

Investor Perspectives

Paul Pacter: Developing accounting standards consistent with the CFA Institute's vision



This Investor Perspective comments on the consistency of recent standards issued by the International Accounting Standards Board (IASB) with the vision set out in July 2007 by the CFA Institute (CFAI) in its landmark policy paper A Comprehensive Financial Reporting Model: Financial Reporting for Investors (the CFAI Model).

The CFAI Model is a framework for developing financial reports and disclosures that meet the needs of investors, such as equity investors, creditors and other providers of capital. The CFAI Model sets out 12 principles intended 'to ensure that financial statements disclosures are relevant, understandable, accurate, and complete'. The CFAI Model also calls for 'broader, more comprehensive business reporting that provides sufficient information to investors that is needed to understand the wealth-generating activities of a company and the results of those activities'.

The CFA Institute developed the CFAI Model during the period from 2002 to 2007 by consulting broadly with its membership, with professional and governmental organisations concerned with financial reporting around the world, and with the public at large. The report may be downloaded from the CFA Institute's website.

The introduction to the CFAI Model states:

‘Corporate financial statements and their related disclosures are fundamental to sound investment decision making. The well-being of the world’s financial markets, and of the millions of investors who entrust their financial present and future to those markets, depends directly on the information financial statements and disclosures provide. Consequently, the quality of the information drives global financial markets. The quality, in turn, depends directly on the principles and standards managers apply when recognizing and measuring the economic activities and events affecting their companies’ operations.

We believe that opportunities exist for making significant improvements in the financial reporting model. In the chapters that follow, we propose changes that we believe will enhance the usefulness of the current reporting model, particularly for the benefit of investors.’

The CFAI Model acknowledges that the proposed changes ‘must be made in an orderly fashion as standard setters gradually revise the reporting standards, and some will take many years to realise’. It also identifies some proposals that could be completed in the ‘near term’. In my view, the IASB’s recent standards are generally consistent with the CFAI Model’s near-term goals, particularly the standards on financial instruments and related disclosures, fair value measurement, business combinations, consolidation, joint arrangements and disclosures of interests in other entities. Further, most of the CFAI Model’s non near-term proposals do not entail one-off actions by the IASB (ie a single new or amended IFRS). Instead, they describe an approach to the continuing design of accounting standards that is broadly consistent with the recent direction of the IASB’s own approach.

I will comment, principle by principle, on how the IASB’s recent actions are consistent with the objectives set out in the CFAI Model. These are my own observations. The Board as a whole has not debated or taken a position on the principles in the CFAI Model.

Principle 1: The primary financial statements must provide the information needed by equity investors, creditors, and other suppliers of risk capital.

In setting out this principle the model notes that ‘for varying historical reasons, GAAP has not always required full and complete recognition of assets and obligations in the primary financial statements or has permitted some items, such as certain contingencies and executory contracts, to escape recognition and disclosure altogether’.

Paul comment: In September 2010, the IASB, along with the US national standard-setter, the Financial Accounting Standards Board (FASB), completed the first phase of their joint project to develop an improved Conceptual Framework for International Financial Reporting Standards (IFRSs) and US generally accepted accounting practices (GAAP). That phase addressed the objective and qualitative characteristics of financial reporting:

‘The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.’

The adopted objective is consistent with CFAI Model Principle 1. The standards that have already been issued and those that are under development by the IASB are clearly moving toward greater recognition of assets and liabilities in the primary financial statements. For example, our new standard on consolidation (IFRS 10 *Consolidated Financial Statements*) will bring structured entities, securitisation vehicles and other assets and liabilities that formerly were off balance sheet onto consolidated statements of financial position. In addition, it will clarify that consolidated balance sheets should include all entities controlled by the parent, not just those in which it has a majority voting interest. In addition, the Board has proposed bringing all leased assets and lease obligations (other than *de minimis* ones) onto lessee balance sheets—including those that historically had only been disclosed as executory contracts (commitments to acquire goods or services in the future). Our proposal on revenue recognition will clarify when an entity’s performance obligations under contracts with

customers should be recognised as liabilities in the seller's balance sheet. The Board's recent amendments to IFRS 7 *Financial Instruments: Disclosures* substantially enhance the disclosures relating to transfers of financial assets—including transactions in which the accounting resulted in derecognition and transactions in which the transferred assets and associated liabilities remain on the transferor's balance sheet. Those disclosures were designed to help users of financial statements to evaluate the nature of, and risks from, an entity's continuing involvement in transferred financial assets. As another example, the Board's current proposals for contingencies would lead to recognition of more contingencies than are recognised at present by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Without question, the broader area of recognition and disclosure of executory contracts mentioned in Principle 1 is one that is likely to be on many people's lists of potential IASB agenda projects. The IASB intends to invite public comment on its future agenda in the second half of 2011.

