

Getting a Better Framework

PROFIT OR LOSS VERSUS OCI

Bulletin



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This Bulletin represents a contribution to the developing debate about what items should be reported in profit or loss and what items should be reported in other comprehensive income. The approach developed in this paper represents EFRAG's current reasoning. By preparing this Bulletin, EFRAG intends to stimulate the debate on the aspects of the approach. This Bulletin does accordingly not present any position of EFRAG at this stage.

Copies of the Bulletin are available from EFRAG's website. A limited number of copies of the Bulletin will also be made available in printed form, and can be obtained from EFRAG.

The paper invites comment on its proposals via the 'Questions for Respondents' at the end of the Bulletin. Such comments should be sent by email to:

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so as to arrive no later than 26 October 2015. All comments received will be placed on the public record unless confidentiality is requested.

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Background and objective of the paper

- 1 Following the 2011 Agenda Consultation, the IASB decided to review its Conceptual Framework, strongly encouraged in this decision by European stakeholders and others. In accordance with European expectations, the main objective for the revision of the Conceptual Framework is to bring clarity to the underlying accounting model on which IFRS are developed and hence avoiding fundamental discussions at standards level. As a result one of the main expectations is that the Conceptual Framework includes guidelines on how to present financial performance, including the role of other comprehensive income (OCI) and recycling (see the IASB's feedback statement in response to the 2011 Agenda Consultation).
- 2 The Exposure Draft *Conceptual Framework for Financial Reporting* ('the ED'):
 - a) Describes profit or loss as the primary source of information about an entity's financial performance in the period.
 - b) Presumes that all income and all expenses will be included in the statement of profit or loss. This presumption is a consequence of the idea that profit or loss is the primary indicator of an entity's financial performance in the period.
 - c) States that the presumption can only be rebutted if excluding an item of income or expense from profit or loss would enhance the relevance of profit or loss for the period and the income or expense arises from a change in a current value.
 - d) States that only the IASB can make the decision to report an item of income or expense in OCI (consistent with existing Standards).
 - e) Presumes that income and expenses reported in OCI will be recycled. This presumption can only be rebutted if there is no clear basis for identifying the period in which the income or expense should be recycled.
- 3 The ED does not provide guidance on what is meant by 'enhance the relevance of profit or loss' in c) above. Past and current discussions in the IFRS standard-setting process demonstrate the diversity of views as to what makes financial reporting relevant and in particular how financial performance should be reported. EFRAG therefore believes that the Conceptual Framework would be incomplete if it does not include more guidance on this issue.
- 4 EFRAG therefore considers that the final Conceptual Framework should include more guidance on when it would enhance the relevance of profit or loss to include changes in net assets in OCI instead of in profit or loss and on the principles relating to the timing of recycling. This paper is an attempt to contribute to helping the IASB fill the void that is found in the ED on this issue.

Approach in the paper

- 5 This paper builds on the following papers:
 - a) *The role of the business model in financial reporting*. This Bulletin was issued in 2013 by EFRAG, the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the *Organismo Italiano di Contabilità* (OIC) and the UK Financial Reporting Council (FRC).
 - b) Role of “*Nature of an Entity’s Business Activities*” in Accounting Standard-Setting. This Bulletin was prepared by Accounting Standards Board of Japan (ASBJ) and presented at the March 2015 ASAF meeting.
 - c) *The reporting of income and expense and the choice of measurement bases*. This Bulletin was prepared by Roger Marshall and Andrew Lennard and presented at the June 2014 ASAF meeting as a contribution of the UK standard setter (the FRC).
- 6 Selected points of these papers are summarised below.

THE ROLE OF THE BUSINESS MODEL IN FINANCIAL REPORTING

- 7 The Bulletin *The role of the business model in financial reporting* discusses whether the business model could, or even should, play a role in financial reporting.
- 8 The Bulletin acknowledges that “there is no universally defined meaning of the term ‘business model’”. It further notes that “It could be difficult to arrive at a universally acceptable definition of the term that could be consistently applied by those who prepare financial information and adequately understood by those that use financial information. For example, there is no agreement as to whether there are two business models such as a trading and a holding model, or if there are more business models that reflect how each entity tries to differentiate itself from its competitors.”
- 9 For the purpose of the Bulletin, “the meaning of the term ‘business model’ focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates.”
- 10 This description reflects that financial reporting “is meant to provide the basis for assessing the financial position and performance of an entity. It assesses and understands how the entity is ‘making money’, how it provides capital providers with appropriate returns on the resources invested in the entity, and how it is exposed to risks and organised to mitigate those risks.”

