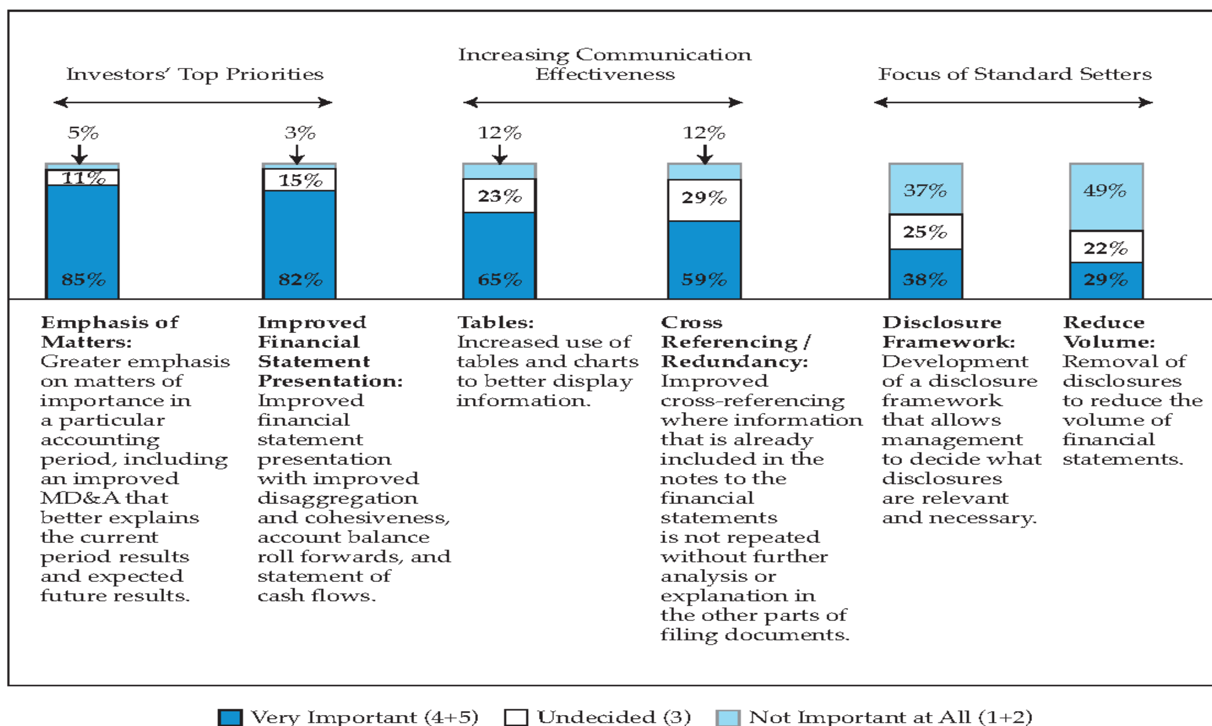
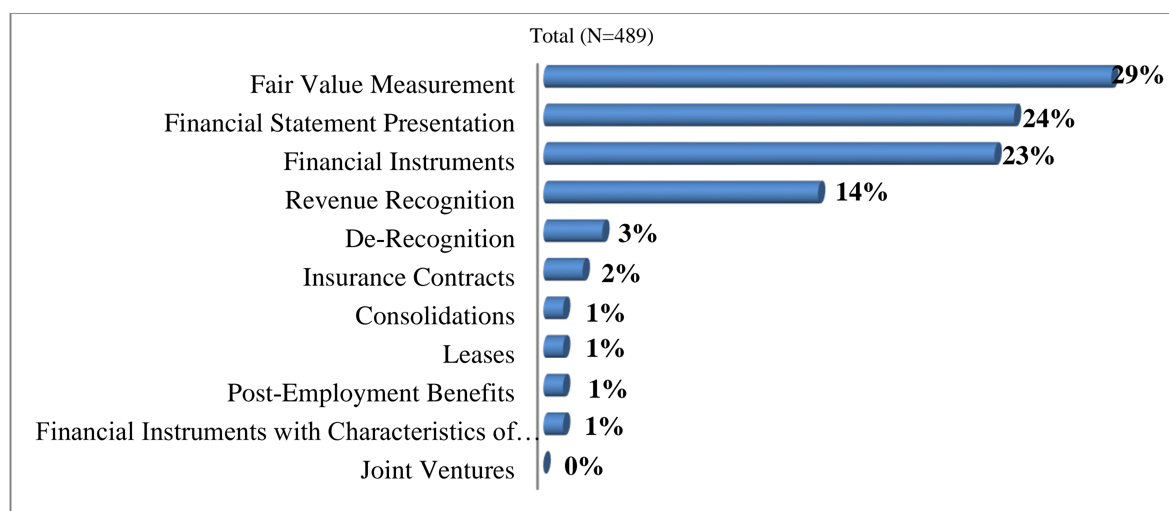


Figure 2: 2010 Memorandum of Understanding Priorities



The ITC observes that, with the exception of net income sub-total, there is a lack of defined summary performance measures within the income statement. Although net income is an integral and widely applied performance measure for capital market participants, the proliferation in issuance of Non-GAAP financial measures (NGFMs) and their widespread application by investors is indicative that beyond net income, there are other important performance measures derived from the income statement (operating profit, EBIT and EBITDA). A forthcoming CFA Institute publication on NGFMs, which includes recently conducted member survey results, highlights that 63% of respondents "always or often" use NGFMs and these alternative measures are, in large part, emblematic of the shortfalls in financial statement presentation requirements.

Furthermore, from a conceptual standpoint, the net income sub-total is not defined. Instead, it represents an ad hoc amalgamation of items with varied economic characteristics (e.g., gains or losses from trading financial instruments, one-off special items, and core earnings from operating activities). Hence, it is beneficial to define useful sub-totals and enhance the income statement structure including considering appropriate disaggregation and aggregation categories. A cogent articulation of principles underlying the sub-totals is likely to provide more robust (continued applicability across business and tax structures and over time) and broadly applicable sub-totals across industries.

We also welcome standard setting activity on the cash flow statement, which has been a long neglected financial statement from a standard setting point of view. Cash flow statement information can be an input for deriving the "free cash flow" metric (a widely applied[3] valuation input) and is also useful for assessing overall earnings quality. A 2009 CFA Institute member survey affirmed the importance of the cash flow statement for financial analysis and the need for greater disaggregation of the cash flow statement. The survey results showed support for disaggregation on the following information components:

[3] Our recent member survey on NGFMs showed that free cash flow and EBITDA are the most widely applied NGFMs. Previous member surveys (2007 and 2009) similarly showed the importance. The 2007 survey showed that 97% of respondents considered the /cash flow statement to be important for financial analysis.

