

Accounting Standards Advisory Forum
The Conceptual Framework
September 2016

**The Linkage between Financial
Performance and Measurement**

Introduction

1. We highly appreciate the IASB's undertaking of the review of the Conceptual Framework for Financial Reporting (hereinafter referred to as the "*Conceptual Framework*") in response to the feedback received from respondents to the IASB's *Agenda Consultation 2011*. Considering that the existing *Conceptual Framework* does not fully address some important areas, such as the concept of financial performance and measurement, we commend the IASB in its undertaking of these areas in the *Conceptual Framework* project.
2. Currently, the IASB is continuing its redeliberation of issues towards the goal of finalising the *Conceptual Framework* in the light of feedback received on the Exposure Draft *Conceptual Framework for Financial Reporting* (hereinafter referred to as the "the ED"). At its June 2016 Board meeting, the IASB made tentative decisions regarding financial performance information, and at its July 2016 Board meeting, the IASB discussed measurement. In this paper, we would like to provide our observations on the IASB's discussions.
3. Some view financial performance from a narrow perspective (such as limited to profit or loss) and others view financial performance from a wide perspective (profit or loss, comprehensive income, financial position and cash flows). Considering that the IASB is of the view that the statement of profit or loss is the primary source of information about an entity's financial performance, this paper focuses on profit or loss. Accordingly, when we refer to the measurement basis from the perspective of the statement(s) of financial performance, we have in mind measurements that are used to calculate profit or loss that is useful. We do not have in mind measurements that are derived from mere changes in assets and liabilities.
4. Our understanding is that the IASB staff has redrafted the Measurement Chapter of the Conceptual Framework for discussion at the September 2016 ASAF meeting. However, this paper has not been updated to reflect the latest proposals.

Background

5. At its June 2016 Board meeting, the IASB tentatively decided that the revised *Conceptual Framework* would:
 - (a) describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period but would not set out the purpose of that statement¹.
 - (b) set out a principle that income and expenses should be included in the statement of profit or loss unless the relevance or faithful representation of the information provided in the statement of profit or loss for the period would be enhanced by

¹ The ED stated that 'the purpose of the statement of profit or loss is to: (a) depict the return that an entity has made on its economic resources during the period; and (b) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.'

including a change in the current value of an asset or a liability (except for some items) in other comprehensive income (OCI). This principle would replace the rebuttable presumption about the use of the statement of profit or loss proposed in the ED. The revised *Conceptual Framework* would state that this is only expected to occur in exceptional circumstances.

- (c) state that a decision about including income and expenses in OCI can be made only by the Board in setting Standards. In making such a decision the Board would need to explain why excluding a change in the current value of an asset or a liability from the statement of profit or loss for the period would enhance the relevance or faithful representation of the information provided in that statement.
- (d) state that in principle, income and expenses included in OCI should be recycled when doing so would enhance the relevance or faithful representation of the information in the statement of profit or loss for that period.

Profit or loss as the primary source of information about financial performance

6. Respondents to the IASB's *Agenda Consultation 2011* identified the reporting of financial performance, including the use of OCI and recycling, as a priority topic that the IASB should address. Many of those respondents were of the view that the IASB should clarify the term "financial performance" because they did not think that mere changes in assets and liabilities² represented "financial performance." In their view, defining financial performance would provide the basis for classifying mere changes of assets and liabilities into items that should be recognised in profit or loss and items that should be recognised in OCI³.
7. Based on the request from respondents, the IASB considered defining, or precisely describing, in the *Conceptual Framework* when an item of income or expenses should be included in the statement of profit or loss or OCI. However, the IASB decided that it was not feasible nor appropriate to do so⁴. Instead, the IASB stated that it would reflect the feedback from those respondents who argued that profit or loss is the primary measure of performance by deciding to "describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period"⁵ (See paragraph 5(a) of this paper).

² The *Conceptual Framework* defines income and expenses in terms of changes in assets and liabilities. Paragraph 7 of IAS1 *Presentation of Financial Statements* defines profit or loss as the total of income less expenses, excluding the components of other comprehensive income. Accordingly, profit or loss, which would be determined as the difference between certain income items and certain expense items, would be derived from changes in certain assets and certain liabilities.

³ Paragraphs 8.3 and 8.11 of the Discussion Paper, *A Review of the Conceptual Framework for Financial Reporting* (hereinafter referred to as the "DP").

⁴ Paragraph 7.36 of the ED.

⁵ Paragraph 7.39 of the ED.

