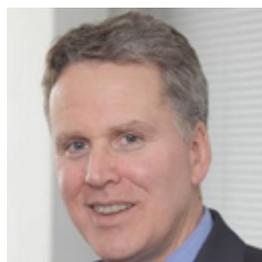


Investor Perspectives

Patrick Finnegan: Performance Reporting: Back to the Future



We published our first public agenda consultation on the IASB's future work plan in July 2011. In the light of this unprecedented consultation, it should be no surprise that the response rate has been very strong with 245 comment letters filed as of the November 2011 deadline. However, although we received more comment letter responses from investors than we typically do, many of the responses came from other stakeholders (such as accounting firms, other accounting standard setters and preparers). So I am writing to those of you who have not had time to respond to consider doing so with a brief response to this edition of *Investor Perspectives*.

The objective of the consultation is straightforward: we want your views on the overall strategic direction of the IASB's agenda and on what areas of accounting need to be improved.

Another way to look at this very important consultation is that we are getting 'back to the future' of the organisation. Our agenda has been dominated by two major influences in recent years: the global financial crisis and convergence with US GAAP. As those two influences wane, we are shifting our focus.

My preliminary reading of the comment letters submitted and the online survey responses finds a broad array of opinions about what our priorities should be, but there are some common themes. For example, many state that we need to:

- finish our work-in-progress;
- complete the update of the conceptual framework; and
- limit the number of new standards-level projects to a manageable level.

In the comments about standards-level projects, many counsel us to make sure that we conduct more in-depth research and planning before adding a project to our agenda, to ensure its timely completion and that it results in a marked improvement to financial reporting. I believe that all of those suggestions are sound and that the Board will give them full consideration.

There is one project, however, that respondents to the agenda consultation believe should be a high priority. It cuts across the conceptual framework and many of our existing and, increasingly, new standards. The project would define 'Other Comprehensive Income' (OCI) and provide expanded guidance on performance presentation. I believe that such a project is of the utmost importance both to investors and all our other stakeholders. On the basis of our comment letter analysis so far, many others appear to agree with that view, but we would like to hear from more investors.

I agree that a definition of OCI is one of the most important, if not *the* most important, issues for the Board to address. Over the last two decades the IASB and its predecessor, IASC, have increasingly used current or fair value concepts for the measurement of assets and liabilities in several areas, most notably in the area of financial instruments, but in several other areas too. It is becoming increasingly challenging to understand performance given the expansion of the use of fair values mixed with the use of historical costs, particularly when the focus is on a single statistic: profit or loss. And, if financial statements are becoming more of an amalgam of mixed attributes, it follows that both cost and fair value should be displayed in one statement or, at least in two consecutive statements, to ensure the highest level of understanding about how performance is measured and communicated.

One of the single biggest challenges the Board has dealt with and continues to face is how to improve recognition and measurement principles without raising concerns that such improvements will create volatility in reported profit or loss. That concern has been pervasive, for example, during the Board's deliberations dealing with the accounting for post-retirement benefits, loan impairment, hedge accounting, financial liabilities, insurance contracts, revenue recognition and hybrid financial instruments, to name just a handful.

The concerns above have often slowed down the Board's progress on several projects and have led the Board to expand the use of OCI to address concerns about volatility and performance masking, but without

providing a definition for it. Unfortunately, decisions on which items should be reported as OCI have not had a consistent conceptual basis. Different reasons have been used to support its use. Some of those reasons include an objective of separating income and expenses between elements judged to be recurring vs. non-recurring, or controllable vs. non-controllable, or volatile vs. non-volatile.

Concerns about the potential for greater volatility in profit or loss caused by new accounting standards will be unabated until the focus on a single measure of performance is reduced. Performance cannot be analysed, understood or communicated in only one statistic. A single measure of performance is, by definition, arbitrary, because it relies on definitions of income and expense elements, which are merely accounting constructs. By moving away from a single measure, we can de-emphasise that focus, help to lower the incentives for management to influence the timing of income and expenses and provide a more balanced view of the elements affecting performance. Consequently, I believe that it is time to provide investors with a definition of OCI and how to use it when evaluating performance.

I therefore recommend that the Board undertake a project dealing with OCI to achieve the following:

- To provide clarity about what is meant by OCI, when and why it is used and how it helps investors to analyse performance.
- To reduce concerns about potential volatility of profit or loss caused by fair value or current value measurements. We would improve the ability of investors to understand performance and to forecast the future by making clear the rationale for why some elements are recognised directly in profit and loss and others are recognised in OCI.
- To enhance the Board's deliberative process by avoiding, or even eliminating, lengthy debates about what information is more relevant or useful to investors; the cost components or fair value components of income; if presentation guidance is provided for both. Moreover, the development of complex and potentially costly accounting standards to determine when an asset or a liability should be measured using either cost or fair value would be eliminated because income components of both attributes would be displayed.
- To improve the relevance of information used for investment analysis. So much of financial analysis depends on how

information is displayed, for example, whether it appears prominently on the face of the financial statements or is in the notes. That is because of limitations on investors' time, the volume of information to analyse and the complexity of the valuation process. The recent changes that we have made to our presentation principles to ensure the prominent display of OCI directly following profit or loss (in either one statement or two) would complement such a project.

If the reporting format is improved so that investors have a better understanding of all changes in net assets, in addition to reported profit or loss, their analysis of performance is likely to become more efficient and effective. However, opponents of fair value and current value measurements may argue that the IASB is adding clutter to the performance statement, not making it more useful. Furthermore, such a format might be viewed as a failure, because it highlights the deficiencies of the mixed attribute model. A further possible danger is that investors will fail to comprehend what is meant by 'comprehensive income'. Would they overreact to reported fair value remeasurements?

On the other hand, the use of more than one performance statistic might draw attention to elements of comprehensive income that are recurring, or operating, or controllable, all of which should enhance, not reduce, the clarity of the performance statement.

Are two numbers better than one? Would it be a basis for more thorough analysis and better decisions? This Board member believes so.

Please tell us what you think.

Patrick Finnegan 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.