- 11 The Bulletin presents the tentative view that “there is a distinction between business model and management intent. Both notions provide relevant information, but business models tend to focus on the larger picture, are, generally, more stable, and usually require much less documentation to make them verifiable.”
- 12 The Bulletin also presents the tentative conclusion that “financial reporting should portray the business model in order to faithfully represent the economic reality of the reporting entity, since it focuses on the actual past and current transactions and events. Therefore, once the business model is identified and observed, the accounting treatment related to a business model should be derived from the business model.”
- 13 Based on the comments received in response to the Bulletin, EFRAG believes that the business model, as described, should be reflected in financial statements.

ROLE OF ‘NATURE OF AN ENTITY’S BUSINESS ACTIVITIES’ IN ACCOUNTING STANDARD-SETTING

- 14 The ASBJ suggests that the first thing to consider when deciding on a measurement basis, is what information would be most useful from the perspective of the statement of profit or loss. EFRAG agrees that the first thing to consider when deciding on a measurement basis, is what information would be most useful from the perspective of the statement of profit or loss because this approach emphasises the objective of providing relevant information about an entity’s financial performance. EFRAG believes that information about an entity’s financial performance is an essential part of providing information that is useful for estimating future cash flows and their uncertainty, which is the information users need from financial statements.
- 15 The measurement that is most useful from the perspective of the statement of profit or loss could be expected to be also the most useful from the perspective of the entity’s financial position. However, this should not be taken for granted, and questioning whether it is can lead to making the set of financial statements more relevant. Therefore EFRAG supports the ASBJ proposal that the measurement basis selected as the most useful for measuring income and expenses for the statement of profit or loss, is tested to assess whether it is also the most useful for the statement of financial position. If a different measurement basis is chosen for the statement of financial position, the difference should be reported in OCI¹.

¹ It is also acknowledged in the ED that OCI should be used for differences resulting from using different measurement bases in the statement of the financial position and the statement of profit or loss.

- 16 The ASBJ further suggests, in tune with EFRAG and main NSS in Europe, that the entity's business activities should play a significant role when determining what measurement basis is most relevant from the perspective of reporting financial performance in the statement of profit or loss. EFRAG agrees with this although EFRAG is referring to the entity's 'business model' instead of 'business activities', as has been done in IFRS 9 *Financial Instruments*.



THE REPORTING OF INCOME AND EXPENSE AND THE CHOICE OF MEASUREMENT BASES

- 17 The paper by Marshall and Lennard also considers that the business model should have an impact on measurement. The paper suggests that, for the purpose of the Conceptual Framework, business models should be classified into two categories:
- a) 'Value-added' businesses, in which an entity obtains inputs from suppliers and employees and, usually after some kind of process, uses those inputs to provide goods and services to customers from which revenue is obtained (for example, those used by retailers, manufacturers, service providers and commercial banks).
 - b) 'Price change' businesses, in which an entity acquires assets (and sometimes liabilities) in order to benefit from gains resulting from changing their value (for example, those used by commodity dealers, investment funds and some other financial activities).
- 18 The paper explains that a cost-based measurement basis generally² should be applied to assets and liabilities within value-added businesses, whereas current market prices should generally be used for entities in price change businesses so as to assess their financial performance.
- 19 The paper also explains that when a value-added business holds assets that are not inputs to its business model (e.g. trade receivables), these assets should not be stated at an entry value, but rather at an amount that reflects the amount, timing and uncertainty of the associated cash flows.
- 20 The starting point of the paper seems to be that assets and liabilities should be measured identically for the purpose of the statement of financial position and for the statement of profit or loss. However, the paper acknowledges that in some cases presenting the income or expense resulting from remeasurement of an asset or liability impairs the ability of the statement of profit or loss to fulfil its purpose.

² The paper does not entirely agree with the ASBJ's rationale for historical cost, and does not propose that historical cost is used in all circumstances.



AGREEMENT ABOUT WHAT SHOULD NOT BE REPORTED IN OCI

- 21 The ED states that only remeasurements of assets and liabilities can be reported in OCI. It is consistent with the papers of the ASBJ and Marshall and Lennard to limit OCI to the reporting of remeasurements of assets and liabilities. Similarly, EFRAG tentatively believes that there would generally not be circumstances where remeasurement of assets and liabilities would provide the most useful information for the statement of profit or loss, but where the most relevant information for the statement of financial position would be presented when assets and liabilities are measured at cost in the statement for financial position. Accordingly, all changes in an entity's economic position as they arise from measuring assets and liabilities at cost, or by reference to a modified cost model (i.e. the lower of cost and another value), are to be reflected in profit or loss.

