

Defining Profit or Loss and OCI... can it be done?

Speech by Hans Hoogervorst, Tokyo, February 5th, 2014

As always, it is a great pleasure to come to Japan, especially now that your country is going through a new phase of economic dynamism. A pleasant by-product of Abenomics is that it improves the purchasing power of foreigners visiting Japan. I promise that I will use the lower exchange rate of the yen to stimulate the local economy during my stay!

This time, my pleasure of being in Japan is mixed with a bit of sadness, as I will be saying goodbye to my good friend Ikuo Nishikawa as Chairman of the ASBJ. Over the past three years I have come to respect Ikuo very much for his deep knowledge of accounting and his great contributions to international standard-setting. What's more; Ikuo is a very personable man and I really enjoyed the time I was able to spend socially with him. Ikuo will continue to make contributions to accounting standard-setting in an academic role, so I hope I will continue to see him in the future. Ikuo, I want to thank you for your professionalism and friendship and I wish you all the best for the future.

Of course I also look forward to cooperating with Ikuo's expected successor, Ono-san, who I am sure will continue to play a strong leadership role for Japan. When it comes to international accounting standards, Japan has always been at the forefront. At every level, Japan has been fully involved in the development and evolution of the IASB and IFRS. Japanese representatives serve in all levels of our governance structure. Japan is among our top financial contributors and is also a big intellectual contributor to our work. The ASBJ fulfils a leadership role in our recently formed Accounting Standards

Advisory Forum, or ASAF. All these reasons made Tokyo into a natural choice as the location for our Asia Oceania office.

This deep involvement in our work has also resulted in some of the biggest Japanese companies, such as Mitsubishi, Mitsui & Co. and Sumitomo Corporation voluntarily adopting IFRS. Many more are expected to follow suit in the near future.

Japanese companies have good practical reasons for embracing IFRS. One of those reasons is that in the past decades Japanese companies have greatly expanded their investments abroad. The number of their foreign subsidiaries has multiplied. Adopting IFRS provides a way to reduce the cost of consolidating different international subsidiaries by using a single reporting language.

Until recently, we did not have very precise information about the use of IFRS around the world. Very little formal research had been conducted on the matter. As a result, there were a lot of rumours that a lot of jurisdictions had not adopted IFRS in full, or were making their own adaptations. So, in 2013 we asked former IASB member Paul Pacter to lead a major research programme to fill in the gaps in our knowledge.

His research project is now nearly complete and the results make fascinating reading. Of the 122 countries researched so far, nearly all have made a public commitment to IFRS as global standards. More than 100 of the 122 countries surveyed have already adopted IFRS for most or all domestic listed companies. Very few jurisdictions have made modifications to the standards, and where they did, they were regarded as temporary. This means that Japanese companies are likely to run into IFRS wherever they go!

Many of the remaining 21 countries permit IFRS for at least some of those listed companies. For example, foreign companies listed in the United States have been able to report using IFRS since 2007. The 450 companies that do so have a total market capitalisation exceeding five trillion dollars. The relationship between the IASB and FASB remains a very important one. Just recently, the US Financial Accounting Foundation gave a clear sign of continued commitment to the joint work of the IASB and the FASB in finalising the remaining convergence projects by making a \$3 Million dollar financial contribution to our work. This important contribution is highly appreciated on our part.

Work programme

In London, we are keenly aware that quite a few Japanese companies are waiting for us to finish some major standards before they will make their final move to adopt IFRS. So you can rest assured we have very strong incentives to get the job done!

Three standards in the making are of great importance to many if not most companies: revenue recognition, leases and financial instruments. The road has been long and sometimes arduous, but the end is now truly in sight. I will take a few moments to update you on our progress.

First, we expect to publish our new revenue recognition standard in the next few months. I call this project the 'jewel in the convergence crown' as the final standard will be almost identical between IFRS and US GAAP.

The second standard I would like to make some comments about is the leases standard. The leases standard is controversial for several reasons. It is intellectually complex; many companies would like to keep their leases off-

balance sheet or they are concerned about implementation costs. Some of these problems we can fix, others will be more challenging.

First of all I would like to point out that the overwhelming majority of users have told us they agree with our analysis that leases contain a heavy element of financing. They do not like the present situation, in which they have to make their own estimates of the hidden leverage underlying lease contracts. They simply want to see leases on the balance sheet and want the rigor and comparability that only an accounting standard can offer.

That said, we have also heard the concerns from preparers regarding the cost of implementing the changes. We take these concerns very seriously. As we take our final decision in the next couple of months you can rest assured that we will do our utmost to keep these costs at a minimum.

