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Conceptual Framework

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Is OCI Unnecessary?

Accounting Standards Board of Japan

Summary of the Paper

1. This paper is the first in a series of short discussion papers that the ASBJ plans to publish in order to contribute to the global discussions regarding financial reporting standards.

2. This paper explores the possibility of abolishing or minimising the use of other comprehensive income (OCI) in the financial statements[1]. In doing so, this paper first considers the usefulness of financial information if we were asked to presume that the same measurement basis must be used for measuring an asset or a liability both from the perspective of the entity's *financial performance* and its *financial position*. In light of the decision-usefulness of financial information, this paper concludes that, if the same measurement basis were to be selected for measuring an asset or a liability, such measurement basis should be determined *solely* from the perspective of the entity's *financial performance*.

3. At the same time, this paper also concludes the assumption to always use the same measurement basis for measuring an asset or a liability from the perspective of the entity's *financial performance* and its *financial position* is unrealistic on the grounds that users have increasingly called for more information measured at current value on the face of the balance sheet. In addition, the Conceptual Framework already indicates that the purposes of balance sheets and income statements are not necessarily congruent with each other, and that the use of two different measurement bases could promote the usefulness of financial information presented on the face of the financial statements. Accordingly, this paper concludes that setting the unfounded goal to *abolish* or *minimise* the use of OCI would be inappropriate or unfeasible, and the use of OCI as the "linkage factor" is *necessary* to maintain the usefulness of financial information presented on the face of the financial statements.

[1] This paper has been prepared on the presumption that the statement of profit or loss and OCI (the income statement) is presented in a multi-layered format with appropriate subtotals. However, this paper does not specifically discuss whether operating income should be presented in the income statement, or whether items should be separately presented in the income statement based on whether those items are recurring or non-recurring in nature. In addition, this paper does not discuss whether some or all of items presented in OCI should be subsequently recycled at some point in time.

Background

Recent Developments

4. The IASB initiated the project to review the Conceptual Framework for Financial Reporting (hereinafter referred to as the "Conceptual Framework"), in response to the comments received on *Agenda Consultation 2011*. In July 2013, the IASB issued a Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (hereinafter referred to as the "IASB's DP"). Among others, the IASB's DP stated that, when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI[2].

5. The IASB's DP also stated that one possible way to deal with the uncertainty about how an asset will contribute to future cash flows would be:

   (a) using one measure in the primary financial statements and disclosing another measure in the notes to the financial statements; or

   (b) using one measure in the statement of financial position and using a different measure to determine the amounts recognised in profit or loss (presenting the difference between the two measures in OCI)[3].

6. The ASBJ prepared a paper titled "Profit or Loss / Measurement" (hereinafter referred to as the "ASBJ's Paper") for discussion at the December 2013 Accounting Standards Advisory Forum (ASAF) meeting. In summary, the ASBJ's Paper suggested the following:

   (a) Comprehensive income, profit or loss and OCI should be defined as separate elements of financial statements in the following manner:

      (i) **Comprehensive income** is the change in net assets during a period except those changes resulting from transactions with owners in their capacity as owners, whereby the recognised assets and liabilities comprising the net assets are

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[2] Paragraph 6.35 of the IASB's DP
[3] Paragraph 6.76 of the IASB's DP

measured using measurement bases that are relevant from the perspective of reporting the entity's *financial position*.

(ii) **Profit or loss** is the change in net assets during a period except those changes resulting from transactions with owners in their capacity as owners, whereby the recognised assets and liabilities comprising the net assets are measured using measurement bases that are relevant from the perspective of reporting the entity's *financial performance*.

(iii) **OCI** is the "linkage factor" that is used when the measurements that are relevant from the perspective of reporting the entity's *financial position* differ from the measurements that are relevant from the perspective of reporting the entity's *financial performance*.

(b) **Profit or loss** represents an all-inclusive measure of irreversible outcomes of an entity's business activities in a certain period.

(c) Two different measurement bases should be used for the same item and thus OCI should be used as the linkage factor, when:

(i) it is relevant from the perspective of reporting the entity's *financial position* to remeasure assets and liabilities that are exposed to certain risks by using the information updated at the reporting date; but

(ii) such remeasurements are not relevant from the perspective of reporting the entity's *financial performance*.