- 22 As noted in *The role of the business model in financial reporting*, “there is no universally defined meaning” of the term ‘business model’. Many may, however, consider it to be an entity’s core activities or its revenue-generating operations. Similar assets and liabilities may be managed in different ways following different business decisions. This results in different streams and timing of cash flows from these assets and liabilities. To provide useful information, financial performance reporting should represent as faithfully as possible those differences, to help users in their assessments of the timing and the amount of future cash flows. The Conceptual Framework could contribute to this by grouping the different business decisions and explain how they could be reflected when selecting the measurement bases for assets, liabilities and related income and expenses. The Marshall and Lennard paper contributed to this. Generally, the subsequent discussion on the paper indicated that the proposal was considered ‘too binary’ as it only included two categories of business models. EFRAG nevertheless believes that the proposal identified the two main categories of business models. The objectives of earning profit from value-added activities and from price changes can be identified in many business models. However, business objectives may change over time as opportunities materialise or certain events and circumstances occur. For example, in the short run, an entity may try to earn rental income from its investment properties, but over the longer run, it may try to benefit from price changes.
- 23 Building on this, EFRAG has identified the following groups of business models³:
- a) **The price change business models.** This includes different business models, all based on different types of capital appreciation. It includes trading activities in which assets (and sometimes liabilities) are bought and sold on the same market in order to benefit from gains resulting from short-term changes in value. Commodity dealers, investment entities and traders often use this business model. It also includes ‘capital appreciation’ activities such as those performed by investment entities. Investments are also bought and sold on the same market, and held for the period deemed necessary to optimise total return. Dealings with derivatives would also fall into this category unless the derivative is used for hedging. For price change businesses, gains in value in the period provide the most relevant measurement of financial performance and should therefore be reported in profit or loss. The same measurement basis is relevant also for the entity’s financial position.
 - b) **The transformation business models** (‘value-added’ businesses as described by Marshall and Lennard), in which an entity obtains and uses economic resources from suppliers and/or employees and, usually after some kind of process, produces goods and services to customers from which revenue is obtained. Inputs may be transformed, combined, or simply transferred from one market to another market. This group of business models includes amongst others the business models of retailers, manufacturing companies, service providers and retail banks. Financial performance reporting of those activities includes the measurement of some margin between revenue generated from sales to customers and the cost of production of the goods or services. Therefore measurement

³ Although EFRAG for the purpose of this paper has identified four categories of business models, the discussion resulting from this paper could result in more categories being identified.

at cost of inputs used to provide the outputs is the relevant measurement basis from a financial performance reporting perspective. Sales to customers are critical events to the cash generating activities and require consumption of other resources. Markets in which the outputs are sold are often not liquid, and more often than not significant uncertainty exists about demand, the effects of competition and innovation. For this reason income following from a transformation business model should not be reported in profit or loss before a performance obligation is satisfied. The question could arise whether outputs, such as finished goods, should be measured on a current value basis in the statement of financial position. It would be a standard level decision to assess whether this would provide the most useful information. The assessment would be based on the uncertainty mentioned above and the selling effort needed.

- c) **Long-term investment business models.** This group includes business models where assets are purchased in order to generate a stream of revenue from period to period. Nevertheless the ultimate cash inflow from the asset is often through sale in the market in which assets were originally bought and generally in a similar ‘condition’ as when it was bought. An entity can hold several investment assets and sell some of these from time to time. The asset may be maintained or not during the periods in which it generates streams of revenue. Cash flow generation is made of regular streams of revenue (e.g. in the form of dividends, or income from letting others use the asset) and of the sale of assets. Those sales are critical events as disinvestment decisions are significant from a stewardship perspective. In those businesses the choice of investments/disinvestments is a reflection of the investment strategy. The business models used by, for example, ‘long-term investors’ such as banks and entities that hold and manage investment properties would generally belong to this group of business models. In many cases there is no ‘added-value’ in these businesses to the assets themselves, the expertise is in the development and the implementation of an investment strategy, including the maintenance of the assets in good operating conditions. Changes in value of the assets from period to period are not relevant to periodic financial performance reporting, as the capital appreciation is secondary to the business model, the central feature is the stream of income derived from the assets. Measurement at cost (less impairment losses) would therefore be relevant from a profit or loss perspective. From the entity’s financial position perspective, however, the asset’s current value provides relevant information as the ultimate cash inflow is through sale, provided that the asset is in the condition in which it would be sold and there are sufficient observable market prices for similar transactions to determine the current value reliably. When these conditions are met, the changes in the value of the investment assets would be reported in OCI. OCI would thus reflect the change in the entity’s exposure to market price risk. Accumulated OCI would represent capital appreciation gains accumulated since the acquisition of the investment asset. This amount would be reported separately in profit or loss when the investment asset is sold (‘recycling’)⁴.