Principle 2: In financial reporting standard-setting as well as statement preparation, the company must be viewed from the perspective of an investor in the company's common equity.

Paul comment: The new Conceptual Framework objective of financial reporting refers to 'existing and potential investors, lenders and other creditors' as the primary user group. The reasons why the Board concluded that this is the primary user group are:

- a. Existing and potential investors, lenders and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.
- b. The Board's and the FASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.
- c. Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

The IASB's primary user group is broader than merely common equity investors, but we do not think that this is in any way a disservice to the equity investors. The information needs of equity investors and lenders and other creditors are similar, because both are concerned with future cash flows to the entity and, ultimately, to themselves. Including equity investors as primary users will ensure that their needs are always considered. Moreover, it is highly unlikely that inclusion of lenders and other creditors in the primary user group will result in excessive additional information or information that is potentially detrimental to equity investors. After all, the Conceptual Framework defines the qualitative characteristics of, and a cost constraint on, what financial information is useful.

Furthermore, as the CFAI Model itself notes: 'Financial statements must serve the needs of all investors, whether equity investors, creditors, or other suppliers of capital to the company'.

Principle 3: Fair value information is the most relevant information for financial decision making.

Paul comment: The importance that the IASB places on fair value information is evident from our recent standard IFRS 13 *Fair Value Measurement*. That standard—which, by the way, is virtually identical to the FASB's standard on fair value—defines fair value (an 'exit price' notion), sets out in a single standard a framework for measuring fair value, and improves the transparency of fair value measurements through its disclosure requirements. It is a pervasive standard, in the sense that it applies to every IFRS that requires or permits fair value measurements or disclosures about fair value measurements. However, IFRS 13 does not require new fair value measurements beyond those that are already required or permitted by other IFRSs.

Many recent and proposed IFRSs require fair value or other current value measurements. For example:

- Share-based payments are measured at fair value under IFRS 2 *Share-based Payment*. Although IFRS 2 does not use the exit price definition of fair value in IFRS 13, it has a current, market based measurement objective.
- Assets and liabilities acquired in a business combination are measured at fair value under IFRS 3 *Business Combinations*.

- Insurance companies are permitted by IFRS 4 *Insurance Contracts* to change accounting policies to measure insurance liabilities using current market interest rates (with changes in profit or loss) as well as other current estimates and assumptions. The reason the IASB did not require fair values in IFRS 4 was that it is working on a comprehensive insurance contracts standard. That project has already resulted in an exposure draft of a comprehensive standard that proposes that all insurance contracts should be measured using current (continually updated) estimates of future cash flows and discount rates. While it is not a true exit price measure (ie how much the insurer would have to pay to a third party to assume the contract obligation), it is much closer to a fair value measurement than to a historical cost measurement.
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires that non-current assets or groups of assets held for sale must be written down to fair value less costs to sell, if this is lower than the carrying amount.
- IFRS 9 *Financial Instruments* restricted the class of financial assets measured at amortised cost to those held to collect contractual cash flows, when those cash flows are solely payments of interest and principle on specified dates. With one exception, all other financial assets are measured at fair value through profit or loss. The exception gives an entity an irrevocable election to present in comprehensive income the fair value changes for equity instruments not held for trading, with additional disclosures. The Board noted in developing IFRS 9 that the views expressed by the user community were divided with regard to requiring all financial assets and liabilities to be measured at fair value through comprehensive income. Many preparers, auditors of financial statements and regulators did not support the recognition in the statement of comprehensive income of changes in fair value for financial assets that are not held for trading or are not managed on a fair value basis. Some users said that they often value an entity on the basis of its business model and that in some circumstances cost-based information would provide relevant information that could be used to predict likely actual cash flows. Moreover, some, including some of those who generally support the broad application of fair value for financial assets, raised concerns about the use of fair value when fair value cannot be determined within a narrow range. Many also believed that other issues, including financial statement presentation, would need to be addressed

before a comprehensive fair value measurement requirement would be feasible for financial instruments. It also should be noted that, for those financial assets and financial liabilities that are measured at amortised cost, IFRS 7 requires disclosure of their fair values.

