The reporting of income and expense and the choice of measurement bases

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1 Introduction

1.1 This paper aims to contribute to the debate on performance reporting and its relation to measurement, which was initiated by the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* ('the IASB DP') and continued in thoughtful and stimulating papers presented by the Accounting Standards Board of Japan (ASBJ) at ASAF's meeting in December 2013 and by Thomas Linsmeier at the March meeting.

1.2 This paper does not represent the official views of the UK Financial Reporting Council (FRC), but rather the personal views of the authors. However, the views expressed are consistent with those expressed by the FRC in its response to the IASB DP.

1.3 We agree with many of the conclusions of the ASBJ and Linsmeier on measurement but approach the rationale from a slightly different perspective. By setting out an alternative rationale, based on the idea of a business model and prudence, we attempt to demonstrate their significance and hence reinforce our view that the Conceptual Framework should specifically acknowledge or refer to them. In brief, our argument is that for many common kinds of businesses cost-based measurement can be argued to provide the perspective most valued by users. It reports profits when input assets, measured at cost, are exchanged for assets with a higher value to the entity. We suggest that this is largely consistent with the idea of 'irreversibility' and the importance of operating profit.

1.4 One area where we do not entirely agree with the other contributors is that of the rationale for historical cost. However, as these issues are of less immediate relevance, they are addressed in an Appendix to this paper.

1.5 We agree with both the ASBJ and Linsmeier on the importance of presenting operating profit: we believe that the idea of the business model is helpful in supporting this.

Structure of this paper

1.6 The following two sections discuss two ideas that are particularly important in forming our views on the issues addressed in this paper: the business model and prudence. We discuss the rationale for our views on measurement in Section 4, reporting income and expenses in Section 5 and recycling in Section 6.

2 The business model

2.1 For this paper, the term 'business model' is used to refer to the way in which a business creates or adds value, which it is able to retain for itself or distribute to shareholders. The business model concept serves as a reminder that investors (and other users of financial statements) are generally interested in the performance of a business. Financial reporting will not serve its purpose well if it is content to merely provide information on the amounts and changes in those amounts of assets and liabilities. It is also necessary to provide information that assists in an assessment of the performance of the business. This does not imply that financial statements should not also report the effect of events and transactions that are outside the business model.

2.2 At least for the purposes of this paper, and probably for the Conceptual Framework, the business model does not need to be considered at a very detailed level. It is sufficient to distinguish two common types of business:[1]

(i) Businesses that obtain 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, a retailer buys goods on a wholesale market and sells them, in different quantities and location, on a retail market. An essentially similar business model is used by manufacturers and businesses that provide services, including professional services. It also, at least arguably, includes those banking activities that involve the making of loans in order to collect repayments.

(ii) Other businesses models involve the acquisition of assets (and sometimes liabilities) in order to benefit from gains resulting from changes in their value. In such a business assets may be purchased and sold on the same market. This kind of business model is used, for example, by commodity dealers, investment funds and some other financial activities.

2.3 The second type of business includes those activities that the ASBJ refer to as 'trading'. However, in order to make the distinction more clearly, we refer to the first type as 'value added' businesses and the second as 'price change' businesses. These labels correspond to the fact that the first type of business adds value by its own activities, whilst the second makes its profits through its skill in forecasting price changes.

[1] The distinction made here is not, of course, novel. Edwards & Bell describe it as follows: "The purposive profit-making activities of a firm can be conveniently divided into (1) those that yield a profit by combining or transforming factors of production into products whose sale value exceeds the value of the factors, and (2) those that yield a gain because the prices of assets rise (or prices of liabilities fall) while such assets (or liabilities) are in possession of the firm. In the first instance profit is developed by *using* factors; in the second it results from *holding* factors or products." *The Theory and Measurement of Business Income* (1961), p36. A similar distinction is made by Stephen H Penman in *Financial reporting quality: is fair value a plus or a minus?* Accounting and Business Research Special Issue: International Accounting Policy Forum (2007) pp33-44.

2.4 Most business activities would seem to fall clearly within one of these two categories. The type of business will in most cases be objectively verifiable. It therefore would not be open to management to contend that they are operating a business of a particular type if that is not consistent with the markets on which they obtain and sell assets, the contracts that they enter into with suppliers and customers and so forth. Although there are some 'grey areas'—for example, private equity funds—we suspect that they would be few. We therefore consider that the categories of value added and price change businesses are sufficiently comprehensive and clear to provide a useful basis for analysis.