7. At the December 2013 ASAF meeting, Mr. Hans Hoogervorst, the Chairman of the IASB, showed his reluctance for the increased use of OCI. Then, in February 2014, he delivered a speech at a conference held in Tokyo, where he stated:

> Summing up, *Profit or Loss is an extremely important indicator of financial performance in a time period*. To provide sufficient rigour, it should be as inclusive as possible. For that reason, Profit or Loss is necessarily a bit rough around the edges. To protect the integrity of Profit or Loss, *we have to be very cautious with OCI, which should only be used as an instrument of last resort.* If our ultimate conclusion were to be that OCI is more of an exception than a rule, finding a conceptual basis for it will be very difficult. Obviously, these are personal and very

preliminary thoughts, given the fact that the Board still needs to digest the very rich feedback we have received thus far. [Emphasis added]

8. In March 2014, the ASAF discussed a paper titled "A Revised Model for Presentation in the Statement(s) of Financial Performance: Potential Implications for Measurement", which was authored by Dr. Thomas J. Linsmeier, a Board member of the FASB. In this paper, Dr. Linsmeier argued that there is no differentiating set of characteristics to define what items are included in OCI rather than Net Income (or profit or loss) other than that standard setters decided for political reasons to present those items below the line net income. This paper went on to propose a new model for presentation in the statement(s) of financial performance, which encompasses the following propositions:
   (a) To require the presentation of two separate statements of financial performance:
      (i) a Statement of Operating Income; and
      (ii) a Statement of Comprehensive Income (which begins with operating income and presents all non-operating income items that yield comprehensive income for the period).
   (b) Either;
      (i) to require a per share number for both operating income and comprehensive income; or
      (ii) to provide users with the weighted average number of common shares outstanding for the period so that users can calculate the income amounts per share that they believe relevant to their decisions.
   (c) To require separate presentation of income based on whether an item is recurring or non-recurring, for each Statement in (a).

Comparison of Views Expressed

9. The IASB's DP explained that both the effects on the statement of profit or loss and OCI (or the income statement) and the statement of financial position (or the balance sheet[4]) should be considered when determining an appropriate measurement basis, but it did not

[4] In this paper, the term "income statement" is used interchangeably with "the statement of profit or loss and OCI", and the term "balance sheet" is used interchangeably with "the statement of financial position".

explain the IASB's preliminary view as to (i) whether the difference should be rare (if any) and (ii) how the difference should be addressed.

10. Mr. Hoogervorst went a step further in his speech by indicating that the use of OCI should be minimised, acknowledging that there may be limited cases where differences would arise. However, Mr. Hoogervorst did not refer to how the measurement basis of an asset or a liability should be determined.

11. On the other hand, in proposing the new reporting model, Dr. Linsmeier's paper questioned whether, and if so in what circumstances, decision-usefulness would be enhanced by differentiating some items from others (as OCI) within either operating income or comprehensive income. The paper also suggested that a measurement basis for an asset or a liability should be determined from the *income statement* perspective (that is, on the basis of whether unrealised gains/losses provide decision-useful information).

12. The ASBJ's Paper stated that relevant measurement bases from the perspectives of *financial performance* and *financial position* should be considered separately, and in the case where the two measurement bases differ, OCI would be the "linkage factor" to bridge the two measurement bases. The ASBJ Paper explained that, although the two measurement bases would be the same in many cases, there would be cases where the resulting relevant measurement bases would be different.

13. The difference in views can be summarised in the table below.

Table: Comparison of Views Expressed

Items	Mr. Hoogervorst's comment	Dr. Linsmeier's paper	ASBJ's Paper
Use of OCI	Minimise the use of OCI	No view was expressed, but questioned if there would be continued demand for use of OCI under the proposed new reporting model	Use of OCI is necessary

Items	Mr. Hoogervorst's comment	Dr. Linsmeier's paper	ASBJ's Paper
Perspective to determine measurement basis (or bases)	N/A	Income statement under the proposed new reporting model	Both financial performance (income statement) and financial position (balance sheet)
Number of Measurement basis (or bases)	Ideally one	Should be one under the proposed new reporting model	Conceptually two but the two are the same in many cases

Possible Effect of Abolishing or Minimising the Use of OCI

Presumptions

14. In reviewing the Conceptual Framework, it has become apparent that many people believe that "profit or loss" is very important for users to assess the entity's financial performance[5]. For example, as quoted earlier in this paper, Mr. Hoogervorst stated in his speech that "profit or loss is an extremely important indicator of financial performance in a time period".