- The Board's current proposal on revenue recognition would measure revenue at the transaction price, with non-cash consideration measured at fair value.
- The Board's current proposal on leases would measure all lease obligations (other than those with terms, including renewal periods, of one year or less) at the present value of the lease payments. They would be reassessed whenever there was an indication that there would be a significant change in the liability since the previous reporting period.
- The Board's current proposal on impairment of financial assets carried at amortised cost would recognise impairments based on expected losses, rather than on losses already incurred. While the instrument would still be carried at amortised cost, in cases of impairment the amount to which the asset is written down would be similar to a fair value measurement. In addition, of course, IFRS 7 would require disclosure of the instrument's fair value whether or not there is an impairment.
- The Board's proposal for non-financial liabilities would require measurement at the amount that the entity would rationally pay to be relieved of the liability. This is a current value measure that would be estimated in the same way as fair value, though from more of an entity-specific perspective.
- IFRSs permit (but do not require) remeasurement of property, plant and equipment at fair value at each reporting date. In some jurisdictions, use of this option is common. IFRSs have a similar and widely used fair value option for investments in real estate and (less commonly used) for intangibles with quoted market prices.

Principle 4: Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone.

Paul comment: The Board has emphasised repeatedly the primacy of relevance of financial information to users of financial statements. If financial information is to be useful, it must be relevant and must faithfully represent what it purports to represent. In the new (2010) version of our

Conceptual Framework, relevance and representational faithfulness (which used to be referred to as ‘reliability’) are *the* two fundamental qualitative characteristics of financial reporting:

- **Relevance.** Relevant financial information is capable of making a difference to the decisions made by users. Information may be capable of making a difference to a decision even if some users choose not to take advantage of it or are already aware of it from other sources.
- **Representational faithfulness.** Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics: it would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board’s objective is to maximise those qualities as much as possible. A complete depiction includes all information that is necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

Actually, the new Conceptual Framework describes a process for applying the qualitative characteristics that starts with identifying the most relevant measure. Step two involves assessing whether that measure is available and can be faithfully represented. But the starting point is relevance.

The Board does not subscribe to the view that measurement reliability is always more important than relevance. In IFRS 3, for example, the Board said (in the context of measuring the fair value of in-process research and development):

“Use of estimates and judgement, by itself, does not mean that information is unreliable [not representationally faithful]; reliability does not require precision or certainty. For example, paragraph 86 of the IASB’s Framework says that ‘In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.’”

Principle 5: Transactions and events that affect the company's economic position must be recognised as they occur in the financial statements.

Paul comment: This principle may seem innocuous, but in some ways it is the most important principle in the CFAI Model. In the vernacular, this principle says that financial reports should 'tell it like it is (warts and all)'. In fact, fair values provide such information by revealing how an entity is performing relative to a market benchmark over the course of its use of an asset or settlement of a liability. Recent IFRSs reflect a 'tell it like it is' approach. There is greater recognition of value changes, off balance sheet obligations are moving onto the balance sheet, although we no longer recognise deferred what-you-may-call-its on the balance sheet that do not meet the definition of an asset or a liability but are simply the result of a revenue or expense smoothing process. A simple illustration: the corridor method for deferring actuarial gains and losses and the spreading of past service cost will soon be history under the IASB's forthcoming changes to IAS 19 *Employee Benefits*.

Principle 6: Investors' information requirements must determine the materiality threshold.

Paul comment: *De minimis non curat lex*—the law does not concern itself with trifles. Nor does accounting. The debate over the years, of course, has been how to assess what is a trifle. Consistently with the CFAI Model Principle 6, the IASB's new Conceptual Framework identifies users' information requirements as the determinant of what is material: 'Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.'

Principle 7: Financial reporting must be neutral.

Paul comment: The IASB certainly agrees. Neutrality is one of the qualitative characteristics of financial reporting that were adopted by the IASB in 2010. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to lead investors or creditors toward particular decisions.