3 Prudence

3.1 Prudence is a commonly used word but can be interpreted in widely different ways. Of these different interpretations, some are basic concepts of IFRS, and some others are completely contrary to the principles of IFRS. It is therefore important that the Conceptual Framework clarifies definitively where prudence has a place, particularly as the most significant role of prudence should be in the development of accounting standards.[2]

3.2 Whilst prudence is commonly defined as the exercise of caution in the face of uncertainty it actually has another important role, which is unrecorded in the current Conceptual Framework. This is the principle of asymmetry in recording gains and losses.[3] The following section describes what actually happens in accounting, although in some limited cases current standards get in the way. Some may agree with these points, but disagree that they are examples of the application of prudence: this seems to be more of a point of terminology than a major difference of opinion.

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2 A clarification of the role of prudence would also be relevant to the interpretation of IAS 8, which requires that accounting policies developed for transactions that are not the subject of an accounting standard are (inter alia) prudent (paragraph 10).

3 The academic literature often refers to this as 'timely loss recognition'. See, for example, S.P. Kothari, Karthik Ramanna, and Douglas J. Skinner (2010) Implications for GAAP from an analysis of positive research in accounting, Journal of Accounting and Economics 50 pp. 246–286, and the discussion by Richard Lambert at pp287–295 of the same issue.

Recognition asymmetry

3.3 Under current practice, operating assets held by a value added business (inventory, tangible fixed assets, intangibles and goodwill) are impaired where they are not expected to be recovered by future cash flows. Where future cash flows are expected to be sufficient they are recognized as they arise. Hence a shortfall in cash flows is recognized immediately, but an excess is not. This is not caution in the face of uncertainty (the future excess cash flows may be completely certain) but asymmetry, which is valued by users. Users evaluating an investment assume that operating assets will generate positive cash flows unless warned to the contrary by impairment losses. Users wishing to hold management to account will wish to understand the reasons for these losses. Users are generally not interested in anticipating operating gains in the financial statements before they are realised although they welcome disclosure in the operating review of expected changes in future operating margins. The ASBJ states *'profit or loss should be recognised where the outcomes are irreversible or deemed irreversible*'. We would agree, subject to the proviso that impairments are deemed irreversible when they are likely to arise whilst gains are recognised when they occur.

3.4 Gains on operating fixed assets are not usually recognised unless they are realised on sale.[4] Conversely they are written down to expected proceeds if a decision is taken to sell them.

3.5 Although operating fixed assets may be revalued upwards, the effect of that revaluation is not reported as income in the profit or loss account: instead it is reported in OCI. The result is that the profit or loss account is prepared on a prudent basis.

3.6 Contingent operating liabilities are recognized where it is considered more likely than not that they will be payable. Conversely contingent operating assets are

4 An exception arises under paragraph 42 of IFRS 3 which requires certain unrealised gains to be recognised in profit or loss where a business combination is achieved in stages: similarly paragraph B98 of IFRS 10 requires certain unrealised gains to be recognised where a parent loses control of a subsidiary.

only recognized when virtually certain to be realized. Again, users expect disclosure of contingent operating assets where material.

Measurement

3.7 However, business activities take place in an uncertain environment. Where the amount of an asset or liability is uncertain (and remains so, after all reasonable attempts to gather more information):

(i) Caution should be exercised to ensure that assumptions are not overly optimistic, and that all relevant factors (such as liquidity) have been addressed. This is particularly the case if the assumptions are not validated by a liquid market.

(ii) Where the measurement basis is fair value and market prices are not available, the results of a number of valuation techniques should be used, and judgement applied in evaluating the results (IFRS 13, paragraph 63).

(iii) The reported amounts of assets and liabilities should reflect an allowance for risk. This increases the amount of a liability (as required by IAS 37 paragraph 43) and reduces the amount of an asset.

(iv) Appropriate disclosure should be made of the measurement technique used and the relevant assumptions (as required for fair value measurements by IFRS 13, paragraph 91). Disclosure should also be made of the risk allowance.