⁴ In OCI the recycling represents a decrease in an entity’s outstanding gains.

d) **The liability driven business models.** In this business model entities accept long-term obligations and may invest in assets to meet these. The business models of insurance companies are typical examples of models included in this group. In order to meet their liabilities when due, these businesses may invest in assets in a business model very similar to the long-term investment business model described above. In those cases the approach described above under c) apply. However where business decisions are based on active asset-liability management, meaningful financial performance reporting requires that measurement decisions on the liability side and asset side are made on a consistent basis, so as to best reflect in profit or loss the economic offsets or mismatches. This is consistent with the request in the ASBJ's paper that "where a liability is managed in combination with an asset or a group of assets, the said measurement basis should be updated at a period-end so that the effect of price changes is recognised in profit or loss, when a liability corresponds to funding of the asset or the group of assets that is held as part of an entity's business activity in which it aims to gain net proceeds from the price changes". A standard-setting process that sets the measurement of assets and deals with liability measurement independently might fail to adequately provide relevant information that reflects the nature of the entity's business model.

In some circumstances entities may have to manage long-term liabilities for their own benefit. This happens, for example, when they grant defined pension benefits as part of their employees' compensation packages; or when entities (such as entities in the mining or energy sector) incur decommissioning liabilities. In such circumstances entities are implementing a liability driven business model and all of the above would apply to them.

How income and expenses are reported in profit or loss or OCI based on the business model

- 24 An entity can have different ways of ‘making money’ and hence more than one business model. As noted above, EFRAG considers that focusing on the entity’s business model (or models) should result in reflecting the entity’s operations and the extent to which they are profitable, and hence provide information that is useful in predicting future cash flows and assessing stewardship. To promote this objective, EFRAG suggests that activities related to the value creation process – i.e. how the entity is creating cash flows – should be reported in profit or loss. EFRAG further believes that the financial performance of an entity is best reflected by considering inflows and outflows of resources⁵.
- 25 While profit or loss should provide information about the entity’s financial performance following its business model, OCI should include other financial reporting constructs on which information would also be useful. This includes:
- a) The effects of using different measurement bases in the statement of financial position and the statement of profit or loss. Sometimes additional useful information results from measuring items at a current value in the statement of financial position while recognising them in the statement of profit or loss on a historical cost basis. This could be the case for long-term business models where the proposed model would result in profit or loss not reflecting gains in the value of items held until the items have been sold. It may be useful to measure such items at a current value in the statement of financial position to reflect information about the cash flow generating capacity under current market conditions.
 - b) Incomplete transactions where recognising part in profit or loss would distort the reporting of financial performance. The most obvious example is cash flow hedges.
- 26 In some cases, the cumulative net amount that has been recognised in OCI and relates to a particular asset or liability will automatically reverse to zero over time. In other cases a net amount recognised in OCI would be recycled to profit or loss. This would, for example, be the case when an asset is sold which was held under a long-term investment business model. In this case the difference, if any, between the measurement for the purpose of the statement of profit or loss and the statement of financial position is recycled from OCI to profit or loss when the asset is sold. This recycling informs users of the financial statements that a transaction has occurred which is material from the perspective of the chosen business model and useful from a stewardship perspective. The information is useful for assessing management’s ability to generate profit from the ultimate cash inflow from the asset. In the statement of profit or loss, amounts that have been recycled should clearly appear as such. The change in other comprehensive income provides information about the decrease in outstanding gains and losses.

⁵ EFRAG is focusing on the inflows and outflows of resources rather than cash flows in order to avoid interpreting the business model too narrowly as being limited to cash transactions and to recognise the impact of non-cash transactions.

When expenses are not specific to a business model

- 27 Regardless of the business model, an entity will typically incur expenses such as tax expenses, various salaries and some changes in provisions such as for litigations. Although these expenses are not related to a specific business model they are incurred as a result of the entity's operation(s) or mere existence. If these expenses are not reported in profit or loss, this statement would generally provide too positive a reflection of the cash flows an entity is generating. A faithful representation of the entity's financial performance would accordingly normally require these expenses being reported in profit or loss.
- 28 Typically, the liabilities to which the expenses relate, will be settled by the transfer of cash. To be useful for assessing future cash flows and an entity's financial position, these liabilities are normally measured at an amount that would reflect the amount an entity would be expected to pay in order to settle the related liability. Such a measurement would usually also provide the most useful information in the statement of profit or loss for assessing the entity's future cash flows. Similarly to what is done when considering the business model, the pattern of cash outflow should be considered when deciding where to present changes in liabilities.
- 29 According to the proposed model, changes in estimates of an item should be reported similarly to the underlying item.

- 30 In this section EFRAG analyses what if anything would change in current IFRS, were the proposals above for reporting in profit or loss or OCI to be applied.