We have already made some decisions designed to reduce implementation costs, such as the exclusion of short-term leases and most variable lease payments. We will seek further improvements by trying to exclude as much as possible what I call “small ticket” items. One possibility is whether to permit our requirements to be applied to a portfolio of leases – for example if an entity leases 100 photocopiers – then those leases could be accounted for as one item.

We may also look to further simplify the distinction between what we call ‘type A’ and ‘type B’-leases. We will probably also limit the changes to lessor accounting, as many do not consider lessor accounting to be especially broken. These are all decisions we will look to take in the coming months.

Finally, I would also like to underline that the leasing standard does not only bring benefits to investors, but also to preparers themselves. We have

found out that many investors, while making their adjustments to balance sheets actually exaggerate the implicit leverage in leases. So paradoxically, the leases standard will make many companies look better in the eyes of investors!

Moreover, I am also convinced that the leases standard will serve as an eye-opener to some executives. When we brought the pension liability to the balance sheet many years ago, there were quite a few executives who for the first time realised the full extent of their pension obligations. Similarly, I expect that more than a few executives are not fully aware of the implicit leverage caused by leases. The leases standard will help them to make better-reasoned decisions between purchasing and leasing.

The third standard that we will shortly finish is financial instruments, IFRS9. We have already published the chapter on general hedge accounting. Last month we finalised our deliberations on classification and measurement. We have also finished our deliberations on impairment, which will result in the incurred loss model being replaced by a much more forward looking expected loss model.

We will work hard to get these three standards out as soon as possible. That means there will soon be a stable platform in place that will make it easier for Japanese companies to make the final jump to IFRS.

Conceptual Framework

In the next part of my speech, I would like to address some of the main topics in our review of the conceptual framework. I know this is of keen interest to our Japanese constituents. The period for public comment on the Discussion Paper has recently closed and I have been reading the many comment letters we received. These letters disprove the myth that

accountants are people who tend to be bereft of emotions. Some of the letters indeed show clear signs of strong passions! Granted, they are merely passionate about accounting, but passionate nonetheless!

We still have to properly analyse all the feedback, but a couple of themes are pretty clear. First of all, it is clear that we will have to do further work on measurement. Our constituents are generally very supportive of our choice for mixed measurement, but they are looking for more in-depth analysis on the different measurement bases and the information they provide.

One very interesting comment came from the European Accounting Association. They propose dropping the term 'measurement' altogether as it suggests a degree of precision that accounting cannot attain. Instead, they believe we should be using the term 'estimation' as this does much more justice to the high degree of subjectivity of accounting. After all, measuring the value of an asset is a much less precise exercise than measuring the temperature or the size of an object. To those who read my speech 'The imprecise world of accounting'¹, it will not come as a surprise that this suggestion has great intellectual appeal to me. Indeed, in between the purchase and the sale of an asset, most of the measurement techniques are in essence estimations.

However, for practical purposes, I do not think it is wise to remove a term that is as ingrained as 'measurement'. We have enough problems as it is with the removal of the word 'prudence', even though very few people raised objections when we did so in 2010. In addition, a clearer recognition of the subjectivity of measurement or estimation does not absolve us from the real

¹ 'The imprecise world of accounting, Amsterdam, June 2012

task at hand in the conceptual framework, which is to create more high level guidance about the different techniques.

Another hotly debated topic in the comment letters is the question of Profit or Loss versus Other Comprehensive Income. Many constituents ask us to define Profit or Loss as an element and to draw a clear distinction with OCI. This is especially the case in Japan, where most constituents ask us to recycle all components of OCI through net income.

While many constituents ask us to define Profit or Loss and OCI, very few give clear indications how this should be done. One could say that this is primarily our responsibility as a standard setter, but the scarcity of concrete suggestions shows the complexity of the problem.

One noticeable exception to this is a courageous effort by the Japanese ASBJ. In a discussion paper for the Accounting Standards Advisory Forum, the ASBJ described the nature of Profit or Loss as an 'all-inclusive measure of irreversible outcomes of an entity's business activities in a certain period'. In this definition the term 'irreversible' does not mean the same as 'realised'. When investments are made for trading purposes, the ASBJ considers the outcome as 'deemed irreversible', even if they are not realised.

The ASBJ paper is so well written that during the meeting I likened its elegance to the neatness of a Bento Box. This was meant to be a great compliment. You must understand that a Bento Box makes a very profound impression on a Dutchman who was brought up with ham and cheese sandwiches wrapped in brown paper bags!