3.8 Rules should not constrain the assessment of available evidence. (The current requirements of IAS 39 for recognising impairment are an exception to this principle.) If assets are more likely than not to be impaired they should be written down. Disclosure should be made where assets would be materially lower if reasonably possible events were to materialize.

Prudence and neutrality

3.9 Perhaps the most widespread objection to prudence is that it is incompatible with neutrality. However, neutrality (like prudence) can be interpreted in different ways.

3.10 It is sometimes suggested that neutrality requires that financial statements reflect even handed treatment of assets and liabilities. As noted above this is neither the current basis of accounting nor what investors actually tell us they want. Financial statements are not the only source of information to investors and sometimes not even the most important source. What investors tell us they value in financial statements is a reliable confirmation of financial performance unaffected by management bias.

3.11 Indeed, that interpretation is not that given in the Conceptual Framework. The Framework describes a neutral depiction as being *'without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.'*

3.12 From an economic perspective, gains and losses affect the entity equally. Therefore conventions that distinguish them depart from that perspective and lack neutrality in the sense discussed in paragraph 3.10 above. However, if the conventions are generally accepted (and based on sound concepts) this does not cause the financial statements to lack neutrality, in the sense of the Framework.

Use of current market prices

3.13 In certain cases, accounting standards may require assets to be recorded at market values, rather than amortised cost. A consequence of this is that gains and losses are likely to be recognised at the same time, rather than asymmetrically. This is generally for one of the following reasons:

- Price change businesses. Here it is generally accepted that positions are marked to market whether in loss or in profit. This reflects the purpose of the business of profiting from price changes. For such a business gains and losses are often, although not always, readily realisable. We agree with the ASBJ that *"the entity has willingly accepted the uncertainty regarding the fluctuations in the current market price and thus the changes…in the current market price should be recognised in profit or loss as they occur"*.

- Derivatives and complex financial instruments are marked to market, as amortised cost (which may be zero) does not provide useful information to users. What then happens in the performance statement depends on whether they are effective hedges or deemed to be part of a price change activity.

3.14 Whilst recognising gains and losses in a price change business should not be problematical in very liquid markets such as gold or large cap equities there is widespread concern that recognizing unrealized gains in illiquid markets, such as that for distressed debt, is not prudent. Not only does caution in the face of uncertainty play a part, but users are concerned both that there is considerable subjectivity in measuring the instruments and that these possibly ephemeral gains are used unnoticed as a basis for bonus or dividend declarations. Whilst there are significant practical problems in applying asymmetry to these types of assets and liabilities, prudence requires that such unrealised gains are properly segregated and separately disclosed. It also requires appropriate risk margins be applied to both assets and liabilities where valuation is uncertain.

4 Measurement considerations

Value added businesses—Operating assets

4.1 A value added business will own assets, such as property, plant and equipment (fixed assets) and inventory that it uses in the generation of revenue. For convenience, we refer to such assets as 'operating assets'. The IASB DP, the ASBJ paper and Linsmeier all agree that such assets should be measured at cost. So do we.

4.2 In our view, cost is relevant for operating assets because they are entry prices: they are the amount at which the assets are purchased, rather than those at which they might be sold. The relevance of entry values for reporting the financial performance of a value added business is directly related to the nature of the business model. The essence of a value added business model is to take advantage of the entity's ability to transform inputs into outputs that can be sold for a greater amount than their cost to the entity. An assessment of the performance of the business in the period therefore requires information on revenues and the cost of inputs consumed in providing the related products: the difference is the margin. Such information clearly also has predictive value, as it assists an assessment of future margins.

4.3 Stating operating assets at cost also provides relevant information on the financial position of a value added business. Such businesses acquire assets in the (generally rational) expectation that they will make a contribution to revenues that is greater than the price paid. However, as the IASB DP notes, the asset is the resource, not the economic benefits that it promises (paragraph 2.14). It would be imprudent to recognise the expected future profits when an asset is acquired, as they are uncertain, and it is preferable to recognise such profits when they arise. This is similar to the view in the ASBJ paper that profit should be recognised when the outcome is 'irreversible'.