- Cash revenue collections from core business activities (94% considered it either important or very important)
- Working capital changes (91% considered it either important or very important)
- Operating cash flow at segment and business subsidiary (83% considered it either important or very important)
- Expenses paid to suppliers (80% considered it either important or very important)
- Expenses paid to employees (75% considered it either important or very important)

Investor Expectations- Financial Statement Presentation Changes and Use of NGFMs
Our forthcoming report on NGFMs conveys investor expectations to the effect that financial statement presentation changes can reduce the need for NGFMs. The report highlights the following key findings from our recent member survey (See Appendix B for detailed charts):

- *Standard setters should define more income statement sub-totals*: There was an expectation (55.1% of respondents) that standard-setters should provide a definition of key sub-totals (operating profit, Earnings before Interest and Tax (EBIT) and Earnings before Interest Tax Depreciation and Amortization (EBITDA)).
- *An improvement in the structure of the profit and loss account is expected*: There was an expectation (56.8% of respondents) that improvements in the structure of the profit and loss account could reduce the need for NGFMs.
- *Enhanced income statement disaggregation is expected*: There was an expectation (65.3% of respondents) that enhanced disaggregation of income statement can reduce the need for NGFMs.
- *An enhanced disaggregation of cash flow statement is expected:* There was an expectation (66.8% of respondents) that enhanced disaggregation and classification of the cash flow statement can reduce the need for NGFMs

Primary Financial Statements Recommendations
As we understand from the ITC, FASB is considering the following alternatives (see Appendix A) pertaining to the comprehensive income statement and cash flow statement.

- Income statement: Providing definitions of either operating activities and/or non-operating activities; determining suitable aggregation criteria (e.g. re-measurements, infrequent items) as a way of improving the structure and usefulness of the income statement.
- Statement of other comprehensive income (OCI): Criteria of reclassification of OCI line items to income statement (recycling) and minimizing the use of reclassification; determining whether single or dual income statement should be required; and according greater prominence to OCI metrics.
- Cash flow statement: Targeted improvements versus redefining key classification categories.

In our response to the alternatives for standard setting presented within the ITC, we recommend the following:

- *"Single comprehensive income statement" mindset*: Rather than treating income statement and OCI as separate standard setting topics, we recommend that FASB improves the structuring and classification of the income statement with a mindset of potentially developing a single comprehensive income statement. In other words, we would encourage the FASB to consider structuring and classification of income statement

line items in a manner that can be extended to encompass OCI line items. Such an approach could help to answer the question of whether we need a single or two-part comprehensive income statement as well as to create greater transparency on useful economic information[4] reported within OCI.

Even if the FASB were to pursue an approach that necessitates or presupposes the need for a two-part comprehensive income statement (income statement & statement of OCI), a robust definition of the structure and classification of the components of income statement could potentially address some of the unresolved issues associated with OCI. Such an approach could potentially preempt the question of whether to and the criteria for reclassifying items from OCI to the income statement. If FASB retains the continued two-part comprehensive income portions, we would also support the according of greater prominence to other earnings measures within OCI.

- *Definitions, classification and disaggregation of income statement*
  - *Operating profit definitions*: We recommend that FASB defines or at the very least describe operating activities. As noted earlier, our survey of NGFMs showed that investors expect that definitions of operating profit can help to reduce the need for NGFMs.

  - *Subcomponents and aggregation criteria*: We strongly support disaggregation by function and nature (Alternative C- Paragraph 4.23) or at a minimum disaggregation by nature as proposed in the CBRM.

    Due to the application of mixed measurement attributes across different accounting standards, it is desirable to have an aggregation of items that are remeasured with a distinction being made between recurring and non-recurring fair value changes. We also support the aggregation of infrequent items- though we recognize that the latter category is subject to abuse or misclassification risk (i.e. entities are likely to overstate infrequent items). In the CBRM and past comment letters, we proposed that aggregation of cash versus accruals other than remeasurements, including contractual accruals and allocations like depreciation.

    Overall, we feel it is important to identify components or required disaggregation of comprehensive income components – regardless of whether this is done in a single or in two income statements. Enhanced disaggregation ought to reflect economics, geographic or other relevant components (business structure, tax structure, technology).

- *Definition, classification and disaggregation of cash flow statement*
  - *A comprehensive rather than targeted approach:* We recommend a fundamental restructuring approach towards the cash flow statement (paragraph 4.84) rather

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[4] Varied evidence of the usefulness of OCI information and challenges in using this information is discussed in our 2015 "Analyzing Bank Performance: Role of Comprehensive Income" report.

than the targeted approaches proposed in paragraphs 4.81 and 4.82, with a reconsideration and definition of the three or four category structure.

We recommend defining and moving away from treating operating cash flows as a residual category. As noted earlier, our 2009 survey showed investors desire greater disaggregation of operating cash flow beyond that which is reported currently. In the CBRM, we argued in favor of a strict definition of financing category that only includes third-party financing separately. A corollary of a strict definition of operating and financing cash flows could be the need for a new residual category. Hence, we would not be opposed to a fourth residual category.

- *Predefined cash flow statement categories enable comparability*: We also prefer predefined categories rather than entities having the flexibility to determine cash flow categories (Alternative B) as this latter option would undermine comparability of reporting entities. As shown in a past 2007 CFA Institute survey (see Appendix B), there was investor preference (71.6%) for predefined categories and very limited support (3.8%) for companies to have total flexibility to define cash flow activities in a way that they think is appropriate.

- *Appropriate cohesiveness*[5] *across income and cash flow statements*: As the ITC (paragraph 4.11) observes, the three category classification of cash flow statement (operating, investing and financing) is more developed than that of the income statement. Ideally, we would prefer if income statement and cash flow statement classification categories were guided by the principle of cohesiveness as was being considered during the 2008/2009 FSP discussion paper. However, the pursuit of the cohesiveness principle should not constrain the objective of respectively enhancing the disaggregation and classification of the income statement and cash flow statement in the best possible manner. In other words, the same classification approaches should not be applied to these two statements if it means eliminating useful classification categories.

  Hence, we do not support the option of changing the classification categories of cash flow statement to be less than the current three categories simply to be consistent with any income statement classification (as may be implied within Alternative C paragraph 4.86). We, however, would support the idea put forward in Paragraph 4.79 that if FASB establishes an operating activities category in the income statement, that definition or description should be considered when redefining operating activities for the cash flow statement such that the two statements would have the same meaning of operating activities.