Ikuro's presentation of this paper in the ASAF meeting of last December led to a very lively and rich discussion. Unfortunately, there was very little

consensus among ASAF participants on how the ingredients of the Bento Box should be arranged and it is clear that a lot of work still needs to be done. Still, the ASBJ made an important contribution to the beginning of the path forward.

Moreover, I think the IASB and our Japanese constituents have a high degree of consensus on some aspects of this difficult issue. In particular we both agree about the importance of Profit or Loss. In the Discussion Paper, the IASB states very clearly that we consider Profit or Loss as the 'primary source of information about the return an entity has made on its economic resources in a period'. This makes very clear that the IASB does not focus exclusively or unevenly on the balance sheet.

We should also not underestimate the degree to which the markets rely on Profit or Loss as defined by GAAP. The P&L is widely used by both unsophisticated and professional investors. Earnings per share are the basis of commonly used valuation techniques such as the Price/Earnings ratio.

If we agree that Profit or Loss is the primary indicator of performance, it needs to be robust and tinker-free. It is absolutely vital that Profit or Loss contains all information that can be relevant to investors and that nothing of importance gets left out. This was the main reason why our predecessor, the IASC, in its time removed the possibility of adjusting Net Income for extraordinary items. One remarkable feature of extraordinary items is that they keep on recurring all the time!

I admit that a broad definition of Profit or Loss comes at a price, namely that it is necessarily a bit rough. It may lack the nuance to adequately portray the performance of an entity in all circumstances. No single income line can

capture everything about a company's performance that a user will need—because of the multi-faceted nature of company performance.²

For this reason, we simply have to accept that preparers and analysts may need non-GAAP measures to fine-tune their presentation or assessment of an entity. That is fine, as long as they are built on the cornerstones of IFRS and can be reconciled with it. I am also convinced that the IASB will have to restart its financial presentation project so as to give more guidance and discipline to the disaggregation of the income statement.

If we accept that Profit or Loss is the primary indicator of performance in a time period, we should be very disciplined in our use of OCI. If we resort to OCI too easily, this would ultimately undermine the credibility of net income and that is something we should avoid at all costs.

From the comment letters it is pretty clear that OCI is another subject that people struggle with. Some aspects of the problem are pretty non-controversial, such as the use of OCI for the fair valuation of Own Credit. This prevents very counter-intuitive results in profit or loss. Likewise, few will challenge the use of OCI as a parking spot for cash flow hedging instruments or foreign currency translation.

But other uses of OCI are much less straightforward. In IFRS9, value changes in strategic equity investments go through OCI. US GAAP will require value changes in all equity investments to go through Profit or Loss. Our OCI-proposals for our upcoming insurance standard are welcomed by many, but

² For a good discussion on this topic, see 'Performance Reporting, a European Discussion Paper, ICAC, Efrag, et. al, 2009

insurers in Australia, the UK, Scandinavia and South Africa see it as a step backwards in accounting.

And what does current practice tell us about the use of OCI? In the last decade, some big American car manufacturers and airline companies were brought to their knees by employee benefits that had been building up over the years. Were these liabilities less real because changes in the estimated costs were merely presented in OCI³? Arguably, the companies in question would have tackled these liabilities earlier—and at less expense—if they had been recognised in Profit or Loss. These examples also make clear how dangerous it is to assume that liabilities which can remain unrealised for many years are somehow less real. Unrealised does not mean unreal.

Some respondents, such as the Canadian Accounting Standards Board, told us that we should not even deal with OCI on a conceptual level since they find it unlikely that a sound conceptual basis can be found. These respondents may have a point, but I believe the examples I just gave mean that we are in urgent need for some guidance around this issue. I also hope that a future financial presentation project may produce better ways of presenting income of a more uncertain nature, without having to resort to the use of OCI.

Summing up, Profit or Loss is an extremely important indicator of financial performance in a time period. To provide sufficient rigour, it should be as inclusive as possible. For that reason, Profit or Loss is necessarily a bit rough around the edges. To protect the integrity of Profit or Loss, we have to be very cautious with OCI, which should only be used as an instrument of last resort. If our ultimate conclusion were to be that OCI is more of an exception

³ As they would have been under IFRS

than a rule, finding a conceptual basis for it will be very difficult. Obviously, these are personal and very preliminary thoughts, given the fact that the Board still needs to digest the very rich feedback we have received thus far.

Close

Ladies and gentlemen, I will now draw to a close.

I have described the close relationship between Japan and the IASB, and how that relationship has blossomed. I would like to thank all of you for your continued support of the IASB and its work. We remain encouraged by Japan's continued commitment to IFRS and we look forward to continuing our work alongside the ASBJ.