REVENUE RECOGNITION

- 31 IFRS 15 *Revenue from Contracts with Customers* would apply to transactions under the transformation business model. IFRS 15 refines when a critical event (when a performance obligation is satisfied) has occurred in these cases and is compatible with the model proposed in this paper.

INVENTORIES, PPE, INTANGIBLE ASSETS, ASSETS HELD FOR SALE AND INVESTMENT PROPERTIES

- 32 The following five Standards are most relevant to transformation business models:
- a) IAS 2 *Inventories*;
 - b) IAS 16 *Property, Plant and Equipment*;
 - c) IAS 38 *Intangible Assets*;
 - d) IAS 40 *Investment properties*; and
 - e) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.
- 33 These Standards are relevant because they either deal with assets that are direct inputs to the transformation process (inventories) or that contribute to the transformation process (PPE and intangible assets). They are also relevant to some 'price change' and 'long-term investment' business models to the extent described below.
- 34 Some of the Standards give room for different business models, explicitly or implicitly. This is generally done by providing accounting policy options rather than providing requirements varying depending on the business model. It is worth noting here that EFRAG's proposal would not leave room for any free option. Different accounting requirements would prevail, facts and circumstances being the basis for the exercise of judgement of the business model to which the assets contribute.



Inventories

- 35 IAS 2 and IAS 40 are examples of Standards that allow or require different accounting treatments depending on the business model of the entity, i.e. giving consideration to the way the assets are contributing to the entity's generation of cash. The activity of commodity broker-traders will usually fall into the 'price change business model' described above. This means that changes in the current value of items of inventory held by a commodity broker-trader should be reported in profit or loss. This would not be inconsistent with the current option in IAS 2. In accordance with EFRAG's proposal this option would be replaced by a requirement.

Investment property

- 36 Under the model developed in this paper, investment property would be measured at fair value through OCI or profit or loss depending on the business model.
- 37 Recognising changes in the fair value of investment property through profit or loss could be required in accordance with the proposal in this paper only if the investment property would be held as a speculative asset and selling the investment property could not be considered a 'critical event'. In most cases, however, this would not be the case. In many cases, an entity will not only hold an investment property with the sole objective of capital appreciation but primarily with the objective of receiving rental income or own use, this includes investment properties held as part of a liability driven business model. Accounting requirements would therefore be in accordance with the 'long-term investment business model' described above.
- 38 IAS 40 requires that when an investment property carried at fair value is transferred to owner-occupied property or inventories, the property's deemed cost for subsequent accounting in accordance with IAS 16 or IAS 2 shall be its fair value at the date of change in use. Under the proposed model, an investment property would generally be measured based on historical cost for the purpose of the statement of profit or loss. Therefore it would not be in accordance with the proposed model to report in profit or loss any uplift in the value of the property when it is transferred to inventory or owner-occupied property. Similarly any expenses reported in profit or loss after the property has been transferred to owner-occupied or inventory should be based on the property's historical cost.

- 39 IAS 40 states that if an owner-occupied property becomes an investment property that will be carried at fair value, an entity shall apply IAS 16 up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with IAS 16 and its fair value in the same way as a revaluation in accordance with IAS 16.
- 40 For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss in accordance with IAS 40. As mentioned above, it would only be compatible with the proposals included in this paper to recognise a gain in profit or loss if the business model of the property is trading and it is not a 'critical event' to sell the property.
- 41 When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall, according to IAS 40, be recognised in profit or loss. Again, it would only be compatible with the proposals included in this paper to recognise a gain in profit or loss if the business model of the property is trading and it is not a 'critical event' to sell the property.

PPE and intangible assets

- 42 All entities will typically hold some PPE and intangible assets. These can be inputs to transformation business models, but can also be held to support another business model. When PPE and intangible assets are held to support a business model that would not fall into the category of transformation business models, they can, however, be considered as being part of a transformation business model. The reason is that the assets in these cases are used as 'inputs' to generate the returns following from these other business models.
- 43 The current IAS 16 and IAS 38 cost model is accordingly in accordance with EFRAG's proposal, as items of PPE and intangible assets. The proposal would result in the depreciations – and any impairments – being recognised in profit or loss based on the historical cost price of an asset. In any event, it would not be in accordance with the proposal to report depreciation of an asset in the statement of profit or loss based on the current value of the asset, as is currently required when the revaluation model is selected.
- 44 The question arises whether cost that provides a relevant measurement basis for reporting profit or loss should also be selected for the entity's financial position.
- 45 According to EFRAG's proposal, historical cost would also be the relevant measurement basis for the statement of financial position when the asset is expected to be entirely consumed by the entity in its transformation process, i.e. when the residual value is estimated to be nil or immaterial. In some circumstances, however, assets are not consumed or they have, in accordance with the business model of the entity, significant residual values so that sales after internal use are a distinct feature of the business model and generate regular streams of