Items to be included in the statement of profit or loss

8. In the light of the initial request from respondents to the *Conceptual Framework* project, the IASB's tentative decision to "describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period" (See paragraph 5(a) of this paper) can be viewed as one step forward. On the other hand, the IASB's decision to "set out a principle that income and expenses should be included in the statement of profit or loss" (See paragraph 5(b) of this paper) implies that comprehensive income, which is defined as "the change in equity during a period resulting from transactions and other events,"⁶ should in principle equal profit or loss. In our view, this would negate the IASB's decision to "describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period" (See paragraph 5(a) of this paper) because this implies that profit or loss would not be independent of comprehensive income.
9. If profit or loss is considered to be the measure of an entity's financial performance that is independent of comprehensive income, such measure would not be useful unless the *Conceptual Framework* provides the foundation, or fundamental characteristics, that would properly separate the changes in assets and liabilities into those that should be included in profit or loss, which is the primary financial performance, and those that should not. The IASB's tentative decision to "set out a principle that income and expenses should be included in the statement of profit or loss" (See paragraph 5(b) of this paper), in our view, could mean that items that are currently included in OCI should be included in profit or loss to the extent possible. We are concerned that this change is likely to change the substance of profit or loss, which has been viewed by constituents as the primary source of information about an entity's financial performance. Given that the IASB stated in its DP that "the IASB has previously acknowledged that users of financial statements from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main measure of an entity's financial performance"⁷, we question whether there is a consensus among constituents regarding whether such significant change in the substance of profit or loss will be accepted.
10. In addition, the IASB's tentative decision states that "income and expenses should be included in the statement of profit or loss unless the relevance or faithful representation of the information provided in the statement of profit or loss for the period would be enhanced by including a change in the current value of an asset or a liability (except for some items) in other comprehensive income (OCI)" (See paragraph 5(b) of this paper), but it does not discuss the relevance of the information provided in the statement of profit or loss for the period nor in what circumstances the relevance of such information would be enhanced. In the ED, the IASB somewhat referred to profit or loss by describing that the purpose of the statement of profit or loss is to depict the return that an entity has made on its economic resources during the period. However, at its June 2016 Board meeting the IASB tentatively decided to remove this description (See paragraph 5(a) of this paper) and, as a result, criteria regarding profit or loss would no longer exist and there would be

⁶ Paragraph 7 of IAS 1.

⁷ Paragraph 8.42 of the DP.

no foundation to determine profit or loss.

11. Based on the discussions above, we believe that the tentative decisions made by the IASB (See paragraph 5 of this paper) would not ensure the usefulness of profit or loss.

Observations on financial performance

12. As long as the statement of profit or loss is the primary source of information about an entity's financial performance, we believe that the *Conceptual Framework* should, at a minimum, provide the foundation, or fundamental characteristics, that information about profit or loss should possess. Even if the IASB concludes that it cannot define profit or loss, it would be necessary to clearly distinguish between profit or loss and comprehensive income by listing the unique characteristics of profit or loss.
13. The ED stated that "the purpose of the statement of profit or loss is to: (a) depict the return that an entity has made on its economic resources during the period; and (b) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources." However, at its June 2016 Board meeting, the IASB tentatively decided to remove this description, with one of the reasons being that that it is not appropriate to single out the purpose of the statement of profit or loss. As a result, criteria regarding profit or loss would no longer exist and we are concerned that, in future standard setting, items that would be included in profit or loss and items that would not would be determined *ad hoc* and that the usefulness of the financial information prepared by applying accounting standards that were developed in such manner would be impaired.
14. Accordingly, even if the IASB determines that it would be difficult to define financial performance or profit or loss⁸, we believe that the *Conceptual Framework* should, at a minimum, describe the fundamental characteristics that information about profit or loss should possess, such as the description in the ED which stated that profit or loss represents "the return that an entity has made on its economic resources during the period".

⁸ In this respect, the ASBJ suggested that profit or loss could be explained in its comment letter in response to the ED as follows:

Profit or loss is a measure which depicts the return for the period that the entity has made on its economic resources from its business activities conducted.

- (a) The return should be depicted when the uncertainty of the return expected at the timing of the initial investment is reduced to the point where it is irreversible or deemed irreversible reflecting the nature of the entity's business activities conducted.
- (b) Profit or loss should be 'all-inclusive' so that the accumulated amount of profit or loss for all accounting periods equals that of cash flows for all accounting periods.

Observations on measurement

Paragraphs 15 to 17 of this paper are based on Agenda Paper 10D prepared by the IASB staff for discussion at the July 2016 Board meeting. As noted in paragraph 4 of this paper, the IASB staff has redrafted the Measurement Chapter of the Conceptual Framework for discussion at the September 2016 ASAF meeting, but this paper has not been updated to reflect the latest proposals.

15. In this section, we would like to provide our observations on the linkage between profit or loss and measurement. The measurement chapter of the ED stated that the information provided in the statement of financial position and the statement(s) of financial performance may be made more relevant by using different dual measurement basis⁹. In this regard, the IASB staff proposed in the Agenda Paper for the July 2016 Board meeting retaining the description regarding the use of more than one relevant measurement basis.
16. On the other hand, in the same Agenda Paper the IASB staff proposed the following¹⁰:
- (a) The revised *Conceptual Framework* should state that a factor to consider when selecting a relevant measurement basis is the characteristics of the asset or liability, including the sensitivity of the value of the item to changes in market factors or other risks and:
- state that where the variability in value is significant; a current value measurement basis is likely to be more relevant than the historical cost basis, and explain the reasons why current value is likely to be more relevant than historical cost when variability in value is significant;
 - identify cases where the characteristics of an asset or liability would suggest a current value for an asset or liability (e.g. assets and liabilities subject to frequent price changes, long-lived assets that are likely to be held for significant periods of time).

