

Framework rethink will shape the landscape for investors

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On 18 July 2013, the IASB published a Discussion Paper which proposes changes to its conceptual framework for financial reporting. The name alone may cause many of you to assume this to be a somewhat theoretical exercise of interest only to accounting geeks with seemingly little relevance to investors. However, this is far from being the case. While a framework for financial reporting is not in itself an accounting standard, the decisions taken now will have far-reaching consequences because the IASB will use the revised framework as it develops new and revised Standards (IFRS).

Background

The framework covers issues such as:

- a) the objective of financial reporting, including a description of who financial reports are aimed at;
- b) the characteristics of useful financial information;
- c) the definitions of the elements of financial reports, such as assets, liabilities and equity, and income and expenses;
- d) when assets and liabilities should be included in the statement of financial position (balance sheet) and how they should be measured; and
- e) how income and expense should be presented in profit or loss and other comprehensive income.

It is important to note that the primary purpose of the framework is to help the IASB set Standards that meet the needs of investors. Thus, the framework has a significant influence on financial reporting. As a result, input from investors at this early stage is of great importance and the IASB is making significant efforts to involve investors in this crucial process.

The framework also has a secondary role: preparers of financial statements are required to consult the framework when they decide how to account for transactions or events that are not covered by IFRS. However, because of the increasingly comprehensive nature of IFRS, such scenarios are relatively rare.

The IASB already has a framework, but it is incomplete and needs updating. Previous work in 2010 led to new descriptions of the objective of financial reporting and the characteristics of useful financial information. This Discussion Paper focuses on filling in gaps and updating the existing framework.

Impact to investors

For this short article I wanted to highlight two key issues covered in the Discussion Paper that are likely to be of particular interest to investors and that could also result in changes to Standards sooner rather than later¹. These are:

- 1) the reporting of performance, including what should be reported in profit or loss and what should be reported outside profit or loss in other comprehensive income; and
- 2) the accounting for items classified as equity and the dilutive effects of some financing instruments on common shareholders.

Performance reporting and other comprehensive income (OCI)

Issue

Most investors will be aware that not all items of income and expense are included in profit or loss. Some items of income and expense (mainly unrealised remeasurements) are reported as other comprehensive income (OCI). This is in effect a secondary category of income which is not included in earnings per share (EPS) and which, as a result, generally gets less attention from investors.

There are some who regard the distinction between profit or loss and OCI to be artificial in that both include items of income and expense (eg gains

¹ Any proposal to change an existing IFRS would need to go through the IASB's normal due process (including a formal decision to add the project to the IASB's agenda).

and losses). They believe that gains and losses can have a variety of characteristics and that it would be better to fully describe these characteristics within a single statement of comprehensive income, which might well include one or more subtotals, but where there is no special status given to profit or loss.

The IASB does not subscribe to this view because it believes that the distinction between profit or loss and OCI provides useful information. Therefore the IASB believes that it is appropriate to preserve the current special status of profit or loss and recognise certain gains and losses outside of profit or loss (ie in OCI). However, this leaves open the question of what exactly OCI is and what it should comprise. In the Discussion Paper, the IASB considers how it could resolve this issue. The IASB has initially concluded that trying to define profit or loss is unlikely to provide a solution and that instead the framework should describe when the use of OCI might be appropriate. Individual Standards would then provide the detail about exactly what should be reported in OCI.

Closely related to the question of what is reported in OCI is whether, in a subsequent period, there should be a 'reclassification' or movement of the gain or loss into profit or loss (some call this 'recycling'). Under current IFRS, some items in OCI are reclassified and others are not. For example, a foreign currency translation difference arising when a foreign subsidiary is consolidated by its parent company is reported in OCI in the period when the difference arises. The cumulative gain or loss is then removed from OCI and reported in profit or loss when either the subsidiary is sold or its activities are discontinued. However, the IASB took a different approach for defined benefit pension plans: actuarial gains and losses are reported in OCI but are not subsequently reclassified to profit or loss.

Decisions about the use of OCI and whether to require reclassification of items reported in OCI have been made in individual Standards over many years. While these decisions were not made at random, most would agree that the conceptual basis for each decision is not necessarily consistent with other decisions and that this is an area that would benefit from a better framework.

Potential solutions

To address this issue, the Discussion Paper identifies three broad categories of income and expense that might qualify for recognition in OCI:

- a) **Bridging items:** these arise when the IASB decides that an asset or a liability should be remeasured in the balance sheet, but that information in profit or loss should be based on a different measurement. Cumulative OCI is then the difference (the bridge) between the two measurements. Recycling these amounts would be a direct consequence of the measurement basis used to determine the amounts reported in profit or loss. An example of a bridging item is the proposed 'fair value through OCI' classification for financial assets (ie some financial assets would be measured at fair value in the balance sheet, but measured at amortised cost for determining profit or loss)².
- b) **Mismatched remeasurements:** these can arise when a gain or loss provides an incomplete picture of the effect of a linked set of assets, liabilities, or past or planned transactions. When this is the case, temporarily recognising the gain or loss in OCI, and reclassifying it to profit or loss when the linked item is recognised, would preserve the integrity of profit or loss as the primary measure of performance. The existing treatment of cash flow hedges is an example of a mismatched remeasurement.
- c) **Transitory remeasurements:** The IASB explored whether a further category of items should qualify for recognition in OCI. This is because not all items currently recognised in OCI can be regarded as either bridging items or mismatched remeasurements. In addition, for some items it may be difficult to identify a basis for reclassification from OCI to profit or loss. Items in this category may arise from the remeasurement of some long term assets and liabilities. For