- *Other financial statement presentation issues*
  - *Strengthen guidance to ensure consistent classification of all cash flow items*: We support the proposed guidance issued in January 2016 (ASU-Statement of Cash Flows (Topic 230)- *Classification of Certain Cash Receipts and Cash Payments*)

[5] Cohesiveness means similar classification of transactions across different financial statements.

that aimed to reduce diversity in practice including that related to the "interest payment portion" on zero coupon bonds and for cash flows with multiple elements that are classified according to the predominant[6] nature of the transaction. We would recommend an extended outreach to investors to identify any other inconsistent classification items (e.g. cash flow for hedging instruments) that investors observe as they analyze and compare companies cash flows.

- *Consider direct cash flow statement*: We have previously supported the direct cash flow statement as it provides greater and meaningful disaggregation of the cash flow statement. During the FSP discussion paper deliberations, a common reservation aired by preparers against the direct cash flow method was the anticipated prohibitive costs associated with this approach. There were also assertions around the difficulties in aggregating and consolidating cash flow statement from a subsidiary level.

  As several years have elapsed since standard setters sought preliminary views from stakeholders on the FSP project, we recommend that FASB should update its cost-benefit analysis of a direct cash flow method requirement, including assessing if and to what extent advances in reporting technology may have lessened these preparer concerns and therefore increased the feasibility of implementation of the direct cash flow statement. The increasing emphasis on Non-GAAP liquidity measures strongly shows the need for the direct method.

- *Consider the statement of financial position presentation at a later stage*: We are not opposed to the prioritization of the performance and liquidity "flow" statements (i.e. comprehensive income portions and cash flow statement). However, FASB should consider addressing the statement of financial position presentation issues at a later stage including the need for roll-forwards of material balance sheet line items as recommended in the CBRM.

Priority #2: Segment reporting

Importance of Improving Segment Reporting for Investors

Segment disclosures complement[7] the consolidated financial statements as they can shed light on differences in legal, regulatory and tax regimes across business units, as well as the differences in economic fundamentals, such as the growth prospects, rates of profitability and degrees of risk including financing and financial structures.

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[6] Determining the predominant nature is a required management judgement that can result in differing cash flow statement classification choices for similar transactions.

[7] As noted in the AIMR (CFA Institute predecessor organization) 1993 Report - 'Financial Reporting in the 1990's and Beyond' – *'Analysts need to know and understand how the various components of a multifaceted enterprise behave economically. One weak member of the group is analogous to a section of blight on a piece of fruit; it has the potential to spread rot over the entirety. Even in the absence of weakness, different segments will generate dissimilar streams of cash flows to which are attached disparate risks and which bring about unique values. Thus, without dis-aggregation, there is no sensible way to predict the overall amounts, timing, or risks of a complete enterprise's future cash flows. There is little dispute over the usefulness of disaggregated financial data'.*

Over the years, investors[8] have consistently highlighted the challenges faced with analyzing segment reporting information. Notwithstanding, the revised update (SFAS 131R and Topic 280), segment information shortcomings persist. The shortcomings investors have highlighted include the following:

- *Inconsistent application of the standard*: There appears to be a wide array of approaches in how companies are applying the standard. In many cases, it seems that companies are aggregating segments with different economic characteristics. This obscures the ability to analyze and value the company appropriately. In some cases, this may be driven by the desire to hide loss-making segments and in other cases, it may be driven by the desire to hide the strong economics of a particular segment (perhaps to shield it from competition). There are also situations where disclosure is based on geographic segments when product/service based segments would be far more useful (this may be driven by internal management structure but seems odd in many cases). In other cases, there is a combination (some product based and other geography-based).

- *Low level of segment granularity*: When valuing businesses with a number of segments with different economic characteristics, the segment disclosure is typically far more important than the consolidated financials. However, the current standard allows a very thin level of granularity with respect to each segment which is in contrast with the relatively more granular disclosure at a consolidated level in terms of revenue and costs. The high level of granularity at a consolidated level is almost useless when the entity consists of segments with very different economic characteristics. Major revenue and cost items would be useful added disclosures.

- *Inconsistent disclosure*: Companies vary on what they disclose in relation to the earnings of each segment. It would be useful if there were some standard lines that became required disclosure in relation to each segment including the following line items: Gross Profit, EBITDA, EBIT, Assets, Capital, and Equity. This would help comparability and analysis.

- *Inconsistent segment disclosure across time periods*: Some companies repeatedly change their segment definitions which may be driven more by a desire to obscure disclosure than any real shift in the way the business is managed and organized.

- *No cash flow and limited balance sheet visibility*: There is typically no cash flow visibility at a segment level (free cash generation, capital intensity) and limited balance sheet visibility (i.e. working capital intensity, return on capital). This limits the usefulness of segment disclosures and the ability to analyze and value segments on a standalone basis.

[8] Previous CFA Institute member surveys (2007, 2003 and 1999) prior to Topic 280 (SFAS 131R) highlighted the high importance and poor quality of segment disclosure items.

- *Reconciliation to US GAAP*: The requirement that reconciliation only is required on a consolidated basis limits the usefulness of segment information when there are large variances vs GAAP. Perhaps material items of reconciliation should be attributed to each segment (cost vs benefit would need to be weighed in this respect).

- *Management, discussion& analysis (MD&A)*: Management discussion should be segment focused, particularly when the economic characteristics of each segment differ widely. In some cases, MD&A lacks sufficient discussion of segment level performance, strategy and competitive position.

Below are some quotes from buy-side investors highlighting experiences and expectations with segment reporting

> *I would save a lot of time and be a very happy person if all companies were required to disclose segmented financials for separate divisions going back ten years somewhere in the 10-k. High-level summaries are all that is needed (i.e., operating income, capital expenditure, invested capital, all on a divisional basis and tracked over time). A lot of companies seem to do some of this (i.e., segmented income statement), but the problem is I can't then figure out how much capital/capital expenditure is allocated to each division, and tracking over time becomes a cumbersome process.*

> *My biggest pet peeve is companies that avoid providing useful segment disclosures. They might have 2 major lines of business and do 85-90% of their sales in North America. The useful segment disclosures would be by line of business, but what they provide is by geography. Maybe they can argue that it would hurt them competitively to provide disclosure by line of business, but my impression is that the economics by business unit are generally already known to those in the industry (e.g. customers, competitors, some sell-side analysts). So through management meetings, conference calls, etc. I can get a rough idea of economics by business unit, but it seems like it would be cleaner to just disclose it in the financials. The current system seems like it could be lending itself to selective disclosure.*

> *I'd like to see more segment information. Most, if not all, companies break revenue and some other metrics down by segment but very few will break down segments gross/operating margins, depreciation & amortization, and regional.*

Segment Reporting Recommendations
As we understand, the proposed standard setting alternatives are a) to reconsider aspects of Topic 280 disclosure requirements (disaggregation elements, reconciliation to consolidated financial statements); b) reexamination of aggregation criteria (e.g. bright lines); and c) determine segment reporting requirements from a governance perspective.