cash flows. An example of this is car fleets held for rental. In such circumstances providing current values on the statement of financial position could be considered as relevant, as is the case in the long-term investment business model. Current values would be required for assets that are not consumed over time, provided that their sale is consistent with the entity's business model and that there are observable prices on the market. When such assets are meant to be used for only a part of their useful life and be sold thereafter, it could be relevant to present current residual values on the statement of financial position. This would require reporting residual values⁶ separately from the component of the asset that is meant to be used in the transformation process of the entity. Depreciation would then, differently from what IAS 16 requires, not vary over time when residual values vary. Changes in residual values would be reported in OCI until the sale occurs. Accumulated changes would be recognised in profit or loss at the time of a sale (differently from the current revaluation model in IAS 16), no net effect on profit or loss being expected at the time of derecognition other than the change in the period. Such a possibility should be assessed to see whether it meets a satisfactory trade-off and does not introduce unnecessary complexity, in particular in the interaction with impairment.

Impairment of assets

- 46 IAS 36 *Impairment of Assets* requires an impairment loss, or a reversal of an impairment loss, to be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in IAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.
- 47 Impairment requirements typically apply to assets that are carried at cost. Therefore no proposal in this paper would trigger any change to IAS 36.

Agriculture

- 48 IAS 41 *Agriculture* considers both revenue recognition and inventories related to agricultural activities. Its requirements are quite different from those of other Standards dealing with transformation activities. In the consultation related to the IASB Exposure Draft on bearer plants, many of the IASB's constituents noted that the Standard would be in need of a complete overhaul. The generic description of transformation business models above could result in some biological assets and agricultural produce being measured at cost while others are measured at current value in the statement of financial position. In some cases it could even be that the selling efforts would be negligible and observable prices would be available. In those cases changes in current value might be recognised in profit or loss. This subject goes beyond the scope of this paper.

⁶ It is outside the scope of this paper to discuss the details of the valuation that would have to be defined at standard level (e.g. what current value should be used and whether costs to sell should be subtracted).

Leases

- 49 IAS 17 *Leases* focuses, from the perspective of the lessee, on the identification of financing arrangements for the purchase of assets. Assets that arise from lease arrangements are dealt with in accordance with accounting requirements for PPE or investment property. From the lessor's perspective, a sale of an asset (for part of its life) has occurred and there is no requirement in IAS 17 that would be influenced by the proposals included in this paper. We anticipate that the same analysis would apply if the forthcoming leases Standard had been issued.

FINANCIAL INSTRUMENTS

Financial assets

- 50 The requirements included in IFRS 9 *Financial Instruments* for basic lending instruments are consistent with the proposals in this paper. Requirements related to all other financial assets (debt and equity instruments) are not, because the business model does not play a role when accounting for these in accordance with IFRS 9.
- 51 EFRAG considers that fair value is the relevant measurement basis in the statement of financial position for:
- a) Financial assets that do not meet the contractual cash flow characteristics test;
 - b) Investments in debt instruments (financial assets) that meet the contractual cash flows characteristics test but are held within the business models where selling the assets is the main objective or an integral part of achieving the business model objective; and
 - c) Hedged items designated in fair value hedges (if the hedged item is designated in respect of risk components, only the revaluation resulting from those risk component).
- 52 In accordance with the proposals in this paper, however, accounting requirements would be different for financial performance reporting. When the financial assets are held for trading, changes in their value should be reported in profit or loss, as for all other 'price change' business models. When they are 'held to collect', or 'to collect and sell', they should be accounted for in accordance with the proposal for 'long-term business models', i.e. they would be measured at cost for the purpose of the statement of profit or loss and impairment losses should be recognised in profit or loss. All other fair value changes would be recorded in OCI until derecognition. At that time, accumulated changes would be recognised in profit or loss.
- 53 IFRS 9 requires that an entity reclassifies a financial asset when its business model for that asset changes. At the date of reclassification of a financial asset from amortised cost to fair value, the asset should be re-measured at fair value and this value will be the new carrying

amount. Any difference between the previous carrying amount and the fair value would be recognised in a separate line item in the income statement. On this, IFRS 9 is compatible with the proposals of this paper insofar as changes in fair value for the particular asset should be recognised in profit or loss under the proposal.

- 54 Impairment requirements typically apply to assets that are carried at cost. Therefore no proposal in this paper would trigger any change to the impairment model.

Financial liabilities

- 55 The model proposed in this paper would require an entity to consider the business model of a liability when considering whether changes in the fair value should be recognised in profit or loss (price change business model) or OCI (transformation or long-term investment business models). In some cases this would not be compatible with the requirements in IFRS 9.
- 56 EFRAG considers that fair value is the relevant measurement basis in the statement of financial position for:
- a) Financial liabilities held for trading; and
 - b) Financial liabilities where it would eliminate or significantly reduce an accounting mismatch.