4.4 Exit prices (selling prices) are generally irrelevant for operating assets such as property, plant and equipment and intangible assets, which are unlikely to be sold. As Linsmeier notes, such assets are often used synergistically with other assets, and thus are costly to extract and sell, and generally do not have well-developed secondary markets that the entity that uses an asset can readily access. The price that a business can obtain for its second-hand operating asset is generally less than the price paid to acquire it. Recognising a loss on the acquisition of an asset would not faithfully represent either the financial performance of the entity or its financial position.

4.5 Prudence may play a role in the selection of a measurement basis. A common example is that inventory is reported at cost even where it is virtually certain to be sold for a greater amount soon after the reporting date. This is the other side of recognition and it is a moot point whether recognition drives measurement or vice versa.

4.6 However, once a measurement basis has been determined, it should, in principle be applied even-handedly. Arbitrary "prudent" deductions from assets or additions to liabilities should not be made. Users cannot determine the amount of this prudence or its variability between periods.

Value added businesses—Assets held for sale or realisation

4.7 Of course a value added business may hold assets that are not inputs to its business model, and hence should not be stated at an entry value, but rather at an amount that reflects the amount, timing and uncertainty of the amount that will be received. Trade receivables are obviously in this category.

4.8 Assets that are obsolete or surplus to requirements, and will only provide future benefits in the form of the proceeds of sale should also be reported at the amount expected to be received—net selling price. Two further points should be noted in this connection:

(i) If the net selling price will exceed the carrying amount, the assets should not be written up through profit or loss; to do so would be to anticipate a profit, contrary to the concept of prudence.

(ii) As the objective is to portray the future benefit, the cost of sale should be deducted.

Both of these points are consistent with the requirements of IFRS 5 *'Non-current assets held for sale and discontinued operations'*.

When is profit earned?

4.9 The ASBJ's view is that '*profit or loss should be recognised when the uncertainty regarding the outcomes of an entity's business activities is reduced to the point where the outcomes are irreversible or deemed irreversible*'.

4.10 It was noted in paragraph 4.3 above that this leads to one conclusion with which we agree: that the future profits that operating assets will earn should, in accordance with the concept of prudence, not be anticipated but recognised only when they arise. On the other hand, the idea of 'irreversible outcomes' could conflict with another consequence of prudence: that impairment of assets should be recognised in profit or loss. As noted above, we think the notion of deeming impairments to be irreversible solves this problem.

4.11 It was suggested above that for a value added business operational assets, which provide the inputs to the business should be reported at cost, while assets held for sale or realisation, such as trade receivables, should be reported at the amount that is expected to be received. On this view, profit would be recognised when inventory is derecognised and a receivable is recognised. In the usual case, of course, the amount of the receivable would be greater than the cost of the inventory. Thus the question of profit recognition becomes that of when to recognise an exchange. Accounting standards address this in considering transactions where the answer may not be clear, for example long-term construction contracts, or when assets are leased rather than sold.

Price change businesses

4.12 As described above, another business model is to acquire assets (and sometimes liabilities) in order to benefit from price changes. Purchases and sales are often made on the same market. As noted in paragraph 3.17 above, current market prices are generally used for such businesses.

4.13 A price change business often has little or no obstacle to selling its assets at current market prices at any given time. Indeed it may be argued that in many such businesses, transactions are relatively unimportant as they merely involve the exchange of an asset for an equivalent amount of cash. Assessing the performance of a price change business clearly requires that assets and liabilities are reported at current market prices. The overall change in such prices is, almost by definition, the key performance metric for such a business.

4.14 It was argued above that the business model of a value added business provides a clear rationale for using entry values for assets and liabilities that are inputs to such a business. It is not so obvious whether entry or exit values should be used for a price change business, but the use of exit values can be defended on the basis that it is only by selling its assets that the entity can obtain cash to make returns to shareholders.

5 Reporting of income and expenses

Operating income

5.1 Both Linsmeier and the ASBJ emphasise the importance of reporting operating income. In our view, operating income can be equated as the result of the application of the business model. For a value added business this would include transactions with customers, employees and suppliers. Operating income represents the core business activities of an entity. It is therefore useful in assessing the prospects for future earnings and the effectiveness of management. Investors like Linsmeier are interested in identifying an entity whose *'core business activities have the potential to provide a persistent (sustainable) positive expected return that compensates me for the risk taken'*.