We recommend that the segment reporting enhancement ought to incorporate all three proposed broad alternatives expressed within the ITC.

- *Support for proposed incremental disclosures*: We support the additional required disclosures (gross margin, working capital and cash flow from operating activities). In addition, we recommend the requirement of equity, capital and total assets information within segment disclosures.

- *CODM and/or governance perspective should not constrain investor information needs*: The disclosure of segments through the "eyes of management" currently occurs through the CODM perspective. However, as investor feedback highlights, the practice of segment reporting through the eyes of CODM has often yielded segment disclosures that are not only inconsistent across reporting periods but also often wanting in their sufficiency and information content quality.

  In response to the alternatives presented within the ITC, we recommend that FASB should require preparers to consider either a hybrid perspective (CODM & governance) or whichever of these two perspectives yields comprehensive information for investors. We posit that if preparers consider information that is reviewed by the CODM and by those charged with governance, rather than picking one or the other perspective; it could help to incentivize management to be as transparent as possible.

  In addition, we recommend that FASB should go even further and stipulate that certain segment metrics, including those that investors have repeatedly expressed as being integral for their valuation, should be provided at a minimum, regardless of whether they are provided to CODM and/or the board.

- *Support for reconciliation to consolidated financial statements*: A reconciliation to consolidated financial statements is most helpful for investors. The ITC has articulated two types of reconciliation
  - Alternative B (paragraph 4.39) – single table reconciliation starting from segment disclosure line item to consolidated total with a note on the financial statement caption next to each reconciliation line (see example ITC- Appendix B).
  - Alternative C (paragraph 4.40) – starting from consolidated financial statement line items to specific segment disclosures. As we understand, in the event that consolidated financial statements are presented by function (e.g. SG&A), this approach can result in limited visibility of the nature of specific line items (e.g. occupancy expense) due to aggregation at the segment disclosure level (see ITC- Appendix C).

  We would prefer Alternative B as it conveys the nature of line items.

- *Support for enhanced disaggregation and subtotals within segment information:* The reconsidered aspects of segment disclosures should also include any balance sheet and cash flow statement line items that investors find useful.

- *Need to ensure consistent segment reporting across periods*: The ITC does not spell out any disclosure principle to ensure consistent and comparable segment reporting across periods.

We recommend that disclosure principles be specified to ensure consistent reporting. Furthermore, any segment disclosures changes should be adopted on a retrospective basis.

Priority #3: Intangible assets

It is currently very challenging for investors to determine if the value of the intangible assets stated on financial reports truly reflects the value of them in reporting entities. As a result, investors have for a long time advocated for improvements in intangible assets accounting (CBRM- Chapter 4- Page 52). There is academic evidence showing that the uncertainty around the value of intangible assets contributes to systematic mispricing of intangible asset intensive companies[9].

Furthermore, different pieces of recently published work[10] have pointed to the increasing irrelevance of financial reporting information that can in large part be attributed to the inadequate accounting of intangible assets. As widely acknowledged, intangible assets are increasingly pervasive and a core asset for modern economy companies. Lev and Gu (2016) highlight that rate of corporate investment in physical capital (tangible assets) fell by 35 percent over the 1977 to 2012 period, whereas the rate of investment in intangibles increased by 60%. Corporate investment in intangible assets outstrips that made towards tangible assets. Yet, the accounting for intangibles is one area where the financial reporting framework lags or fails to meet the needs of the modern economy.

The ITC identifies perceived shortcomings of existing recognition and measurement requirements arising from the inconsistent treatment between acquired and internally generated intangibles- epitomized by the lack of recognition of the latter category of intangibles. Many investors seem to share this concern. For example, our forthcoming CFA Institute publication on Non-GAAP financial measures showed that some investors tend to agree with the backing out of amortization of acquired intangible in the calculation of NGFMs, predicated on the inconsistent accounting treatment of intangible assets. Furthermore, Lev and Gu (2016) illustrate how differential accounting treatment between acquired and internally generated intangible assets can result in a company with exactly the same nature and portfolio of intangible assets, reporting differing ROEs depending on whether it has adopted either an acquisition based or organic growth strategy.

As we understand, a principal reason for not recognizing internally generated intangibles is the measurement unreliability associated with these assets due to their uniqueness and non-tradability. However, Lev and Gu (2016) point out and provide examples illustrating that

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[9] Lev, B., and F. Gu. 2016. *The End of Accounting and the Path Forward for Investors and Managers*. Hoboken, NJ: John Wiley & Sons.

[10] These publications include: a) Lev, B., and F. Gu. 2016. *The End of Accounting and the Path Forward for Investors and Managers*. Hoboken, NJ: John Wiley & Sons. This textbook provides extended empirical evidence showing that the decline in value relevance of key financial statement information components has occurred from 1950 to 2013. The noted decline is observed for earnings and book value of equity. b) Harvard Business Review feature (Sherman,D.H. and Young, D.S, 2016, Where Financial Reporting Falls Short, Harvard Business Review, July- August, 2016 https://hbr.org/2016/07/where-financial-reporting-still-falls-short) c) Federation of European Accountants 2015 discussion paper on the future of corporate reporting http://www.fee.be/images/FEECogitoPaper_-_TheFutureofCorporateReporting.pdf.

measurement unreliability can also apply to acquired intangible assets. The ITC also highlights the mismatch between expenditure on internally generated intangible assets and the benefits derived from these assets (i.e. lack of correlation in amounts and a significant timing mismatch between intangible asset costs and the realized benefits). But this mismatch can exist for tangible assets without precluding balance sheet recognition for such assets.

Other Intangible Accounting Issues

- *Research versus development spend*: It is desirable to distinguish between research versus development expenses.
- *Income statement presentation*: There is need for a greater disaggregation of income statement sales, general and administrative (SG&A) line items to reflect intangible asset related expenses.
- *Questionable amortization approaches for certain types of intangibles*: In our recent NGFM survey, some investors also expressed concerns about double counting of expenses as a result of the amortization of certain types of acquired intangible assets (e.g. customer relationships, brands) while concurrently incurring ongoing SG&A expenses in respect of maintaining these acquired customers. A survey of institutional investors by the Financial Reporting Council (UK) echoed these concerns on the amortization of intangibles with a proposed categorization[11] of intangibles into a) wasting assets; b) "organically replaced" assets and proposing that only wasting assets should be amortized while "organically replaced" assets should be subject to impairment approach.