Some would prefer to have accounting standards designed to help achieve political or social or macroeconomic objectives. But this is wrong, no matter how worthy those objectives may be. Accounting standards should not intentionally mask volatility or ignore losses because it might have consequences on an entity's (or industry's) ability to raise capital or its cost of capital. Similarly, accounting standards should not be designed to encourage or discourage what some might view as socially desirable actions by businesses, such as providing pensions or medical benefits to retired employees. The role of accounting role is to make the consequences of such actions transparent to the investor. This kind of issue came up repeatedly as a result of the global financial crisis that started in 2007, when some said that financial reporting standards should be designed to achieve prudential regulation as well as investor reporting. As a bank depositor or insurance policyholder (or as a regulator), I might take some comfort in knowing that loan loss reserves or claims payment reserves are measured, for prudential regulatory purposes, on a worst-case basis or even intentionally overstated. But as an investor I want the bank's or insurer's balance sheet to reflect the amounts the company honestly expects to collect or to pay, with clear disclosure of what the reported amounts represent.

Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference to users' decisions.

Principle 8: All changes in net assets, including changes in fair values, must be recorded as incurred in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners.

Paul comment: The IASB and the FASB are jointly working on a broad project on financial statement presentation that has many components, one of which is described as reporting financial performance. A goal of that project is to require that all financial performance should be presented in a single performance statement. This is almost, but not quite, the same goal as that set out in Principle 8 because the single performance statement being developed in our financial statement presentation project would not include changes in net assets that result from owners' investments and withdrawals. Instead, owners' investments and withdrawals would continue to be presented in a separate statement of changes in equity.

In May 2010 the IASB published an exposure draft entitled *Presentation of Items of Other Comprehensive Income*. That proposal would have required all entities to present a single, continuous statement displaying two sections: profit or loss and other comprehensive income (OCI). Each item of OCI would be classified into (a) items that might be reclassified to profit or loss in subsequent periods and (b) items that will not be subsequently reclassified into profit or loss. The exposure draft also proposed changing the title of the statement of comprehensive income to the statement of profit or loss and other comprehensive income. Unfortunately (in my view) that proposal met considerable resistance from the IASB's constituents for a variety of reasons, including:

- a. views that profit or loss (as opposed to total comprehensive income) should be the primary indicator of performance;
- b. concern about a lack of principles for which items should be presented in OCI; and
- c. concern about a lack of a principle regarding recycling—presenting the same item of income or expense initially within OCI and, in a subsequent reporting period, presenting it again in measuring the subtotal of profit or loss (net income).

In November 2010, the IASB and the FASB tentatively decided to continue to permit entities to present net income and OCI either in a single continuous statement or in two separate, but consecutive, statements. Items of OCI could be presented either net of tax with details in the notes or gross of tax with each item's tax effect displayed parenthetically. Items of OCI would be grouped based on whether they are potentially recyclable to profit or loss after initial recognition. The current calculation of earnings per share based on profit or loss would be retained. The Board expects to publish those amendments to IAS 1 before the end of June 2011.

Without question, the broader area of financial statement presentation will be on the shortlist of candidates to be considered in the IASB's public consultation on its future agenda, which is expected to get under way in the second half of 2011.

Principle 9: The cash flow statement provides information essential to the analysis of a company and must be prepared using the direct method only.

Paul comment: In July 2001 the IASB put on its agenda a project on performance reporting. Later the title of the project changed into reporting comprehensive income. The IASB worked on this project on its own until 2005, when the FASB joined. Some time thereafter the project transformed into a much broader one on financial statement presentation, which was aimed at replacing IAS 1 *Presentation of Financial Statements* and IAS 7 *Statement of Cash Flows*. In September 2007 the Board revised IAS 1 to require, from January 2009, (among other things) a statement of comprehensive income either as the sole performance statement or as an adjunct to an income statement. In addition, in October 2008 the Board published a discussion paper on presentation in which two major changes were proposed for discussion:

- Complete revamping of the basic financial statements using a ‘cohesiveness plus disaggregation’ approach.
- Requiring the direct method for the statement of cash flows.

In the Board’s view (as noted in the discussion paper), a direct method of presenting operating cash flows is more consistent with the objectives of financial statement presentation than an indirect method, because:

- a. the operating cash receipts and payments that an entity presents using a direct method are consistent with the cohesiveness objective, which helps users to relate information about operating assets and liabilities and operating income and expenses to operating cash receipts and payments.
- b. information about operating cash receipts and payments helps to achieve the disaggregation objective, because that information can be of significant help to users in assessing the amount, timing and uncertainty of an entity’s future operating cash flows.
- c. information about the relationships of operating cash receipts and payments is useful in assessing an entity’s ability to generate sufficient cash from operations to pay debts, reinvest in operations and make distributions to owners. Consequently, a direct method of presenting operating cash flows provides information that is consistent with the liquidity and financial flexibility objective.