5.2 For a value added business, operating income is the difference between revenues and several different kinds of expenses. The amount of revenue and various expenses may be related to each other, and may change differently in response to different factors. It is therefore useful to disclose separately revenue and expenses, analysed by nature and/or function. Unusual or non-recurring items should not be excluded from operating income, but should be separately disclosed: as the ASBJ note, they have implications for assessing management competence.

5.3 The main objection to a requirement to disclose operating income is the difficulty of defining it robustly.[5] However, it would seem to be feasible for an accounting standard to:

(i) describe the general nature of operating income, which might expressly refer to the results of the business model;

(ii) state what is generally included or excluded from operating income; and

(iii) require disclosure of how operating income is determined.

5.4 Such an approach may not ensure that all entities, even within a particular industry interpret 'operating income' identically. Differences in interpretation will obviously impair comparability between entities, at least to some extent. However, arguably it is preferable to frame requirements so as to secure the provision of the most relevant information, rather than attempt to provide a rigid definition that enables painless comparability of a number that makes no sense to the management of either entity. Some investors also note that they value information on how management view their core business: this might be suppressed by a rigid approach.

Statement of profit or loss

5.5 Linsmeier suggests that all income and expenses should be reported in two statements: a Statement of Operating Income and a Statement of Comprehensive Income. Items that would be reported only in the Statement of Comprehensive Income would include the results of investing, financing, tax and discontinued operations. The ASBJ, in contrast, consider that operating profit should be only a subset of profit or loss, which in turn is consistent with cash flows.

5.6 The IASB DP states:

The IASB has previously acknowledged that many investors, creditors, preparers and others view profit or loss as a useful performance measure and that 'profit or

[5] The 1977 version of IAS 1 'Presentation of Financial Statements' required a line item in the income statement for the results of operating activities, but it was deleted as the IASB decided not to require disclosure of an undefined term (IAS 1, BC55). Presumably, the IASB considered providing a definition but was not able to do so.

loss' as a subtotal or a phrase is deeply ingrained in the economy, business and investors' minds. Users from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main indicator of an entity's performance. (paragraph 8.19)

It may be questioned whether a Statement of Operating Profit would be considered to be sufficiently comprehensive to provide a replacement for a Statement of Profit or Loss. As the ASBJ note, a robust and comprehensive statement of profit or loss is necessary to enable an assessment of stewardship.

5.7 The IASB staff paper 'Conceptual Framework: High level overview of feedback on the Discussion Paper' says of responses to Section 8 of the IASB DP:

The following key themes emerged:

(a) Most respondents agreed that profit or loss should be required to be presented as a total or subtotal.

(b) Many respondents disagreed with treating profit or loss as a default category and urged the IASB to define or better describe profit or loss and its purpose; however, only a few made suggestions as to how that might be done. No consensus view emerged.

5.8 The FRC response is in line with these views. However, it was one of the few that suggested how the purpose of the statement of profit or loss should be described. The FRC suggestion was:

The objective of the statement of profit or loss is to present income and expenses for the period in order to report the returns of the period, and facilitate an assessment of accountability and future returns.

5.9 The FRC considers that such a description is necessary in order to clarify the significance of the statement of profit or loss and to provide a rationale for what should be included or omitted from it. In particular, it follows that income and expenses should be excluded from the statement of profit of loss if they impede the achievement of the statement's objective. Such income and expense will arise where it is concluded that part or all of the change in an asset or liability as in the statement of financial position does not represent returns of the period or facilitate an assessment of accountability and future returns. This is similar to (perhaps identical with) the ASBJ's view that items that are excluded from profit or loss when a different measurement basis is used in the statement of financial position from that used in the statement of profit or loss.

Different measurement bases in the statement of financial position and profit or loss

5.10 It is not immediately obvious why a different measurement basis might be used in the statement of financial position from that used in the statement of profit or loss. After all, if the statement of financial position fairly reports the value of an asset, why should not consumption of that asset be fairly represented by consumption of that value?