Recommendations on Intangible Assets

The ITC presents several alternatives for standards development (a holistic review of recognition and measurements; a targeted update of recognition and measurement by focusing on research and development (R&D); improving disclosures; and convergence with IFRS- IAS 38 requirements).

We recommend a combination of three of the standard setting alternatives proposed within the ITC, specifically a holistic but phased/multi-stage approach to recognition and measurement requirements coupled with enhanced disclosures. For example, FASB should consider reviewing the accounting for software[12] as a suitable starting point and then moving onto other intangibles. We do not believe simply converging with IFRS (IAS 38) or focusing exclusively on and stopping with a subset of intangibles (R&D) will satisfy the need for a fundamental overhaul of requirements. As described in the ITC paragraphs 1.18 and 1.47, very few intangible assets have been capitalized under IAS 38, perhaps because of flaws in the capitalization criteria (too high, too subjective, too late in the process).

Our preliminary recommendation is for the consistent recognition of intangibles (purchased and internally generated) with a preference for the application of the fair value measurement approach accompanied by enhanced disclosures. At the very least, both the FASB and SEC should enhance the disclosures of intangibles. As we observed in the CBRM and financial

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[11] Separable intangible assets with finite useful lives and identifiable future revenue streams (e.g. wireless spectrum) are seen as "wasting" intangible assets. Intangible assets that arise from and are renewed through the company conducting its day-to-day business (e.g. customer lists and brands) are described as "organically replaced" assets.

[12] Accounting for software requirements allow the capitalization of software. However, in practice, the threshold for capitalization is quite high and is different for internal use software versus software for sale, lease and marketing - to the extent that capitalization is quite rare.

reporting disclosures report, intangibles disclosures are amongst the most troublesome and inadequate set of disclosures for investors.

Recommended Intangibles Recognition and Measurement Approach
As noted above, our preliminary recommendation is for the consistent recognition of all intangibles (purchased and internally generated) with a preference for the application of fair value measurement approach. Fair value measurement is the approach that comes closest to depicting the most economically relevant and up to date value of held intangibles across reporting periods.

We are aware of the following challenges associated with the fair value measurement approach for intangibles: a) the lack of observable market data; b) inconsistent and sometimes inadequate valuation approaches; and c) non-separability (value of intangibles is often driven by a combination of assets presenting a challenge of unbundling and ascribing value to individual assets). That said, improving intangibles valuation practices has been a focus of valuation practitioners, American Institute of Certified Public Accountants[13] (AICPA), American Society of Appraisers (ASA), and the International Valuation Standards Council (IVSC) in a manner that ought to assuage fair value measurement related concerns. Furthermore, robust disclosures can help to convey any measurement uncertainty and underlying information risk associated with the reported value of intangible assets.

One of the questions that the ITC poses is that if fair value measurement is applied towards intangible assets, where should the gains or losses be presented (income statement or OCI)? This question largely reflects potential concerns of an incremental volatility of earnings arising from a fair value measurement approach. However, we observe that concerns about the “geography” of remeasurements is a cross-cutting issue that continually arises for almost every recognition and measurement topic and this ought to simply reinforce the importance of enhancing the presentation primary financial statements. In other words, the completion of the primary financial statements project is vital to improving other key areas of financial reporting and that is why we see it as #1 priority.

As noted above, our articulated support for fair value measurement of intangible assets is a preliminary view- premised on our general support for this particular measurement basis as articulated in the CBRM. Should the FASB include intangible assets on its agenda, we will undertake a more extensive outreach to elicit updated views from our broader membership on the appropriate measurement for different types of intangible assets.

Finally, if FASB were to adopt a cost recognition approach for all intangibles or maintain the current approach of only capitalizing acquired intangibles and either amortizing or impairing these in subsequent measurement, we would recommend a review of suitable amortization versus impairment approaches for different classes of intangibles. As noted earlier, many investors question the appropriateness of amortizing certain types of intangible assets (e.g. acquired customer lists).

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[13] AICPA intends to launch the Certified in Entity and Intangibles Valuation (CEIV) credential targeted at financial professionals who perform fair value measurements for public company financial reporting purposes.

Recommended Intangibles Disclosures
In the CBRM we recommended disclosures of the following:

- Estimates of the fair value of identifiable intangibles that are not recognized in the financial statements. In addition, nonfinancial indicators, such as market size and share and customer retention data, are useful disclosures.
- The principles used for recognition and measurement of intangible assets recorded in the financial statements.
- Information about intangibles that are embedded in other tangible or financial assets, such as core deposit intangibles.
- The nature of any goodwill recognized and the key variables that would be assessed in impairment tests of the goodwill.

Other disclosures that investors (see 2014 FRC report) have emphasized as important include the following items:

- Gross spend or capitalized amounts, by the categories of intangible assets;
- Method of valuation e.g. hierarchy of valuation and cash flow assumptions used;
- Subsequent amortization and impairment for each category of intangible assets;
- Commercial reasons behind the company's acquisitions or development of intangible assets, in particular for asset-light companies.

Given the decision within the FASB disclosure framework to curtail forward-looking information, we recommend that FASB and SEC take a holistic view and work jointly towards enhancing disclosures of the intangibles related information that is desired by investors. The most useful information is likely to be forward-looking in nature. Examples of useful disclosures that will be appropriate in the MD&A section include:

- Product development pipeline information;
- Intellectual property (IP) expiry exposure- revenue from products coming off patent in the next x years.

As the ITC notes, reporting entities may have proprietary concerns in respect of forward-looking information. However, as Lev and Gu (2016) point out and illustrate with the case study of Pfizer's multi-year disclosure of its product pipeline, concerns about proprietary costs (i.e. adverse competitive effects from divulging information) tend to be overstated.

Lesser Priority Topics

Pensions and post-employment benefits

The ITC recognizes two main issues related to pensions and other retirement post-employment benefits, namely: a) delayed recognition of gains/losses (smoothing); and b) the measurement of the defined benefit obligation.

Recommendations for Pensions and Post-Employment Benefits
Recognition and Measurement: We concur with the view that the smoothing of actuarial gains or losses and prior service costs can distort the depiction of the reflected periodic economic cost of pensions. Hence, we would support eliminating smoothing requirements. One of the options presented in the ITC is for US GAAP to converge with IFRS related requirements (IAS 19 R)-

where actuarial gains or losses are presented in OCI with no reclassification to the income statement and past/prior service costs are immediately recognized through the profit and loss statement. We would support such an approach or any other that reduces the complexity associated with smoothing of these two components of pension costs (actuarial gains or losses and prior service costs).