² The primary difference between the proposed fair value through OCI (FVOCI) category for debt instruments and the current available for sale category is that classification as FVOCI would be required if a financial asset meets specific criteria. In addition, impairment would be based on expected cash flows (as proposed) instead of fair value. Therefore, unlike available for sale today, profit or loss for debt instruments classified as FVOCI would be completely aligned with that for instruments classified as amortised cost. For more information on the proposed FVOCI category, see:

- **Snapshot: Financial Instruments: *Classification and Measurement (Limited Amendments to IFRS 9)***
- **Exposure Draft: *Classification and Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010))***

example, many (including the IASB when it recently revised the pensions accounting Standard) believe that it is appropriate to recognise pension remeasurements (actuarial gains and losses) outside of profit or loss. This is because the OCI treatment differentiates those gains and losses from current period employee service and financing costs. In addition, there is no subsequent reclassification for pension remeasurements.

In the Discussion Paper, the IASB reviews two possible approaches to using OCI which would comprise some or all of the above categories. The first is referred to as a 'narrow' approach where OCI would include only bridging items and mismatched remeasurements. The second is referred to as a 'broad' approach. This approach would include not only bridging items and mismatched remeasurements, but also some transitory remeasurements. The narrow approach would define what is in OCI quite tightly, and would restrict the use of OCI considerably. The broad approach would permit wider use of OCI, but rely on a rather less precise definition of what it includes. Both approaches have pros and cons, and the IASB has not yet developed a preference for one over the other. Input from investors will be one important factor for the IASB to consider when it decides where its preference lies.

The use of OCI and the issue of reclassification to profit or loss create much debate. Some feel that OCI should not exist at all. Some accept that OCI is a useful way of disaggregating gains and losses but believe that reclassification makes no sense because, in effect, it results in the same item being recognised twice. The Discussion Paper does not provide definitive answers to these issues but rather different ways one might consider using OCI. A decision will only come with finalisation of the framework and, indeed, in subsequent Standards or revisions to Standards. However, it does provide a sound basis for starting an informed debate that we hope will include investors' views. Clearly changes in how income and expenses are presented will have a significant impact on investors.

Equity and dilutive effects on common shareholders

Issue

The current IFRS framework defines a liability as an obligation for the company to deliver cash; equity is then a residual representing other claims on the business cash flows. However, the measurement of items classified

as equity may not always provide the information that investors need to make capital allocation decisions.

A good example of an existing problem to investors is the accounting treatment of a written call option on common shares. If a company writes a call option, then, as long as it is equity-settled, it is classified as equity, because the company cannot be obliged to deliver cash upon settlement. Because it is classified as equity the option is not remeasured. Therefore, today, investors in the common shares have little information about the impact of this option on their holdings. The only indication of the likely effect of the option on future results is given by the diluted earnings per share measurement. But even this measurement tells only part of the story, because the calculation of diluted earnings per share only takes account of the intrinsic value of the option. It does not tell investors about the time value of the option and the related potential future dilution. For common shareholders to really understand the impact of this call option, they need updated information about the time value of that option. While this is currently provided in the statement of comprehensive income for a cash-settled option because of its classification as a liability, no such information is provided about options classified as equity.

Potential solution

In this Discussion Paper we have put forward proposals which may provide investors with more relevant information about the impact of other equity claims. The main change we propose is to expand the role of the existing statement of changes in equity to include updated information about the measurement of equity claims other than those of common shareholders (the Discussion Paper calls them 'secondary equity claims').

The idea in the Discussion Paper is to require the remeasurement of such 'secondary' equity claims through the statement of changes in equity. This is not as radical as it might seem, because in effect we already do this for non-controlling interests. Equity claims of minority shareholders in a partially-owned subsidiary are also classified as equity in the consolidated accounts. Their measurement is updated each period to reflect changes in the underlying net assets attributable to these minority shareholders. Such amounts are not reported as deductions in arriving at comprehensive income but as part of the statement of changes in equity. In effect, the minority's share of group profit shows how the wealth created in the period is allocated between the different equity claims.

The Discussion Paper goes into some detail about the possible use of the statement of changes in equity to give more information about the effects of equity claims. However, the actual framework, when finalised, would merely outline the underlying concepts, including the definitions of the various elements and the objective regarding remeasurement. The detail of how secondary equity claims would be remeasured is something that would be addressed in an actual revision to a Standard, which would, of course, go through our usual deliberations and exposure for public comment.

What are your views?

Your thoughts on this article or on any of the other issues raised in the Discussion Paper are very welcome. You can download a copy of the ***Discussion Paper: A Review of the Conceptual Framework for Financial Reporting*** and the **Snapshot summary**, and you can find more information on the ***Conceptual Framework project page***. The IASB expects to start considering feedback received on the Discussion Paper in early 2014. If you would like to discuss this topic or other areas of accounting, please contact me at scooper@ifrs.org, or Barbara Davidson, who is in charge of our investor liaison programme, at bdavidson@ifrs.org.