

Articulation, profit or loss and OCI in the IASB Conceptual Framework: different shades of clean (or dirty) surplus

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Life-changing Learning
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Aim of this paper and presentation

To convince the IASB to review the 2015 IASB CF ED in order to:

1. provide a definition of profit (as one of two basic concepts)
2. adopt the appropriate approach to articulation (direct or indirect)
3. clarify its approach to recognition and measurement.



Structure of the presentation

1. Profit in the 2015 ED
2. Synthesizing concepts of profit and approaches to the determination of profit in the literature
3. Critiquing profit or loss and OCI in the 2015 IASB CF ED
4. Suggestions for improving the 2015 IASB CF ED
5. Conclusion



1. Profit in the 2015 IASB CF ED (1/2)

1. Profit is not defined as an element of the financial statements
2. Valuation approach to the determination of income → all-inclusive (comprehensive) income. **But not clean surplus equity?**
3. Separate disclosure of profit or loss and OCI (and retained earnings and accumulated OCI). **But no conceptual basis for distinction between items in profit or loss and items in OCI, or for recycling.**



1. Profit in the 2015 ED (2/2)

- There is a rebuttable presumption that profit or loss is all-inclusive (IASB, 2015a: 7.23). Income and expense and expense items related to assets and liabilities measured at **historical cost** are included in profit or loss → no rebuttal.
- For those measured at **current values**, this presumption can be rebutted ‘by IASB, and only the IASB’ (IASB, 2015b: BC7.43), when the IASB concludes that excluding items from profit or loss would enhance the **relevance** of the information in the statement of profit or loss for the period (IASB, 2015b: BC7.43).
- If there is no conceptual distinction between profit or loss and OCI, how does relevance provide a conceptual basis for making this distinction?



2. Concepts of profit and the determination of profit (1/6)

Two basic concepts of profit (adapted from Barker 2010):

Not meaningful differences among equity	Profit (ret earn) is fundamentally different
profit = income – expenses = Δ equity	profit = income – expenses = Δ retained earnings
Δ equity = Δ net assets	Δ retained earnings $\stackrel{?}{=} \Delta$ net assets
If CV: Unrealised items in retained earnings	If CV: Unrealised items in dirty surplus
If CV: No capital maintenance adjustments	If CV: Capital maintenance adjustments
No recycling	Recycling to maintain indirect articulation
Clean surplus/Dirty profit in retained earnings	Dirty surplus/Clean profit in retained earnings



2. Concepts of profit and the determination of profit (2/6)

Law of conservation of income:

‘Total lifetime income of a firm is invariant to changes in accounting methods for the purpose of financial reporting’.

‘This *Law of Conservation of Income* always holds as long as income is calculated using a **clean surplus rule**: All changes in owners’ equity, except the transactions with the shareholders themselves, must pass through the income statement’ (Sunder, 1997: 67).

An argument for the **articulation** of financial statements.



2. Concepts of profit and the determination of profit (3/6)

$$\sum \text{economic income} = \sum \text{accrual accounting profit} = \sum \text{cash profit}$$

Accrual accounting profit = cash + accruals → the allocation problem in financial accounting

The two ideal approaches to income determination:

- **Transactions approach – realized profit** → retained earnings may only include realized gains and losses
- **Valuation approach – accretion income** → retained earnings may include unrealized gains and losses

$$\sum \text{economic income} = \sum \text{accretion income} = \sum \text{realized profit} = \sum \text{cash profit}$$



2. Concepts of profit and the determination of profit (4/6)

Accretion concept of income

Δ in value of asset or liability objectively measurable (Phillips, 1973)

Realization concept of income

Δ in value of asset objectively measurable

Δ in value of asset confirmed by transaction or event

Δ in value of asset permanent (goods or services delivered)

(Horngren, 1965)

Expense recognition through product or period matching. Barker and Penman (2017) describe other forms of matching.



2. Concepts of profit and the determination of profit (5/6)

In reality neither ideal approach works because of different business models and different constituents' preferences:

- **Valuation approach:** The IASB/FASB revenue recognition project and IFRS 15 (Wagenhofer, 2014).
- **Transactions approach:** The ASBJ 2006 Conceptual Framework DP invented the 'released-from-risk' recognition criterion (ASBJ, 2006).



2. Concepts of profit and the determination of profit (6/6)

Two types of compromise:

Compromises based on valuation approach and direct articulation

Barker & Penman (2016/17 WP) Combines Penman's ideas about FV and clean surplus with a classification of 4 different forms of matching.

Compromises based on transactions approach and indirect articulation

1. Horngren (1965) Liberal recognition, strict realization
2. US GAAP standards
3. ASBJ (2006) and Nishikawa (2013) Dual measurement and recycling.



3. Critiquing profit or loss and OCI in the 2015 IASB CF ED (1/2)

1) Relevance as the conceptual basis for rebutting the presumption that profit or loss should be all-inclusive

The ED discusses recognition mainly in respect of assets and liabilities.

