The dangers of ignoring unrealised income

Speech by Hans Hoogervorst, IASB Chairman

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It is a great pleasure to be in Tokyo again and I thank our host KPMG for co-sponsoring this important conference with the IFRS Foundation.

I intend to discuss two issues with you today: first I will tell you about our most recent insights in the use of IFRS around the world. Of course I will discuss in more detail recent developments in Japan. Secondly, I want to discuss with you in depth one of the most important issues in our discussions on the new *Conceptual Framework*: namely the meaning of Profit or Loss and Other Comprehensive Income (OCI).

The use of IFRS around the world

I think it is fair to say that the spread of IFRS around the world has been an astonishing success. Ten years ago, nobody used IFRS, now it has spread to all corners of the world. Recently, we published a pocket book which gives a very precise picture of the actual use of IFRS around the world and you can also find this information on our website.

Of the 130 jurisdictions we have researched thus far, 107 require the use of IFRS for all or most companies. 13 more permit the use of IFRS in their jurisdiction.

In Asia-Oceania, the dynamics for IFRS are still strong. Of course, Australia and New Zealand are fully on board. So are Asian tigers like Korea, Malaysia, Singapore and Hong Kong. China has not yet adopted, but its standards are very close to IFRS and the Chinese government is committed to full convergence as a final goal. Moreover, many Chinese companies that have a listing in Hong Kong report in full IFRS to attract foreign investors.

The use of IFRS in Japan

Japan is an extremely interesting case in terms of the adoption of IFRS. In almost all jurisdictions, adoption of IFRS was made obligatory to all listed firms by a decision of public officials. As you know,

in Japan it is a matter of choice for individual firms to adopt or not. So Japanese companies will only choose to adopt IFRS if they think it is a strong business case.

This is now happening at a rapid pace. The number of IFRS adopting companies in Japan has more than doubled from 20 to 44 over the past year. The Keidanren expects about 60 companies, representing 20% of the Tokyo market cap, to have adopted IFRS by the end of next year. So Japan is getting there.

The Japanese companies that have adopted IFRS tell us they did it for the following reasons. First, for companies with many subsidiaries around the world, it is simply cost effective to have one single financial reporting language for both internal and external reporting. Using IFRS also makes it easier for Japanese companies to communicate with investors around the world. These investors do not necessarily understand the intricacies of Japanese GAAP, but they do understand IFRS. So the use of IFRS will make it more attractive to foreign investors to invest in Japanese shares. The receptive climate for IFRS in Japan is also due to the very constructive engagement by both the ASBJ and the Japanese FSA. The IASB is very grateful for their efforts.

The IASB has noticed with great interest the recent exposure draft by the ASBJ of a new set of Japanese accounting standards, the so-called Japan's Modified International Standards (JMIS). The JMIS in essence consist of most IFRSs as issued by the IASB combined with two major modifications as proposed by the ASBJ. These two modifications relate to the treatment of Goodwill and recycling of some OCI-items.

I know the ASBJ has worked very hard to produce JMIS in a very short period of time and I commend my colleagues for their efforts. Also, it is commendable that the differences with IFRS have been kept very small. Currently, there are many more differences between Japanese GAAP and IFRS than these two issues, so the proposed modifications could have been much more numerous.

What now remains to be seen is to what extent Japanese Modified International Standards will be an attractive option for Japanese companies. I know that many Japanese companies feel very strongly about the amortisation of Goodwill and recycling of all OCI items. For some of them, JMIS might be a serious option, perhaps as an intermediate step to full IFRS adoption.

The drawback of JMIS, however, will be that they will not be recognised by foreign investors as IFRS, simply because JMIS differ from IFRS. Even when such differences are small, they tend to confuse

investors. Also, a company reporting in JMIS would continue to work with two different accounting languages, one for its Japanese activities and another for its subsidiaries abroad.

So a company that decides to adopt JMIS would have to incur all the costs of conversion to new accounting standards, without gaining the full benefits of IFRS in terms of cost reduction and improved international investor relations. For that reason, my preliminary expectation would be that for the majority of Japanese companies that are a considering a change in accounting standards, adoption of IFRS will probably remain the more attractive option.

Finally, I would like to remark that both the issues of Goodwill and recycling will be considered very seriously in the Post-implementation Review of business combinations and our work on the *Conceptual Framework*.

The *Conceptual framework*

This brings me to our current work on the revision of the *Conceptual Framework*. One of the most difficult issues in our work on the *Conceptual Framework* is the question how to distinguish between Profit or Loss on the one hand and Other Comprehensive Income on the other.

