IASB Speech

The big question of measurement

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Introduction

Ladies and Gentlemen,

Today, I would like to discuss with you a few interrelated items of our Exposure Draft of the *Conceptual Framework*. You know the *Conceptual Framework* is an extremely important document, since it provides the underlying principles of the standard setting by the International Accounting Standards Board (IASB). Our constituents care a lot about the philosophy with which the IASB conducts its standard-setting, so many people follow our work on the *Conceptual Framework* with great interest.

I will first discuss the measurement chapter of our Exposure Draft and make some general observations about the relative strengths and weaknesses of historical cost and current measurement. I will build on a speech I gave earlier this year in Paris on this issue. More specifically, I will speak about the measurement of long-term investments. I will then go on to talk about the importance of the Statement of Profit or Loss and the use of Other Comprehensive Income (OCI).

Historical cost or current value?

So let us start with measurement. In our Exposure Draft, we describe two basic categories of measurement techniques: historical cost on the one hand and current value on the other. Within the current value category it is fair value accounting that generates most controversy. Fair value and historical cost are at the opposite ends of the measurement spectrum, with fair value demanding a full updating of all variables, while historical cost requires only intermittent and irregular updating.

The fans of historical cost like it for its alleged objectivity and relative stability. They dislike fair value for the volatility resulting from changes in market prices. They also tend to believe fair value accounting is more prone to abuse, because it can be subjective, especially when relying on model based measurement.

The fans of fair value like it for the very reason that it does require a full update of all inputs at each reporting date. They believe this gives the most meaningful picture of the financial position and performance of an entity. They consider historical cost to be a primitive measurement basis that provides information that very quickly becomes outdated.

Let me first explain why I think the dichotomy between historical cost and fair value is not as stark as one would expect. First of all, for many transactions, historical cost starts and ends with fair value (or values that come very close to it): the original purchase price and the selling price of an asset or liability. The dates of purchase and sale are when historical cost is most objective.

Secondly, despite its name, historical cost gets updated too, albeit less so than fair value. A common updating of historical cost is depreciating Property, Plant and Equipment. Depreciation is an allocation of cost to reflect the consumption of an asset during its economic life. This is an assessment that certainly is not free from subjectivity.

Subjectivity in historical cost accounting is even more pronounced when an asset is impaired. Then, an estimate of its value-in-use usually is made. That estimate is based on management's estimates of future cash flows which are certainly no less subjective than mark-to-model valuations. With this subjectivity, there is also room for abuse. Practice has shown many instances of 'big bath' impairments by new CEOs that then may be used to bolster earnings in future years.

In conclusion, historical cost is to some extent based on fair value; it needs a degree of current measurement to maintain its relevance, it is not free from subjective updating requirements; and it is also vulnerable to abuse. In sum, all the vulnerabilities that are often attributed to fair value accounting can be equally pertinent to historical cost accounting.

Mixing the models

Despite all these shortcomings of historical cost accounting, the IASB has not opted for current value measurement in general, or fair value in particular, as the default measurement basis. For many economic activities, we are not convinced that using fair value for measurement would lead to relevant information. The main reason is that the current market price of many assets is not of primary importance if such assets are being used in combination with other assets to produce goods or services. For example, it may not be extremely relevant to know the present market value of the robots of a car manufacturer if the company intends to keep them to produce cars. Using fair value, with its frequent updates, can also be a costly exercise compared to cost accounting. So its use must be justified in terms of cost/benefit.

However, for assets that are actively traded, fair value tends to be much more relevant than historical cost. For example, financial instruments that are held for trading must be measured at fair value and this usually generates little controversy.

But it is not enough to just look at how a company uses an asset. Equally important can be the characteristics of the asset or the liability, for example the sensitivity of its value to changes in market prices or to other risks inherent in the item. In case of derivatives, for example, measurement at historical cost makes no sense even if they are not held for trading purposes. Derivatives can expose a company to volatile risks, which can only be properly measured using fair value.

In my speech earlier this year in Paris, I formulated three high-level principles that can be used in selecting either historical cost or current value as a measurement basis.

- If the nature of business activities is to use assets in combination with other assets to produce goods or services, this generally points in the direction of historical cost
- If the nature of business activities is to trade assets or liabilities in active markets, this would generally point in the direction of current value measurement
- If an asset or a liability is highly sensitive to market factors or to other risks in the item, this would generally point in the direction of current value measurement.

Cash conversion cycles

Today I would like to make an additional observation on this issue, which is that historical cost works best for business activities with relatively short cash conversion cycles. In such circumstances, assets and liabilities tend to get refreshed relatively frequently, which means that historical cost retains much of its relevance. For most business activities which have relatively short cash conversion cycles historical cost, despite its shortcomings, will do just fine.