Disclosures: Similar to other topics (income taxes, inventory), we recommend that FASB should consider reviewing any shortfalls within existing pensions disclosures under its review of the disclosure framework.

Distinguishing Liabilities and Equity

We understand that a key concern motivating the project on distinguishing the characteristics of liabilities and equity is the high incidences of restatements associated with this accounting matter. The ITC has also highlighted difficulties experienced in respect of accounting for the following:

- Redeemable equity instruments (mandatorily redeemable shares);
- Equity linked or indexed instruments (options and forwards);
- Convertible instruments (debt and preferred shares).

We are, however, less persuaded by the priority of this project, in part, because of the long-running consideration going as far back as 1990 and failure to resolve or develop a robust conceptual model. In the evaluation of existing literature and prospective classification models there are various factors or indicators that are applied or proposed to differentiate liability from equity including:

- Present versus future ownership claims;
- Entitlement to residual claims on assets at liquidation of the reporting entity;
- Relative subordination of claims (e.g. who are bearers of residual claims);
- Form of settlement of obligations (e.g. cash, asset transfer settlement versus equity instrument settlement);
- Variability in the value of obligations that are settled through equity instruments;
- The timing of obligations (e.g. obligations that only arise at liquidation are considered to be different from other obligations).

Clearly, there have been multiple models proposed by accounting standard setters but none of these models has been deemed satisfactory or sufficiently robust for adoption purposes in replacement of current practice. In tandem, ongoing financial innovation is likely to make it even more challenging to develop a robust model that will pre-empt potentially difficult judgments for certain financial instruments. It seems inevitable that gray areas in practical classification across the broad spectrum of financial instruments will arise due to these multiple ways of considering equity versus debt.

Recommendations for Distinguishing Liabilities from Equity

Starting Point: Prioritize Needs of Equity Investors

The starting point for any framework[14] for the development of a decision-useful classification system for liabilities and equity should address several key questions, including:

- Who are the primary users of the classification system?
- What important attributes distinguish liabilities and equities for these users?
- Can one classification system, combined with additional disclosure, satisfy users requiring different types of information?

The authors of the above framework assert the following:

> *Any liability-equity classification system is unlikely to encompass the attributes of central importance to all subgroups, trade-offs are inevitable, and some subgroups' demands for information may not be met by the classification ultimately designed. Identifying subgroups unmet demands may assist in designing disclosures to help satisfy those information needs.*

As expressed in CFA Institute's CBRM, we hold the view that equity shareholders should be seen as the primary users of financial statements and their analytical needs should be prioritized when designing financial reporting requirements. From this perspective, we have historically supported a strict definition of equity- also previously described as the basic ownership approach.

Preferred Approach

As noted, developing a robust conceptual framework that can ensure an appropriate or non-contentious boundary for all financial instruments seems to have defied attainment via sustained standard setters' efforts. Therefore, in line with our recent commentary[15], we advocate for a strict definition of equity and liability accompanied by enhanced disclosures for financial instruments where it has proven challenging to categorize them as either equity or liabilities.

As far as the ITC alternatives are concerned, the targeted approach for simple instruments Alternative A- Paragraphs 3.20 to 3.23 is aligned to our preference for a strict definition of equity. That being said, it remains hard for users of financial statements to opine on the proposed approaches towards complex instruments (i.e. targeted or holistic) with any sense of anticipating whether these approaches will preempt the interpretation challenges that are currently in place- especially given the backdrop of ongoing financial innovation.

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[14] Botosan, C.A., Koonce, L.,Ryan, S.G., Stone, M.S., and Wahlen, J.M (2005), *Accounting for Liabilities: Conceptual Issues, Standard Setting, and Evidence from Academic Research*, Accounting Horizons, Vol.19, No.3, pp 159-186.- These academic authors

[15] 2014 CFA comment letter on IFRS conceptual framework- Financial Instruments with Characteristics of Equity; 2016 IASB agenda consultation letter

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Thank you again for the opportunity to comment on the ITC. If you or your staff have questions or seek further elaboration of our views, please contact Vincent Papa, Ph.D., CPA, CFA by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/ Vincent Papa

Vincent Papa, Ph.D. CPA, CFA
Interim Head, Financial Reporting Policy
Standards & Advocacy Division
CFA Institute

/s/ Tony Sondhi

Tony Sondhi, Ph.D
Chair
Corporate Disclosure Policy Council

cc: Sandra Peters, CPA, CFA; Head Financial Reporting Policy
cc: Hans Hoogervorst, IASB, Chairman

CFA Institute

APPENDIX A (FASB standard setting alternatives)

COMPREHENSIVE INCOME STATEMENT PORTIONS ENHANCEMENT ALTERNATIVES

Income Statement Proposed Enhancement # 1: Categorize the income statement into operating and non-operating activities

- Alternative A: FASB would describe, not define, operating activities; and would allow for management to determine its composition through accounting policy
- Alternative B: FASB would define operating activities with a standardized definition that would be supported with detailed descriptions and examples.
- Alternative C: FASB would define non-operating activities, and the operating activities would be the residual earnings category

Income Statement Proposed Enhancement # 2: Combining or separating earnings components and presenting discrete lines

- Alternative A: FASB would reexamine current guidance in Topic 225, Income Statement, on infrequently occurring transactions or events.
- Alternative B: Identify and define a type of earnings component that is termed as a re-measurement. Alternative B may include a separate presentation of items identified in Alternative A
- Alternative C: Functional lines would be disaggregated into natural components. This approach potentially involves aspects of distinguishing both infrequently occurring items and remeasurements.

FASB OCI Enhancement Considerations

OCI Enhancement Proposal #1 Minimize the use of reclassification adjustments

OCI Enhancement Proposal #2 Remove the option for presenting comprehensive income over two statements

OCI Enhancement Proposal #3 Emphasize other earnings per share measures

STATEMENT OF CASH FLOWS ALTERNATIVES

Cash Flow Statement Enhancement Proposal #1: Targeted improvements to provide greater disaggregation of specific cash flows

- An example of greater disaggregation would be disaggregation of cash payments for capital expenditure into maintenance and expansionary expenditures

Cash Flow Statement Enhancement Proposal # 2: Provide additional classification guidance for certain types of cash flows

Cash Flow Statement Enhancement Proposal # 3: Reconsider the definitions of each classification category and the three-category structure

- Alternative A: A standardized cash flow with defined categories including the three-category structure (operating, investing and financing). FASB is considering introducing a fourth residual category and not viewing operating cash flows as a residual category. FASB would provide application guidance clarifying the order of precedence (e.g. cash flows from operating activities would be classified first, after which the remaining cash flows would be classified within investing, financing, or residual activities).
- Alternative B: Classification and presentation of cash would be representative of how an entity internally evaluates its cash flows.
- Alternative C: FASB would structure the cash flow statement to be structured to focus foremost on a line-by-line interrelationship with the income statement to display the cash effects of the various income statement lines. This approach would separate cash payments and cash receipts on the basis of linkage to the respective income statement caption.