On the other hand, the Board also noted that the principal advantage of an indirect method of presenting operating cash flows is that it reconciles profit or loss or net income to net operating cash flows, and many users have asked for that type of reconciling information.

In their responses to the discussion paper and in subsequent outreach activities conducted by the IASB and the FASB, users of financial statements had mixed views regarding the direct and indirect methods of disaggregating operating cash flows. Those who preferred an indirect method noted that an indirect method provides a helpful link between income from continuing operations, changes in some line items in the statement of financial position, and net operating cash flows. They also said that an indirect method clearly presents non-cash operating expenses, such as depreciation.

Even those who favoured the direct method felt that the disaggregation of non-recurring items, capital expenditures and cash flows associated with operating finance liabilities would be the right amount of 'direct' operating cash flow items. The rest of the operating cash flows, in their view, should be presented indirectly as at present.

For the time being, the financial statement presentation project is on hold to allow completion of other projects. Clearly, the direct versus indirect debate will be reopened when the financial statement presentation project is reactivated. Given the divergence of views on the direct method versus the indirect method (including the mixed views of users), it is not possible to predict the direction that the project might take on this issue. Furthermore, some believe that other aspects of the financial statement presentation project—particularly performance reporting, definitions of profit and loss and of other comprehensive income and recycling—are of greater urgency than the statement of cash flows.

I would like to add a comment on the importance the Board attaches to the cash flow statement from the perspective of the *IFRS for Small and Medium-sized Entities* (SMEs). In the exposure draft that preceded the IFRS for SMEs, the Board proposed that a cash flow statement should be a mandatory component of a complete set of financial statements for SMEs. We got a lot of resistance from small companies, saying that they had not been required to prepare a cash flow statement under their local GAAP, and that preparing it would be needlessly complicated and costly. Users of the financial statements of SMEs, on the other hand, consistently argued that a cash flow statement is essential to help them assess liquidity and solvency in making lending and credit decisions about small companies. Despite considerable pressure, the Board kept its requirement for a cash

flow statement (that is, it acknowledged the primacy of relevance) in finalising the standard.

Principle 10: Changes affecting each of the financial statements should be reported and explained on a disaggregated basis.

Paul comment: As noted in my comments on Principle 9, in October 2008, as part of its project on financial statement presentation, the Board published a discussion paper that proposed a complete revamping of the basic financial statements using a ‘cohesiveness plus disaggregation’ approach. In July 2010 the IASB and the FASB posted on their websites a staff draft of an exposure draft that reflected their tentative decisions to date as a basis for extended stakeholder outreach activities. A principle in that staff draft was that an entity must present information in its financial statements in a manner that disaggregates information to explain the components of its financial position and financial performance.

The staff draft went on to describe the disaggregation principle as follows:

An entity shall present information in its financial statements so that:

- a. the activities the entity engages in are clear;
- b. the cash flows of the entity are clear; and
- c. the relationships between an asset or a liability and the effects of a change in that asset or liability are faithfully represented across the statements of financial position, comprehensive income and cash flows.

An entity shall use the following factors in determining the items to disaggregate and present in its financial statements:

- a. the function of the item;
- b. the nature of the item; and
- c. the measurement basis of the item.

In the staff draft, ‘function’ referred to the primary activities (and assets and liabilities used in those activities) in which an entity is engaged, such as selling goods, providing services, manufacturing, advertising, marketing, business development or administration. ‘Nature’ referred to the economic characteristics or attributes that distinguish assets, liabilities, income and expense items and cash flows that do not respond similarly to similar

economic events, such as wholesale revenues and retail revenues; materials, labour, transport and energy costs; or fixed-income investments and equity investments. Finally, 'measurement basis' referred to the method or basis used to measure an asset or a liability, such as fair value or historical cost.

I believe that this proposal is consistent with the objective of Principle 10 in the CFAI Model.

Principle 11: Individual line items should be reported based upon the nature of the items rather than the function for which they are used.

Paul comment: As noted in the previous comments on Principle 10, the results of the Board's tentative decisions in the financial statement presentation project would be to disaggregate information based on both nature and function. I believe that the objective of Principle 11 would be achieved.

Principle 12: Disclosures must provide all the additional information investors require to understand the items recognised in the financial statements, their measurement properties, and risk exposures.