15. At the same time, some argue that the use of OCI should be abolished or minimised. In the following paragraphs, this paper will explore the consequences on the usefulness of financial statements, if the use of OCI were to be abolished or minimised.

[5] For example, paragraph 8.19 of the IASB's DP stated that "the IASB has previously acknowledged that many investors, creditors, preparers and others view profit or loss as a useful performance measure and that 'profit or loss' as a subtotal or a phrase is deeply ingrained in the economy, business and investors' minds. Users from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main indicator of an entity's performance".

Possible Effects on the Usefulness of Financial Statements

16. Abolishing the use of OCI would mean that it would be impossible to use two measurement bases to measure the same asset or liability. In such case, changes in the measurement of assets and liabilities would be recognised in profit or loss/comprehensive income without exception, unless such changes relate to contributions from (or distributions to) equity participants. Therefore, the amount presented as profit or loss/comprehensive income would ultimately depend on the measurement basis selected for each asset and liability.

17. If we were to presume that the same measurement basis must be used for measuring an asset or a liability both for the balance sheet and income statement purposes, the two major alternatives regarding the perspective to be considered in determining a measurement basis are:

   (a) to require the use of a measurement basis that is relevant solely from the perspective of reporting the entity's *financial performance;* and

   (b) to require the use of a measurement basis that is relevant solely from the perspective of reporting the entity's *financial position*.

18. First, let us assume that the measurement bases are determined solely from the perspective of reporting the entity's *financial position*. Changes in the measurement of assets and liabilities would be recognised in profit or loss/comprehensive income without exception, and remeasurement gains or losses on items that are currently measured using OCI would be recognised through profit or loss.

19. For example, as part of the limited amendment to IFRS 9 *Financial Instruments*, the IASB decided that financial instruments that meet both of the following criteria shall be measured at FV-OCI:

   (a) The asset is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale, and

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

20. Recognising remeasurement gains or losses on such financial instruments through profit or loss would mean that unrealised gains or losses would be recognised in profit or loss, even when such instruments are held in a business model in which assets are managed both in order to collect contractual cash flows and for sale. In such situations, recognising remeasurement gains or losses through profit or loss would result in the loss of the amortised cost information in the income statement, although an entity's performance on such instruments will be ultimately affected by both their contractual cash flows and the realisation of fair value[6].

21. The ASBJ believes that it is critical to ensure that remeasurement gains or losses on assets and liabilities is not recognised in profit or loss when unrealised gains or losses are irrelevant for predicting future cash inflows to the entity, because financial reporting stakeholders (including users) have long advocated the utmost importance of the flow information in making decisions about providing resources to the entity.

22. Accordingly, if the ASBJ were asked to choose one perspective, from either the perspective of reporting the entity's *financial performance* or the perspective of reporting the entity's *financial position*, on which to determine the measurement bases of assets and liabilities, similar to the proposition in Dr. Linsmeier's paper, the ASBJ would conclude that such measurement bases should be determined from the perspective of reporting the entity's *financial performance*. The role of general purpose financial reports stated in the Conceptual Framework[7] already indicates that the balance sheet in itself is not designed to show the value of a reporting entity (thus, recognition of internally generated goodwill is precluded).

[6] Please see paragraph BC22 of IASB's ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9.* The IASB decided to finalise the limited amendments to IFRS 9 without significantly changing the requirements relating to the FV-OCI category.

[7] Paragraph OB7 of the existing Conceptual Framework states that, "General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity".

23. Yet, determining the measurement bases solely from the perspective of reporting the entit*y's financial performance* would mean that many items that are currently measured at current value using OCI will be measured at cost-based measures both for balance sheet and income statement purposes. This would represent the loss of the current value information of such financial instruments from the balance sheet.