SEGMENT REPORTING ALTERNATIVES

Segment Reporting Enhancement Alternative #1 Reconsider aspects of the Topic 280 Disclosure Requirements

- Alternative A: Certain pieces of individual segment information that have unique significance to users would be added to the required segment disclosures and would only be reported by segment if those items and amounts are reviewed regularly by CODM (e.g. gross margin, operating cash flows, and working capital). Conforming changes could be made as any income statement changes (e.g. if functional lines are disaggregated into natural components, then segment disclosures could be amended to require disaggregation of segment functional amounts
- Alternative B: Alternative A disclosures would be reported in a single, structured table- whereby segment totals would be reconciled to consolidated totals and require a narrative description of the line captions on the financial statements where those consolidated amounts are located. Individual segments would be disclosed in the table only if that information is regularly reviewed by the CODM.
- Alternative C: Replace Topic 280 disclosures with a disclosure principle mandating SR along the lines of presented in the consolidated financial statements but limited to items regularly reviewed by the CODM.

Segment Reporting Enhancement Alternative #2 Reexamine aggregation criteria

- Aggregation criteria would be reexamined to introduce greater standardization and additional aggregation tests could be introduced into the criteria.
- Quantitative thresholds could be introduced to clarify when individual segments can be aggregated.

Segment Reporting Enhancement Alternative # 3 Apply the segment reporting standard from a governance perspective

- Rather than being provided from the CODM perspective, segment information could be identified at the level of the governing body, such as the board of directors or trustees and the package of information that is reviewed regularly by that governance group.

INTANGIBLE ASSETS ALTERNATIVES

Enhancement Alternative 1: Cost or fair value recognition of all intangible assets

Enhancement Alternative 2: Cost or fair value recognition of research and development

Enhancement Alternative 3: Disclosures

Enhancement Alternative 4: Convergence with IAS 38

PENSIONS AND OTHER POSTRETIREMENT BENEFIT PLANS

Enhancement Alternative 1: Converge with IAS 19, Employee Benefits

Enhancement Alternative 2: Eliminate all smoothing and recognize the measured changes immediately in the income statement

Item	GAAP	IFRS
Actuarial Gains and Losses	Recognized immediately in earnings or recognized in other comprehensive income and subsequently amortized to earnings	Recognized in other comprehensive income and not amortized to earnings
Return on plan assets	The expected return on plan assets is determined by multiplying the market-related value of plan assets by the expected long-term rate of return on plan assets	Interest income on plan assets is determined by multiplying the fair value of the plan assets by the same discount rate used to calculate the interest cost on the defined benefit obligation
Prior service cost	Recognized in other comprehensive income and subsequently amortized to earnings	Immediately recognized in earnings
Curtailment or Settlement Gain/Loss	Affected by the unamortized net gains and losses, transition assets or obligations, and prior service cost or credit in the other comprehensive income	Not affected by gains and losses in other comprehensive income

DISTINGUISHING LIABILITIES FROM EQUITY

Enhancement Alternative 1 Targeted Improvements

- Targeted improvements- Simple instruments
  - Alternative A: Equity classification–no obligations to transfer assets or shares (indexation and settlement are irrelevant)–Similar to previously described “basic ownership” approach
  - Alternative B: Distinguishes between obligations to transfer assets versus shares (indexation and settlement matter)–similar to previously described “ownership settlement” approach
- Targeted improvements–Complex instrument
  - Alternative A: Bifurcate all conversion options from the host contract
  - Alternative B: Bifurcate conversion options from host contract if the instrument is “compound”

Enhancement Alternative 1 Holistic Examination

APPENDIX B (Selection of Member Survey Results)

Figures 3 to 7 present 2016 NGFM survey and 2007 survey.