The CFAI Model points out that such disclosures can include, for example:

- Financial reporting methods used.
- Models used for estimation and measurement.
- Assumptions used.
- Sensitivity analyses of point estimates.
- Information about risk exposures.
- Information explaining why changes in important items have occurred.

Paul comment: It might be easiest to consider the IASB's consistency with the objective in this principle by commenting on the examples in the CFAI Model:

- **Financial reporting methods used.** IAS 1 requires an entity to disclose a summary of significant accounting policies. IAS 1 says: 'In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and

conditions are reflected in reported financial performance and financial position. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in IFRSs.'

- **Models used for estimation and measurement.** IAS 1 requires disclosure of the measurement basis (or bases) used in preparing the financial statements. IAS 1 notes: 'It is important for an entity to inform users of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which an entity prepares the financial statements significantly affects users' analysis.'
- **Assumptions used.** Several years ago, the IASB adopted a requirement that an entity should disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (for which separate disclosure is required), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Many IFRSs require disclosure of the key assumptions used in estimating the value of an asset or a liability. For example, for fair value measurements categorised within Level 3 of the fair value hierarchy, IFRS 13 requires a quantitative disclosure of the significant inputs and assumptions used in the measurement.
- **Sensitivity analyses of point estimates.** The IASB has adopted requirements for a number of sensitivity analyses, and several others are under consideration. For example:
 - **General.** IAS 1 points out that determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. Examples include measuring the recoverable amounts of property, plant and equipment, the effect of technological obsolescence on inventories, provisions subject to the future outcome of litigation in progress, and long-term employee benefit liabilities such as pension obligations. For estimates of this type, IAS 1 requires disclosure of 'the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity'.

- **Financial instruments.** IFRS 7 requires all entities—not only financial institutions—to disclose a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date, and the methods and assumptions used in preparing the sensitivity analysis. IFRS 7 also requires disclosure of a sensitivity analysis for each currency to which an entity has significant exposure.
- **Fair value measurement.** Our new IFRS 13 requires, for recurring fair value measurements categorised within Level 3 of the fair value hierarchy (ie measures that use unobservable inputs), a ‘narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement’. IFRS 13 also requires a quantitative sensitivity analysis disclosure for financial instruments in Level 3.
- **Insurance.** Insurers are already required by IFRS 4 to disclose either (a) a sensitivity analysis that shows how profit or loss and equity would have been affected if changes in the relevant risk variable that were reasonably possible at the end of the reporting period had occurred, along with the methods and assumptions used in preparing the sensitivity analysis, or (b) qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer’s future cash flows. The Board’s current insurance contracts proposals would carry those disclosures forward.
- **Defined benefit obligations.** IAS 19 will be amended in mid-2011 to require an employer that sponsors a defined benefit plan to provide an indication of risk by disclosing how the effect of a change to the actuarial assumptions that is reasonably possible at the end of the reporting period would have affected the defined benefit obligation at the end of the reporting period. An entity must provide this disclosure for all significant actuarial assumptions where a reasonably

possible change would have a material effect on the defined benefit obligation.

- **Information about risk exposures.** Almost every recent IFRS has required this type of disclosure. To use financial instruments as an example, IFRS 7 requires quantitative disclosures about credit risk, liquidity risk, and market risk. IFRS 7 also requires qualitative disclosures about exposures and risk management policies for each type of risk arising from financial instruments. Just recently the Board issued IFRS 12 *Interests in Other Entities*. Among other things, that standard requires disclosures about:
 - The nature of the risks associated with an entity's interests in consolidated structured entities.
 - The nature of the risks associated with an entity's interests in unconsolidated structured entities.
 - Risks associated with an entity's interests in joint ventures and associates.
- **Information explaining why changes in important items have occurred.** In late 2010, the IASB issued a pronouncement entitled IFRS Practice Statement *Management Commentary*. This is the Board's first foray into an area of financial reporting outside the financial statements. While not an IFRS, the Practice Statement offers guidance on preparing and presenting a management commentary—a narrative report accompanying financial statements that have been prepared in accordance with IFRSs. The management commentary provides users with historical and prospective commentary on the entity's financial position, financial performance and cash flows. It also provides management with an opportunity to explain their objectives and their strategies for achieving those objectives. Users of financial reports routinely use the type of information provided in a management commentary to help them evaluate an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives.

Paul Pacter is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.