Factors to consider when selecting a measurement basis:

- how that asset or liability contributes to the entity's future cash flows (IASB, 2015a: 6.54a),
- the riskiness of the asset or liability such as its cash flow variability and its sensitivity to changes in market factors (IASB, 2015a: 6.54),
- the level of measurement uncertainty (IASB, 2015a: 6.55), which is not the same as, but is sometimes intensified by outcome uncertainty (IASB, 2015a: 6.56).

No hierarchy of factors to clarify the concept of **relevance!**



3. Critiquing profit or loss and OCI in the 2015 IASB CF ED (2/2)

2) The ED suggests both mixed measurement and dual measurement (which implies dual recognition/dual financial performance/dual financial position).

Because of the business model and riskiness of the asset or liability, in respect of some assets or liabilities, dual measurement provides **more relevant** information than using a single measurement basis.

This results in the change in current value of the asset or liability being split into the income or expense measured at historical cost in the statement of profit or loss and the remaining income or expense amount presented in OCI (IASB, 2015: 6.77).

Dual measurement without adopting the realization concept as basis for the distinction between profit or loss and OCI, or for recycling, mixes up the two basic concepts of profit.



4. Suggestions for improving the 2015 IASB CF ED (1/4)

1. To compromise between valuation and transactions approaches

- Valuation approach / all-inclusive profit / clean surplus equity / **mixed measurement / direct articulation**

Compromise by providing strict approach to mixed measurement, meticulous disclosure about realization and matching, but accept some unrealized gains and losses in retained earnings (e.g., Barker and Penman, 2017).

- Transactions approach / realized profit / realized retained earnings / **dual measurement → indirect articulation via recycling**

Compromise by adopting comprehensive income as secondary concept, distinguish between profit or loss and OCI, and between retained earnings and accumulated OCI, and use **recycling** to maintain indirect articulation between profit or loss and retained earnings.



4. Suggestions for improving the 2015 IASB CF ED (2/4)

2. Clarify approach to the selection of a measurement basis:

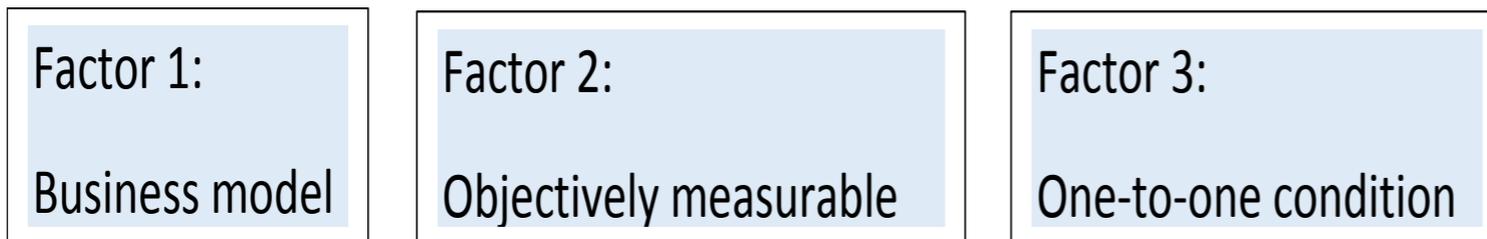
- a) Clarify when FV and HC are appropriate via a hierarchy of three factors: (1) **business model**, (2) **objectively measurable**, and (3) Penman's **one-to-one condition***.
- b) For cases to which these factors does not neatly apply: use the deprival value decision rule to determine which current value measurement basis—**replacement cost**, **net realisable value** or **value-in-use**—provides relevant information about risk exposure of assets (and liabilities).

*Penman's (2007) three conditions: business model, one-to-one condition, match FV of assets with FV of jointly used liabilities to create shareholder value.



4. Suggestions for improving the 2015 IASB CF ED (3/4)

2. Under either concept of profit, selection of a measurement basis:



Transformation: → **Historical cost** (in case of impairment: deprival value)

Speculation: → Fair value? – Observable market price?

No: **Deprival value**

Yes: → One-to-one condition (exit price = entry price?)

No: **Deprival value**

Yes: **Fair value**

Unclear/both: → **Deprival value** = the lower of replacement cost and recoverable amount (ra)

(ra = the higher of net realisable value and value in use)



4. Value to the business or the deprival value rule (4/4)

Deprival value applied to liabilities is called ‘relief value’.

Nobes (2011: 522) suggests that those liabilities with active markets could be measured at fair value. Relief value for liabilities without active markets should be the cost of performance, unless the cost of release or the cost of transfer can be shown to be lower.



5. Conclusion

The 2015 IASB CF ED does not define a concept of profit and therefore its compromise between the valuation and the transactions approaches mixes up the two basic ways of compromising. Did the IASB do this by mistake, or for political or other reasons?

Questions to answer:

- Why, and in what ways, are all-inclusive profit (and direct articulation) or permanent retained earnings (and indirect articulation) necessary for **decision-usefulness** and/or **stewardship** purposes?
- Which constituents does the IASB need to satisfy more urgently? (FASB/SEC or EFRAG/ASBJ)



The end

Thank you