Hedge accounting

- 57 Including hedge accounting and setting for it the objective of best depicting an entity's risk strategies is in principle quite consistent with EFRAG's proposals. EFRAG's proposals could have knock-on effects on the IFRS 9 general hedge accounting model. In principle, the proposals included in this paper would require the financial statements to reflect economic hedging as reflected in an entity's risk management business model. Some form of hedge accounting would be needed to reflect any mismatches between the measurement of the hedged item and the hedging instrument. However, for the purpose of this paper it does not seem useful to discuss hedge accounting further.

INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

- 58 The characterisation of associates and joint ventures in current IFRS focuses on the level of influence the investor exercises on the investee and does not consider the business context in which they are held.
- 59 The proposals in this paper would require the identification of the economic role played by the holdings in the investee and determination of the accounting requirements accordingly.
- 60 EFRAG would expect most joint ventures and many associates to be held with the view of contributing indirectly to the core activities of the entity. The accounting could therefore follow the business model of the core activities to which they contribute. In any event the investment

should be regarded as the unit of account, when considering how to apply one or the other business model.

- 61 Some associates as they are defined today may be held for capital appreciation only. When that is the case they should be accounted for in accordance with the 'price change' business model. This is, for example, the case in investment entities.
- 62 It is outside the scope of this paper to discuss how the equity method would fit with the proposals included in this paper.


INSURANCE CONTRACTS AND EMPLOYEE BENEFITS

Insurance contracts

- 63 As the insurance contracts Standard is currently under development, this paper will not comment in great detail on whether the proposals would be compatible with the requirements in the forthcoming Standard. It should be noted, however, that EFRAG's proposals relevant to this discussion in its various comment letters to the IASB in this regard are consistent with the approach in this paper.

Employee benefits

- 64 The proposal included in this paper would generally result in liabilities being measured for the purpose of the statement of profit or loss at the amount the entity would expect to pay, following its business model (if relevant), in order to settle the liability.
- 65 IAS 19 *Employee Benefits* requires short-term employee benefits and expenses related to defined contribution plans to be recognised in profit or loss unless another IFRS requires or permits the inclusion of the benefits in the cost of an asset. This is compatible with the proposals included in this paper.
- 66 For defined benefit plans, the proposals included in this paper would generally result in the following components of defined benefit costs being recognised in profit or loss:
- a) Service costs;
 - b) Net interest on the net defined benefit liability (asset); and

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- c) All changes in the estimate of expected cash outflows included in the measurement of the liability, other than changes in market inputs.
- 67 IAS 19 requires item c) to be recognised in OCI, together with all other changes in estimates that concur to the measurement of the net benefit liability (asset).
- 68 In accordance with paragraph 23 d), investments in assets should follow the accounting for long-term business models and the measurement of the assets and liabilities should be considered at the same time so as not to trigger inconsistencies that would obscure the measurement of the entity's financial performance as reported in profit or loss.
- 69 The proposals in this paper, however, do not provide any specific guidance on whether the discount rate (part of the remeasurements of the net defined benefit liability (asset)) should be updated, and if so, whether the effect of changes should be included in OCI or in profit or loss. This will be a standards level decision. A decision about whether the change in the interest rate should be included in profit or loss or OCI would also be relevant for other long-term employee benefits.



THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

- 70 The impact of changes in foreign exchange rates resulting from holding foreign currency assets or liabilities or foreign currency transactions should be reported similarly to the value changes in the underlying item. The model proposed would accordingly generally result in foreign currency changes being recognised in profit or loss. An exception would, however, exist for currency changes that relate to value changes not reported in profit or loss of assets and liabilities measured at a current value. These currency changes should be reported in OCI.
- 71 It would be compatible with the proposals of this paper to recognise exchange differences resulting from translation to a presentation currency in OCI. Unlike the impact of the changes in foreign exchange rates, the translation to a presentation currency would not have a direct impact on cash flows. The proposals of this paper would accordingly be similar to the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.



PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

- 72 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* does not provide any guidance on where to recognise resulting income and expenses. This would mean that they should be recognised in profit or loss following IAS 1 unless another Standard requires recognition in OCI. As the amounts represent estimated cash outflows (and changes in those estimates), recognising the expenses from these liabilities and the effect of changes in these liabilities in profit or loss would generally be the effect of the proposals in this paper (see paragraphs 27 - 29 above). Remeasurements would under the proposed model be regarded in a similar way to impairment losses and reversals of such losses. These should accordingly be reported in profit or loss which is similar to the requirements of IAS 37.
- 73 Whether the discount rate should be updated, and if so, whether the effect of changes should be reported in profit or loss would deserve further debate, and is accordingly out of the scope of this paper.