24. It is possible for accounting standard setters to require that the fair value information of such financial instruments be disclosed in the notes to financial statements, such that financial statements as a whole continue to provide the two sets of information. Some may argue that whether information is presented on the face of the financial statements or in the notes to financial statements does not matter, as long as the information is disclosed in the financial statements.

25. However, many believe that whether the information is required to be presented on the face of the financial statements or in the notes to financial statements would result in different levels of care and scrutiny in the measurement by preparers and auditors. In addition, in some jurisdictions, the information disclosed in the notes to financial statements of public companies would be made available well after earnings releases are disclosed[8]. For these reasons, these stakeholders believe that the location of the information presented does matter.

26. Moreover, in recent years, users of financial reports have increasingly called for more current value information to be provided on the balance sheet. Therefore, it is simply unrealistic to assume that the user community would embrace the idea that many items that are currently measured at current value using OCI should be measured using cost-based measures, even if such current value information were to be presented in the notes to financial statements.

27. Accordingly, the ASBJ does not believe that abolishing or significantly reducing the use of OCI is a feasible goal to achieve.

[8] For example, please see paragraph BC103 of the FASB's proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.*

Promoting Usefulness of Financial Information

Purposes of the Income Statement and the Balance Sheet

28. If the purposes of the income statement and the balance sheet were designed to be consistent, measurement bases determined from the perspective of reporting an entity's *financial performance* and its *financial position* would also be consistent. For example, if the income statement were simply designed to provide information about "changes in the value of stock between two points in time", the selection of relevant measurement bases from the perspective of the income statement (that is, the flow information) and the balance sheet (that is, the stock information) would be the same.

29. However, the ASBJ believes that the Conceptual Framework states otherwise. The Conceptual Framework[9] states that information about a reporting entity's financial performance during a period (which is primarily represented in the income statements) is useful in assessing the entity's ability to generate future net cash inflows into the entity[10].

30. It also acknowledges that such information is useful for users to understand the return that the entity has produced on its economic resources, and provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources (management's accountability or stewardship)[11].

31. At the same time, the Conceptual Framework states that information about the nature and amounts of a reporting entity's economic resources and claims (which is primarily represented on the balance sheet) can help users identify the reporting entity's financial strengths and weaknesses[12], and to assess the reporting entity's (a) liquidity and solvency, (b) needs for additional financing and (c) how successful it is likely to be in obtaining financing. In addition, the Conceptual Framework explains that resource providers are interested in the information that would help them to assess returns that they expect.

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[9] Chapter 1: *The objective of general purpose financial reporting*
[10] Paragraph OB18 of the Conceptual Framework
[11] Paragraph OB16 of the Conceptual Framework
[12] Paragraph OB13 of the Conceptual Framework

32. These various roles of general purpose financial reports demonstrate that the purpose of the income statements is not simply to provide information about “changes in the value of stock between two points in time”. Accordingly, the ASBJ believes that the selection of the measurement bases from the perspective of reporting an entity’s *financial performance* and its *financial position* would inherently differ, and that the natural conclusion derived from the Conceptual Framework is that it would be inappropriate or unfeasible to try to abolish or minimise the use of OCI.

Benefit of Using Two Different Measurement Bases for Presenting Balance Sheets and Income Statements

33. Having concluded that the purposes of the balance sheet and the income statement are not necessarily congruent with each other, the following paragraphs consider whether, and if so how, using two different measurement bases for the purpose of reporting an entity’s *financial performance* and *financial position* contribute to useful financial information presented on the face of the financial statements.

34. As explained in the ASBJ Paper, measurement bases relevant from the perspective of reporting an entity’s *financial performance* and *financial position* would be the same in many cases[13]. However, the ASBJ believes that these different perspectives may lead to different conclusions on what would be the most relevant measurement basis for a particular asset or liability, for example, when there is high degree of uncertainty[14] regarding how an asset will contribute to future cash inflows to the entity or how a liability will be settled resulting in future cash outflows from the entity. When there is such high degree of uncertainty regarding the manner in which future cash flows will be realised, it would be almost impossible to specify a single measurement basis for an asset or a liability that fulfils both perspectives at the same time.