In our discussions thus far, we have not been able to draw a binary distinction between Profit or Loss and OCI. We have not discovered one single principle which would lead items of income to fall into either category through an automatic or even semi-automatic process. Still, I believe that the significance of some of our tentative decisions should not be underestimated.

First of all, we have defined Profit or Loss as the "primary source of information about the return an entity has made on its economic resources in a period". This means that we see Profit or Loss as the most relevant source of information on the performance of the reporting entity in a time period.

For the IASB this represents a shift from a previously held position. In the recent past, the Board originally expressed a preference for a single statement of performance in which there was no clear hierarchy between Profit or Loss and OCI. So the fact that the IASB has now identified Profit or Loss as the primary source of information on an entity's performance in a time period can be seen as a 'rehabilitation' of the P&L.

I think this is a wise decision. We should not underestimate the degree to which the markets, both professional and unsophisticated investors, rely on Profit or Loss. When companies issue their

quarterly or annual statements, the headlines usually focus on Profit or Loss. Profit or Loss is the basis of many ‘buy-or-hold’-decisions. It is also the basis for commonly used valuation techniques such as the Price/Earnings ratio. In sum, we should not underestimate the need of the markets for Profit or Loss as a summary performance indicator.

If we agree that Profit or Loss is the primary indicator of performance, it needs to be robust. The ASBJ has tried to capture this robustness in its definition of Profit or Loss, namely: ‘Profit or Loss represents an all-inclusive measure of irreversible outcomes of an entity’s business activities in a certain period.” According to this definition, Profit or Loss should be both ‘all-inclusive’ and ‘irreversible’.

Later on in my speech I will give you my thoughts on the notion of ‘irreversibility’, which I think is problematic. However, I am very sympathetic towards the notion of ‘all-inclusiveness’. I completely agree with the ASBJ when they state that: “From the perspective of stewardship, financial statements should be all-inclusive and any profit or loss should be disclosed even if certain transactions or events are considered non-recurring (…)”

Indeed, a non-recurring event, such as a provision for a restructuring, can still have a large impact on profits and dividends. Furthermore, “one-off” items of income often signal dramatic shifts in strategy or market conditions of an entity. So Profit or Loss should be as all-inclusive as possible to make sure that nothing of interest escapes the attention of market participants.

If we accept that Profit or Loss is the primary indicator of performance in a time period and that it should be as all-inclusive as possible, what does that mean for the use of OCI?

In its June meeting, the IASB decided that there should be a rebuttable presumption that all items of income and expense should be included in Profit or Loss, unless the IASB concludes in a particular Standard that including an item in OCI enhances the relevance of Profit or Loss in that period. I think the significance of this principle has also not been fully appreciated. It implicates clearly that the standard-setter has to pass a high hurdle when resorting to OCI.

So far, so good, but the question then becomes how high the hurdle to the use of OCI should be and how exactly it should be defined. This is where things become complicated.

In the past, the IASB has made a number of seemingly ad hoc decisions on the use of OCI. Although these decisions were taken without the guidance of an overarching principle, I believe many of them made a lot of sense. One example is cash flow hedges, where OCI is used to temporarily park the

value changes of derivatives until the forecast transaction is completed. Without the use of OCI, accounting for cash flow hedges simply does not make sense.

Another example is foreign currency translation of a foreign operation, in which OCI serves as a 'plug' between year-end and average exchange rates. Most will agree that including this plug in Profit or Loss would not lead to relevant performance information.

Besides this collection of 'assorted plugs', the Board has identified a more homogeneous category of possible uses of OCI. This is the category of dual measurement. Dual measurement occurs when the IASB concludes that one measurement basis is appropriate for the statement of financial position and another measurement basis is appropriate for Profit or Loss. In these cases OCI serves as the bridge between Profit or Loss and the balance sheet.

A good example is the FV/OCI category for debt investments in IFRS 9 *Financial Instruments*. As the business model of this category is to both collect contractual cash flows and to sell, both amortised cost and fair value information are deemed to be relevant, whereby OCI serves as the bridge between the two. If the use of dual measurement is deemed defensible conceptually, then the use of OCI in this case follows logically.

The IASB also considered, and rejected, an even broader approach to the use of OCI. Such an approach would be based on the view that most elements of unrealised income are best presented outside profit or loss. Such unrealised income could result from periodic remeasurements of long-term assets or liabilities. These can reverse fully or significantly over the holding period. In this view, income with such a high degree of outcome uncertainty should not be included in Profit or Loss as long as it is not realised. The pension liability or assets held with a long-term horizon could be candidates for OCI in this broad approach.