INCOME TAXES

- 74 IAS 12 *Income Taxes* requires that current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. This would be consistent with the proposal included in this paper as the tax effects of those items reported in profit or loss should also appear in profit or loss.
- 75 In very limited cases, the proposals in this paper could be incompatible with other requirements included in IAS 12. IAS 12 notes that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities. Although the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities would generally reflect the business model, there could in theory be differences between expectations and the business model. These would most often arise when an entity's business model is changing such as when an entity decides to start developing the results of research for its own use rather than selling the intellectual property that it has developed in conformity with its business model to date. Another example where part of a tax expense could be recognised in OCI would follow from the rebuttable presumption included in IAS 12 that the carrying amount of an investment property will be recovered through sale.

Questions to constituents

EFRAG invites comments on all matters in this Bulletin, particularly in relation to the questions set out below. Comments are more helpful if they:

- a) Address the question as stated;
- b) Indicate the specific paragraph reference, to which the comments relate; and/or
- c) Describe any alternative approaches EFRAG should consider.

All comments should be received by 26 October 2015.

Question 1 – Different measurement bases

The Bulletin suggests that the first thing to consider when deciding on a measurement basis is what information would be most useful from the perspective of the statement of profit or loss. The measurement that is most useful from the perspective of the statement of profit or loss could be expected to be also the most useful from the perspective of the entity's financial position. However, this should not be taken for granted, and questioning whether it is can lead to making the set of financial statements more relevant. Therefore the measurement basis selected as the most useful for measuring income and expenses for the statement of profit or loss is tested to assess whether it is also the most useful for the statement of financial position. If a different measurement basis is chosen for the statement of financial position, the difference should be reported in OCI.

Do you agree that different measurement bases may be needed to provide relevant information in both the statement of financial position and in the statement of profit or loss? Do you agree that the first step in the process should be to identify the most relevant measurement basis for the statement of profit or loss? Do you agree that the choice of both measurement bases be driven by the business model?

Question 2 – Considering the business model

The Bulletin identifies four groups of business models:

- a) The price change business models;
- b) The transformation business models;
- c) The long-term investment business models; and
- d) The liability driven business models.

The Bulletin suggests that measurement of assets, liabilities, income and expenses should be based on these business models.

Do you agree with the descriptions of the various business models? Do you agree with the suggestions in the paper in how they would be portrayed in the profit or loss and financial position of entities? Are there other business models that it would be necessary to identify for financial reporting perspectives? If so what are they? What measurement bases would they require and why?

Question 3 – OCI items

The Bulletin proposes to include in OCI:

- a) Differences resulting from applying different measurement bases in the statement of profit or loss and the statement of financial performance; and
- b) Incomplete transactions (e.g. cash flow hedges) where recognising part in profit or loss would distort the reporting of financial performance.

What are your views on the proposal to include differences resulting from applying different measurement bases and incomplete transactions in OCI?

Question 4 – Recycling

The Bulletin proposes that for long-term business models changes in value of the assets from period to period are not relevant to periodic financial performance reporting, as the capital appreciation is secondary to the business model where the central feature is the stream of income derived from the assets. Measurement at cost (less impairment losses) would therefore be relevant from a profit or loss perspective. From the entity's financial position perspective, however, the asset's current value provides relevant information as the ultimate cash inflow is through sale, provided that the asset is in the condition in which it would be sold and there are sufficient observable market prices or market inputs for similar transactions to determine the current value reliably. When these conditions are met, the changes in the value of the investment assets would be reported in OCI. OCI would thus reflect the change in the entity's exposure to market price risk. Accumulated OCI would represent capital appreciation gains accumulated since the acquisition of the investment asset. This amount would be reported separately in profit or loss when the investment asset is sold ('recycling').

What are your views on the proposal to recycle amounts included in OCI as a result of applying different measurement bases under long-term investment business models?

Question 5 – Current value measurements in the statement of financial position

This Bulletin suggests that different measurement bases could be chosen for the statement of financial position and the statement of profit or loss. The difference should be reported in OCI.

For the purpose of the statement of the financial position (not the statement of profit or loss), would you be in favour of greater use of current value measurements than required today? What are the reasons for your views?

Question 6 – Changes in interest rates

This Bulletin does not provide any specific guidance on whether the discount rate used when measuring assets and liabilities such as a net defined benefit liability (asset) or a provision should be updated, and if so, whether the effect of changes should be included in OCI or in profit or loss.

Do you think the discount rate should be updated, and if so, should the effect of the changes be included in OCI or in profit or loss? What are the reasons for your views?



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