5.11 We agree with the ASBJ, however, that in some cases presenting the income or expense resulting from remeasurement of an asset or liability would impair the ability of the statement of profit or loss to fulfil its purpose, as stated in paragraph 5.8 above. Possible examples include:

(i) Where the outcome is not yet irreversible. For example the revaluation of a factory building goes through OCI rather than operating income.[6]

(ii) Where a standard requires current values to be used for assets and liabilities for which no good market exists. Such a decision may be made because historical cost fails to provide useful information, for example, for exotic financial instruments or for pension liabilities. It may be reasoned that the changes in value of such assets and liabilities are so unreliable that their inclusion in profit or loss obscures, rather than assists, an assessment of the performance of the business. They might therefore be excluded from profit or loss, and reported in OCI.[7]

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6 Holding gains and losses on operational assets of a value added business are discussed further in Appendix 1.

7 One of the issues to be considered in prescribing such a treatment is the lack of comparability in the treatment of, for example, derivatives that are traded on a market and those that are not.

(iii) Where a derivative is entered into as a cash flow hedge, a better assessment of the entity's business model may be facilitated by recognising any gain or loss in profit or loss in the same period as the related transaction. Remeasurements occurring in an earlier period than the related transaction could therefore be reported in OCI.

(iv) Strategic investments. These are holdings in the equity of other entities that are held for the long-term to strengthen its business ties with the investee. Capital appreciation is not a major objective. For such investments the current market price may be the most relevant amount for the purpose of assessing the entity's financial position, but changes in the current market price are irrelevant to an assessment of the entity's performance for the period.[8]

(iv) Where the remeasured amount of a liability reflects changes in the entity's own credit risk. A gain from an increase in an entity's own credit risk (or a loss from a decrease) does not, at least arguably represent a return of the period or assist in assessing either accountability or future returns, and the effect of such changes may be reported in OCI.

5.12 Often a value added business will hold derivatives only as cash flow hedges and equities only as strategic investments. If the above suggestions are accepted, the profit or loss would contain the same amounts as those suggested by the ASBJ.

5.13 However, if a value added business engages in speculation, for example by holding equities other than strategic investments, or derivatives other than as cash flow hedges, then it is engaging in a price change business activity and it is appropriate for such assets to be reported at current market prices.

5.14 A difficult case arises where an asset, such as a debt security is held either for collection or for sale, and the entity has the practical ability to sell. The ASBJ

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8 This is an example where reporting by a value added and a price change business might differ: all gains and losses on a similar investment held by a price change business would be recognised in profit or loss. This is consistent with the ASBJ's view that such a business willingly assumes all risks of price changes as part of its trading strategy, and can generate cash flows equivalent to the current market price. A value added business assumes the risk of price changes only incidentally to a larger purpose and may well not have the ability to sell at the current price: indeed market fluctuations may never be reflected in cash flows.

suggest that in such a case, the current market price should be used in the statement of financial position, but not in reporting profit or loss, as the uncertainty concerning future cash flows has not been reduced to the point where the outcome is irreversible, or may be deemed irreversible. In contrast, Linsmeier's position is that current market prices are generally relevant for assets that may be sold. The ASBJ's position is, however, strengthened by the point that such assets are not held for capital gain, and that the gain is not irreversible and may indeed never occur.

6 Recycling

6.1 The FRC's proposed description of the objective of the statement of profit or loss, which is set out in paragraph 5.8 above, emphasises the importance of its providing an account of the income and expenses <u>of the period</u>. One consequence of this is that items should only be recycled where doing so provides relevant information about an event of the period. The view that all items should necessarily be recycled seems to be justified by the ASBJ on the basis that the all profits and losses should be reflected in profit or loss of at least one period. Under this view recycling may be required in order to ensure that the <u>cumulative</u> amount reported in profit or loss is correct. In our view, it is inappropriate to sacrifice a representationally faithful statement of the income and expense <u>of the period i</u>n order to achieve a desired <u>cumulative</u> position. It follows that not all income and expenses reported in OCI may be recycled.

6.2 For example, the ASBJ concede that it may be difficult to determine an appropriate recycling method for gains and losses on defined benefit assets or liabilities, but express the hope that an acceptable method can be developed. In our view unless such a method involves giving enhanced information on an event of the period in which recycling takes place, it should not be adopted.

6.3 One common suggestion is that changes in value should be reported in OCI until realised, and that realisation is the event that justifies recycling (for example, the IASB DP notes this view at paragraph 8.24(b). The FRC response observes:

We question whether recycling is the only or best means of providing the information about realisation that is required in order to fulfil the objectives of financial statements. The decision on how this information is best reported may be better addressed in the development of standards rather than in the Conceptual Framework.