2016 NGFM Survey

Figure 3. Need for Definition of Sub-Totals

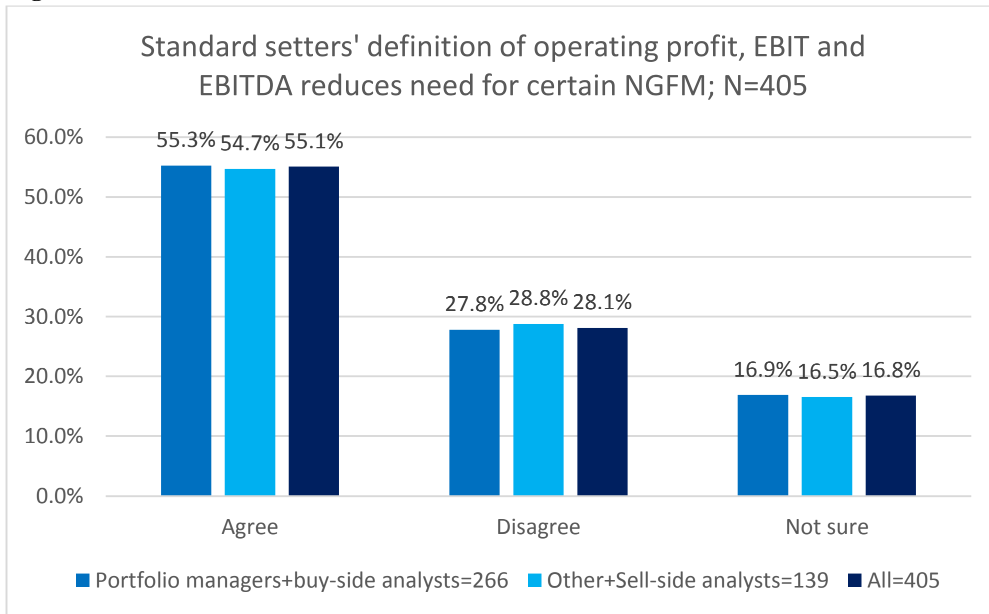


Figure 4: Improve the Structure of Profit and Loss

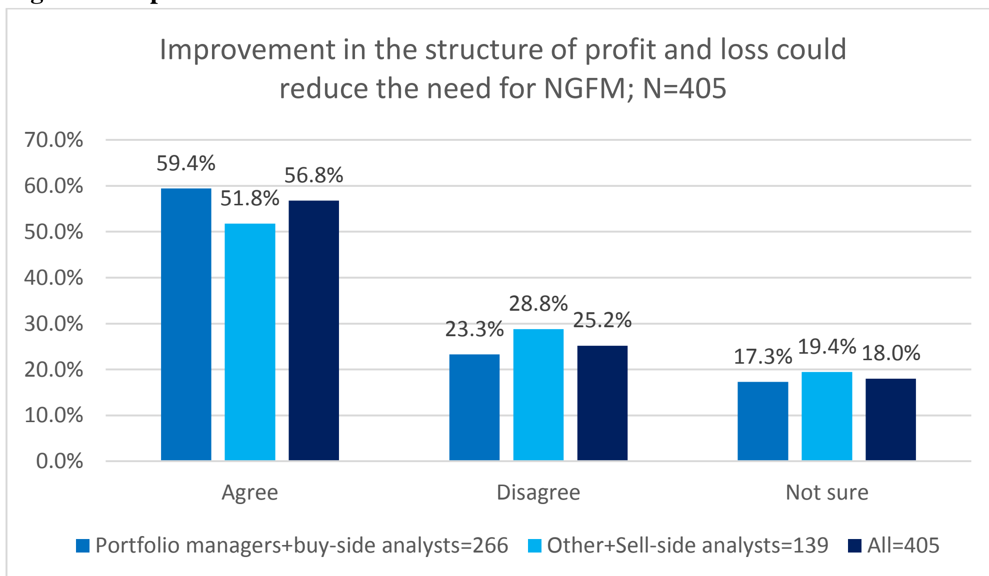


Figure 5: Enhance Disaggregation of Income Statements

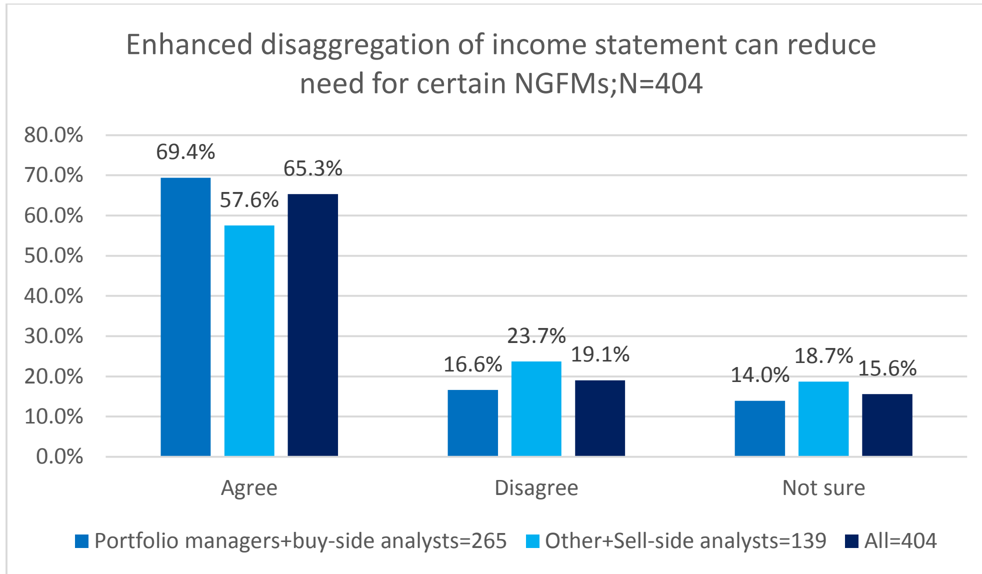
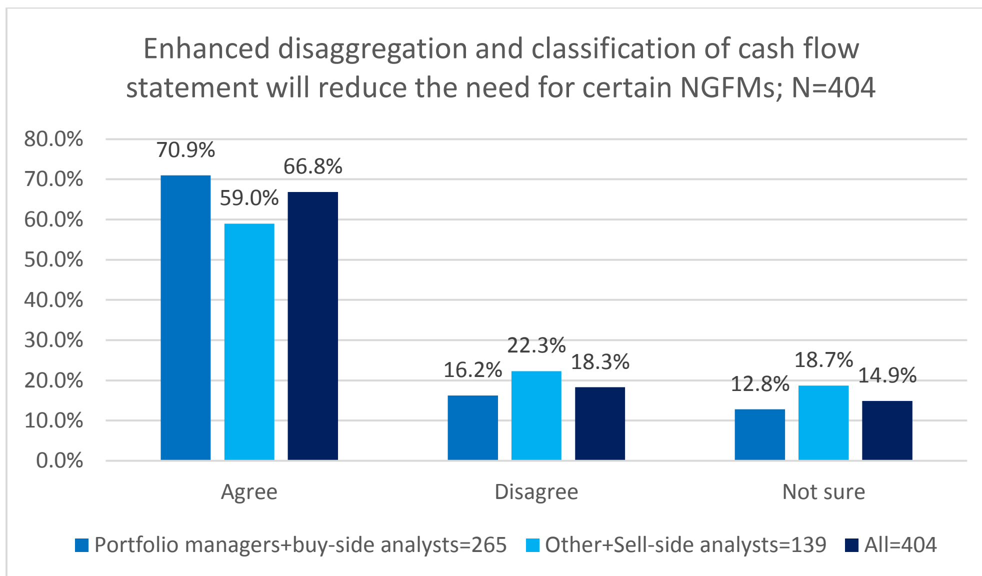


Figure 6: Enhance Disaggregation and Classification of Cash Flow Statement



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2007 Cash flow Presentation Survey

In the 2007 survey, we sought respondent views on the appropriate presentation of cash flow activities.

Figure 7

Under IFRS and US GAAP, companies are required to disaggregate and present separately cash flow information by the following activities: operating, investing and financing. In these current standards, investing and financing activities are defined and operating activities are all other activities not defined as investing or financing. Survey question was how should cash flow activities be defined?	**Number of responses**	**Percentage response**
Cash flow activities should be predefined similar to current standards	272	71.6%
Cash flow activities should have some broad definitions; companies should have some flexibility to define cash flow activities in a way that they think is appropriate	91	23.9%
Cash flow activities should not be predefined; companies should have the flexibility to define cash flow activities in a way that they think is appropriate	8	2.1%
Total	380	100%

Excluded 2.4% (9 respondents) had no opinion.