35. In this situation, when two different measurement bases are used for an asset or a liability, one measurement basis would help users assess the prospects for the future cash inflows or outflows (that is, the amount and timing of future cash flows), and the

[13] Please see paragraph 12 of this paper.
[14] Uncertainty in this paragraph does not refer to the level of uncertainty in estimates.

other measurement basis would help users assess the entity's financial strengths and weaknesses. In other words, financial information presented on the face of the financial statements would be most useful, when one measurement basis is used for the asset or liability to determine the amounts recognised in profit or loss, while another measurement basis is used for the same asset or the liability in the balance sheet.

36. This assertion may be further explained by analysing an illustrative example. For example, if an entity holds debt financial instruments primarily to collect their contractual cash flows but may sell those instruments depending on the circumstances, measuring the asset using amortised cost would help users assess the prospects for future net cash inflows to the entity, because it would provide information about contractual yields on the instruments. However, amortised cost information would not be most helpful for users to assess the entity's financial strengths and weaknesses, because such information would not reflect current market trends. Rather, current value information would be more helpful for users in that assessment, because such information better reflects the updated information about the amount that the entity may receive if it sold those instruments at the market.

37. In addition, amortised cost information would also be helpful for users to assess how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. This is because gains or losses that will be recognised on the sales of such instruments would reflect the differences between the entity's prospects for future cash inflows based on the contractual yields and the actual cash inflows attained upon the sales of those financial instruments, and unrealised gains or losses presented in the balance sheet would reflect opportunity gains or losses that the entity might have recognised if it had sold those instruments at the market as of the end of the reporting period.

38. Accordingly, the ASBJ believes that, in those cases described above, using two different measurement bases for the balance sheet and the income statement would promote usefulness of information presented on the face of financial statements as a whole.

Decision Process of Measurement Bases

39. During the December 2013 ASAF meeting, it was noted that if a measurement based on a particular measurement basis were argued to be too "soft" (which, we understand, means that the outcome is subject to a uncertainty that is too high) for the purpose of reporting an entity's *financial performance*, it may also be argued that such measurement would be equally inappropriate for the purpose of presenting an entity's *financial position*, for the same reason that such a measurement basis would be considered to be too "soft". Following the comment, it was suggested that measurement bases from the perspective of an entity's *financial position* and the perspective of an entity's *financial performance* should not be considered separately but for in exceptional cases.

40. However, as stated in paragraph 21 of this paper, the ASBJ believes that the determination of measurement bases should begin with the perspective of reporting an entity's *financial performance*, and the determination of measurement bases from the perspective of reporting an entity's *financial position* should follow. OCI should be used when, in response to the user's call for current value information presented on the face of the financial statements, these measurement bases are found to be different.

41. This standards-setter's decision-process is different from that stated in paragraph 39 of this paper. Therefore, the ASBJ is of the view that it is inappropriate to set a goal that the use of OCI should be minimised, with the assumption that measurement bases from the perspective of reporting an entity's *financial performance* and its *financial position* should not be considered separately.

Conclusion

42. Based on the analysis in this paper, trying to measure an asset or a liability using the same measurement basis for each asset and liability and to *abolish* or *minimise* the use of OCI is inappropriate or unfeasible. Rather, greater conscience should be given to the two different perspectives (that is, perspectives of reporting an entity's *financial*

performance and its *financial position*) when determining measurement bases, although such measurement bases would be the same in many cases. If relevant measurement bases are found to be different for fulfilling the differing purposes, it would be *necessary* to use OCI as the “linkage factor”, so as to maintain the usefulness of financial information presented on the face of the financial statements.

43. The approach explained in the previous paragraph would not justify every OCI item currently required or permitted in the existing requirements in IFRSs; rather it could give rise to inconsistencies between the principles that may be stated in the Conceptual Framework and accounting requirements in individual standards. Yet the ASBJ believes that such inconsistencies would provide good opportunities for the IASB to consider whether, and if so how, such inconsistencies should be addressed in the future standard-setting process, which would ultimately contribute to the high quality financial reporting in accordance with IFRSs.