For the ASBJ the outcome uncertainty of unrealised income is an important reason for the possible use of OCI. For the ASBJ, the robustness of Profit or Loss does not only mean that it should be 'all-inclusive', but also that should be what it calls 'irreversible'.

The ASBJ explicitly refers to the Stewardship principle in its proposal to classify such long-term assets and liabilities in OCI. Not only in Japan, but around the world, many point to the dangers of including unrealised components of income in Profit or Loss. They point out that inclusion of unrealised income may lead to unwarranted increases in compensation and dividends.

While this broad approach to OCI certainly has an intuitive appeal, I believe it is fraught with difficulties. I think that a systematic relegation of unrealised income items to OCI can result in a lack of faithful presentation. I also think it can be detrimental from a stewardship perspective. Let me explain why.

First of all, unrealised income does not only consist of gains, but also of losses. Downplaying the significance of unrealised losses can be very hazardous.

A very real example of the dangers of OCI is what happened in the first decade of this century with some big American car manufacturers and airline companies. Their employee benefit schemes had caused huge liabilities to build up in Accumulated OCI. Although unrealised, these deficits were not unreal. Indeed, they were an important ingredient in the bankruptcy of some of them.

Table 1

The dangers of OCI
Equity and Defined Benefit Plans

General Motors - 2008 ($B)

Shareholders' Equity (Dr)/Cr	
Total Equity	AOCI
(85)	(32)

Delta Airlines - 2005 ($B)

Shareholders' Equity (Dr)/Cr	
Total Equity	AOCI
(9.9)	(2.7)

United Airlines – 2002 ($B)

Shareholders' Equity (Dr)/Cr	
Total Equity	AOCI
(2.5)	(2.7)

The steady increase of these liabilities did not hit Profit or Loss. Arguably, these problems would have been confronted much earlier on if they had been presented in Profit or Loss. The companies in question would have probably been forced to retain more of their earnings at the expense of dividends. So from a stewardship perspective, the use of OCI for unrealised employee benefits had dramatic consequences.

Postponement of recognition of losses until they have become irreversible has one big disadvantage, namely that they have indeed become irreversible!

This is the very reason why in the case of derivatives we chose a very different treatment of unrealised income. Derivatives can remain unrealised for a long time and their value can be volatile and reversible. Still, presenting them in OCI has never been considered a serious option, except in the context of hedge accounting.

The decision to measure derivatives at fair value through Profit or Loss was very much inspired by the wish to make their impact clearly visible. This accounting treatment was chosen after some highly visible accidents, such as the bankruptcy of Orange County in 1994. These incidents had clearly demonstrated that derivatives could indeed be ‘weapons of mass destruction’. Full exposure of their possible impact to the sunshine of Profit or Loss was thought to be the best disinfectant.

Theoretically, it would be possible to address the dangers of unrealised income by presenting unrealised profits through OCI and unrealised losses through Profit or Loss. In fact, many central banks do this in practice in order to keep part of their profits out of reach of the greedy hands of Ministers of Finance. However, this would lead to an extreme bias, indeed a complete asymmetry in financial reporting. Faithful presentation of economic reality would get lost and investors would completely lose track of the performance of a company.

Clearly, excluding unrealised elements of income from Profit or Loss is not without risks. The dangers of unwarranted profit-taking are better addressed through regulatory or legal restrictions around dividends and remuneration, which is common practice in many jurisdictions. Accounting can help in identifying those parts of income which have a highly uncertain outcome but it should not end up hiding potentially risky developments.

I would conclude that a systematic relegation of unrealised profits or losses to OCI is extremely problematical. Moreover, where OCI is used to capture short-term ‘market volatility’ of long-term assets or liabilities, the information it contains should not be ignored. While income in OCI may be of a less certain nature than income captured in Profit or Loss, OCI may contain indicators of risk that

may materialise sooner than you think. Clearly, ignoring unrealised elements of income may be hazardous to your financial health.

Finally, I would like to make a comment on recycling that will sound like music to many Japanese ears. The majority of the IASB decided that, given the primacy of Profit or Loss, there should be a rebuttable presumption that all items included in OCI should end up being recycled in Profit or Loss.

But before you start lighting bonfires, I would like to point out that this decision does not automatically mean that in all our Standards recycling will become the rule. There may be circumstances in which recycling may be too complex for it to be applied in a meaningful manner.

I would also like to point out that recycling does not necessarily solve the problems of unrealised income staying hidden too long. The example of employee benefits liabilities I just gave is a case in point. Under US GAAP, they would ultimately all have been recycled in Profit or Loss, but clearly it did not happen in a timely fashion. Nevertheless, the decision making of the IASB is a clear signal that recycling should be the rule rather than the exception. On this festive note, I would like to conclude my speech.