6.4 There may, however, be cases where recycling is helpful. If an operational asset is revalued, a gain may be reported in OCI rather than the profit or loss account as it cannot be realised as long as the asset is required for use. If in a subsequent period the asset is sold as operations have been moved elsewhere, the constraint on sale no longer applies, and it may be helpful to report the gain made possible by the move in the same period as the expenses incurred in making the move.

6.5 For the above reasons, we do not agree with the view that all items that are reported in OCI should automatically be recycled. In our view, recycling should be used only where it enhances the relevance of profit or loss, because it represents an event of a period, or completes the depiction of an event that is recognised in the period. The latter is the category of 'mismatched remeasurements' described in the IASB DP.

6.6 The clearest example of a mismatched remeasurement is a cash flow hedge. It was suggested above that gains or losses on a derivative of a cash flow hedge might initially be reported in OCI: recycling that gain or loss to profit or loss in the period in which the related transaction takes place would complete the depiction of the impact of the transaction on the entity, and enhance an assessment of its business model.[9]

[9] The IASB DP suggests that another example of a mismatched remeasurement is exchange gains and losses on the translation of an investment in a foreign operation. However, it also notes that some consider that these remeasurements are of the nature of capital maintenance adjustments. We consider this view merits further consideration than can be given in this paper and hence do not give this as an example of a mismatched remeasurement.

APPENDIX

Some further thoughts on the rationale for selecting a measurement basis

1 In the body of the paper we support the views expressed by the ASBJ and Linsmeier that current market prices are not the most relevant measurement basis for value added businesses. In reaching these conclusions we have not relied on the following arguments:

(i) The only added information provided by the use of current values is the recognition of holding gains.

(ii) That the recognition of changes in market prices is irrelevant for value added businesses, as they have no implications for the future cash flows.

These propositions may merit further reflection.

2 It is commonly assumed that the choice of measurement basis is between historical cost and a current market price. However, this binary choice fails to distinguish two questions:

(i) whether an entry or an exit price is more relevant (and why); and

(ii) whether a historical or a current price is more relevant (and why).

3 It is not always clear whether current market prices represent an entry or an exit value. However, fair value is defined in IFRS 13 as an exit value, and it would seem that it is often taken for granted that it is an exit value.

4 In the discussion in the body of this paper, it is suggested that entry prices (costs) are relevant for the operating assets of a value added business. That argument, however, does not address the second question: whether historical cost or current cost should be preferred in some or all circumstances. That is also a question that is not explored in the IASB DP, although some respondents, including the FRC, suggested that the Conceptual Framework should address the issue.

5 In its response to the IASB DP, the FRC stated:

We do not suggest that the Conceptual Framework should be a manifesto for the wholesale introduction of price-level adjusted accounting; but we do think that it should provide a rationale for the circumstances in which standards should require a measurement basis that takes account of price changes.

6 In that spirit, this paper does not seek to make a case for a comprehensive current value system. However, if the propositions set out in paragraph 1 are accepted, they may preclude consideration of the relative merits of current and historical measurement bases that the FRC urges.

Is the additional information from current values only the recognition of unrealised gains and losses?

7 Linsmeier suggests that current values are not relevant for value added business because current values merely report unrealised gains and losses. As the assets will not be sold, these gains merely represent the opportunity cost of holding rather than selling the asset—information that may be communicated in the notes to the financial statements. However, one of the main potential benefits of using a current entry price (such as replacement cost) is that it has the consequence that the cost of consumption of the asset can be reported in current terms.

8 It is helpful to consider the position of a value added business that purchases a commodity as the main input to a manufactured product, such as an entity that purchases sugar and sells sweets (candies). Reporting its inventory of sugar at current value provides relevant information in the statement of financial position: for example, it enables comparison between the financial position of different entities, which is obscured by historical cost, especially if price changes are significant—different entities may have identical inventory but different historical costs simply because they acquired them at different times. Using current value to report the cost of sales in a the period in which it is used facilitates comparison, and also reports the cost of the sugar consumed in the period at an amount that is economically relevant, and can also be reasoned to

have higher predictive value, as the cost of future production is more likely to resemble current than historical cost. The challenge for the analyst in interpreting historical cost information is particularly difficult if they have no information on the prices at which the inventory consumed in the period was acquired.