Conversely, for assets and liabilities with very long duration, historical cost tends to be less relevant. Although it may be interesting to know what you paid for an equity investment years ago, its historical cost obviously tells you little about its current value. So, the longer the timespan of business activities, the less relevant historical cost becomes.

This is the main reason why we have chosen current measurement as the predominant measurement basis for long-duration liabilities such as the pension and insurance liability. Obviously, it does not make sense to discount such liabilities with historical interest rates. The Fed Fund rate was around six per cent at the beginning of this century. Discounting a life insurance liability incurred in 2001 at this historical rate clearly does not provide a faithful representation of the present economic reality in which interest rates are close to zero.

Interestingly, there are some who plead for historical cost as the predominant measurement basis for long-term investment in financial instruments. This school believes that historical cost adequately reflects the revenue streams that such long term investments generate. In this line of reasoning, capital appreciation is of secondary relevance and should only be recognised in Other Comprehensive Income. Only when the assets are sold, the accumulated capital appreciation in OCI will be recycled through Profit or Loss.

The underlying thought is that changes in market value of long term investments can be volatile in the short run and that they could cloud the measurement of the performance of a company when included in Profit or Loss. The proponents of this approach argue that the discerning investor can find information on the changes in market values in OCI.

I am not convinced by this line of reasoning. First of all, I do not think that capital appreciation is a secondary objective to most long-term investors. The most successful long–term investor of all times –Warren Buffet–always shows capital appreciation as the leading performance indicator of Berkshire Hathaway. It is also clear that most long-term investors pay very close attention to short-term fluctuations in their investments, even if their intention is to hold on to them for the long term. After all, they can never know if a short term movement is the beginning of a long-term trend which requires an adjustment in their investment portfolio.

But even without blatant manipulation, this accounting treatment of long-term investments can lead to odd effects. Suppose a company is planning to sell an investment that it acquired 30 years ago. All the capital appreciation that has accumulated gradually over the years would be recognized as profit in the year in which the investment is sold. I think this abrupt recycling of profit from OCI does not properly reflect performance of the company in that particular year.

Profit or Loss - the primary source of information

Let me now discuss some other aspects of OCI. Having talked to a lot of investors in the last couple of years, I have been struck by how many of them have told me that they pay little attention to OCI and solely focus on the statement of Profit or Loss. The growing realisation that users have trouble understanding OCI has led the IASB to some important conclusions in the Exposure Draft of the *Conceptual Framework*. First of all, we have defined Profit or Loss as the "primary source of information about an entity's financial performance 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 clearly stated that it sees 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.

If we accept that Profit or Loss is the primary indicator of performance in a time period, there should be a presumption that all income and all expenses will be included. Our Exposure Draft mentions that income and expenses can only be excluded from the statement of Profit or Loss when doing so would enhance the relevance of the information in that statement for the period. In short, there must be a high hurdle for the use of 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 Discussion Paper which preceded the Exposure Draft of the *Conceptual Framework*, we included some possible principles for the use of OCI. Unfortunately, these proposals did not seem to resonate with many; perhaps people needed more time to digest our ideas.

I still think that parts of the Discussion Paper contained excellent analysis on circumstances in which the use of OCI enhances the relevance of Profit or Loss. I am thinking specifically on the section which describes so-called 'mismatched remeasurements'.

When OCI is useful

One example of such a mismatched remeasurements are cash flow hedges. In cash flow hedges, OCI is used to temporarily park the value changes of derivatives until the forecast transaction that is being hedged is completed. Without the use of OCI, cash flow hedge accounting simply does not make sense.

OCI can also be useful when accounting leads to clearly counter-intuitive outcomes. One example is the fair value of own credit. When an entity is in trouble, the fair value of its own credit will decline. This will lead to an artificial increase in earnings, because the entity will normally not be able to buy back its own debt at a discount, at least not as long as it is a going concern. The use of OCI is clearly justified in this case.

These are examples in which the application of OCI is more or less clear cut. Most other applications of OCI, however, give rise to some degree of ambivalence. Yes, the use of OCI for the pension liability avoids short term volatility in Profit or Loss. But is it right to allow the cost of employee benefits to build up in OCI, without hitting Profit or Loss, while they have shown to be capable of bankrupting companies?

Equally, the use of OCI for changes in the discount rate of insurance liabilities prevents volatility in earnings. This can help to distinguish more clearly between the underwriting performance of an insurance company and the impact of macro-economic variables. But isn’t the current interest rate environment capable of severely depressing the profitability of the insurance industry? Is OCI really the best place to show the possibly devastating impact of low interest rates? Many insurers have told us they prefer to report the changes in the discount rate in Profit or Loss, and we have decided to introduce an option to do so.

Close

Measurement and the use of OCI will be two of the main topics we will be discussing with our constituents in our outreach around the world on the *Conceptual Framework*. We hope you will join us in debating these important issues and in helping us bringing the *Conceptual Framework* forward.

I thank you for your attention.