9 A similar perspective is adopted in the long-standing UK accounting for property, plant and equipment, which permits revaluation of property, plant and equipment, consistently with the current requirements of IAS 16 'Property, Plant and Equipment'. Whilst the gains resulting from such a revaluation are excluded from profit, the cost of consumption is based on the revalued amount, and not on historical cost. There are plenty of reasons to be sceptical as to whether depreciation accurately reflects the cost of consumption, particularly for assets that have very long lives, but it seems reasonable to suggest that depreciation based on an up-to-date value comes closer than that based on a historical transaction perhaps a couple of decades ago.

10 We therefore consider the view that current values merely report holding gains and losses that are of doubtful relevance is incomplete, because it does not consider the consequent cost of consumption. We discuss the relevance of holding gains and losses below.

Are changes in market prices relevant for the operating assets of a value added business?

11 In addressing assets used in business operations to generate revenue or income, the ASBJ paper states:

The ASBJ thinks that cost-based measurement is relevant from the perspectives of reporting both an entity's financial position and financial performance because the changes in current market prices do not have any relationship to the future cash flows that will be generated from using the assets in business activities. (paragraph 54).

12 Whilst it is clear that changes in the input prices for assets held by a value added business will not have a direct (one to one) effect on its future cash flows, as the

assets will not be sold at input prices, it may be too extreme to say that 'they do not have any relationship' to future cash flows. The extent to which changes in input prices alter future cash flows will depend on a number of factors including:

(i) The extent of competition in the entity's industry, and the extent to which changes in the entity's input prices also affect its competitors; and

(ii) The extent to which price changes can be passed on to customers through higher selling prices (that is, the elasticity of demand for the entity's products).

13 Fortunately it is not the responsibility of the accountant to provide a forecast of the cash flow implications, but it is clear that an entity that holds more inventory is better off when prices increase than another that holds less. Arguably, the usefulness of financial reporting is increased if that is reflected.

Reporting holding gains and losses

14 It was promised above that this paper would revisit the question of the relevance of holding gains and losses on operational assets held by a value added business. These would arise if current entry values were used and would represent the change in such values in the period in which the assets were held by the entity.

15 As explained earlier, the view that the use of current values for value added businesses is not chiefly based on the relevance of such holding gains and losses, but rather on the increased relevance of the cost of consumption of such assets if stated in current terms.

16 The most basic point to make about the reporting of holding gains is that they should be segregated from the margin. The importance of information on margins was emphasised in the body of this paper: essentially it is the difference between the amount achieved from sale of products and the cost of providing them. This information would be obscured if holding gains are intermingled with sales and cost of sales. The predictive value of holding gains and losses is also markedly different from that of the current margin.

17 That said, there are a number of possibilities for the reporting of holding gains and losses. In the case of a business that processes a commodity (such as the confectioner) it might be argued that gains and losses on its raw material are so intrinsically linked to its business that they should be recorded in operating profit. Another view is that they should be reported in profit or loss, but outside operating profit.

18 In the case of property, plant and equipment, the view might be taken that holding gains and losses are so large and irregular that their recognition in profit or loss would impair the ability of the statement of profit or loss to fulfil its purpose, as discussed in Section 5 of this paper. On this view, they would be reported (as presently required by IAS 16) in OCI. A more radical suggestion is that holding gains and losses on (at least) property, plant and equipment should not be reported as income and expenses. This view might be justified if the purpose of recognising such gains and losses was to enable the current cost of consumption to be reported in future periods, rather than to reflect an increase in wealth. On this view the gains and losses would not be reported in either profit or loss or OCI, but presumably would feature in the reconciliation of equity. Possibly such items might be 'capital maintenance adjustments'.

19 These are some possibilities for reporting holding gains and losses on operational assets held by a value added business. No single conclusion is offered here, beyond insisting that they are segregated from the margin. We do not attempt to make the case for a comprehensive current value system of accounting. Clearly if it is concluded in a future debate that some such assets and liabilities should be reported at current values, the reporting of holding gains and losses will require further consideration.