⁹ Paragraph 6.76 of the ED stated that in some cases, because of the way in which an asset or a liability contributes to future cash flows or because of the characteristics of the asset or the liability, the information provided in the statement of financial position and the statement(s) of financial performance is made more relevant by using:

- (a) a current value measurement basis for the asset or the liability in the statement of financial position;
- (b) a different measurement basis to determine the related income or expenses in the statement of profit or loss.
- In addition, the paragraph 6.77 of the ED stated that in the cases noted above total income or total expenses arising from the changes in the current values in the statement of financial position would be separated into two components: the statement of profit or loss and other comprehensive income.

¹⁰ At its July 2016 Board meeting, the IASB directed the staff to present at a future Board meeting, a revised discussion about how selecting a measurement basis might be influenced by:

- (a) the characteristics of an asset or a liability (including variability of cash flows and sensitivity of the value of the item to changes in market or other factors); and
- (b) how an asset or a liability contributes to future cash flows. In particular, the staff will consider a distinction between items that contribute directly and indirectly to cash flows, and the rationale for the classification and measurement requirements in IFRS 9 *Financial Instruments*.

- (b) The revised *Conceptual Framework* should state that a factor to consider when selecting a relevant measurement basis is the contribution of the asset or liability to future cash flows and:
- state that a cost measurement basis is likely to provide relevant information for revenue generating assets and liabilities—that is those held for use in producing goods and services for customers;
 - state that for assets (liabilities) that produce (require) cash flows directly, a measurement basis that reflects a current value such as fair value is likely to provide relevant information.
17. The IASB staff proposed retaining the description in the ED that, in selecting a measurement basis, it was important to consider what information the measurement basis would produce both in the statement of financial position and the statement(s) of financial performance (See paragraph 15 of this paper). However, it was not clear whether the discussion at the July 2016 Board meeting was from the perspective of the statement of financial position or the statement(s) of financial performance (See paragraph 16 of this paper). As we stated in paragraph 3 of this paper, when we refer to the measurement basis from the perspective of the statement(s) of financial performance, we have in mind the measurements that are used to calculate profit or loss that is useful. If the discussion was only from the perspective of the statement of financial position without the consideration of how the selection of the measurement basis would affect profit or loss and if the issue of whether changes in assets and liabilities should be included in profit or loss or OCI is viewed merely as a presentation issue, the linkage between profit or loss and measurement would be lost.
18. The IASB tentatively decided that whether the changes in the current value of an asset or a liability is included in profit or loss or OCI would depend on whether the relevance or faithful representation of the information provided in the statement of profit or loss for the period would be enhanced (See paragraph 5(b) of this paper). However, given that the relevance or faithful representation of the information provided in the statement of profit or loss is unclear (See paragraph 10 of this paper) and the linkage between profit or loss and measurement is lost, the foundation for profit or loss to be useful becomes even more vulnerable.
19. We are of view that the measurement basis should be selected appropriately from the perspective of the statement of financial position and from the statement(s) of financial performance, respectively. Such selection should begin with considering the measurement basis from the perspective of the statement of profit or loss and the measurement basis selected should possess the fundamental characteristics that information about profit or loss should possess. If the measurement basis from the perspective of the statement of financial position and the measurement basis from the perspective of the statement(s) of financial performance differ, the difference in the changes in the measurements should be included in OCI. By doing so, it becomes possible to distinguish between changes in assets and liabilities that should be included in profit or loss and those that should be included in OCI.

20. In addition, for example, we think that the requirements regarding classification and measurement in IFRS 9 *Financial Instruments* (for example, classification of financial assets considering both the contractual cash flows and the entity's business model) cannot be explained in a reasonable manner without introducing the concept of selecting a measurement basis from the perspective of the statement of profit or loss. If the assets are held within a business model in which they are managed both in order to collect contractual cash flows and for sale, the performance of such assets will be affected by both the collection of contractual cash flows and the realisation of fair values. Accordingly, IFRS 9 requires that such assets shall be measured at fair value from the perspective of the statement of financial position and changes in the measurement based on amortised cost shall be presented in profit or loss from the perspective of the statement of profit or loss¹¹. We think that this requirement illustrates how the measurement basis is selected appropriately from the perspective of the statement of financial position and from the perspective of the statement of profit or loss, in order to enhance the relevance of information provided in both statements.
21. Based on the discussions above, we believe that in order to calculate profit or loss that is useful, the measurement basis should be selected appropriately, from the perspective of the statement of financial position and from the perspective of the statement of profit or loss, respectively. We believe that the measurement basis should first be selected from the perspective of the statement of profit or loss and such measurement basis should possess the fundamental characteristics that information about profit or loss should possess, and in doing so, it is necessary to provide a linkage between financial performance and measurement.
22. In this respect, the EFRAG will be presenting a paper titled "Measurement and the Conceptual Framework" for discussion at the September 2016 ASAF meeting. EFRAG also states that the reporting of performance is inextricably linked with the measurement basis used and that it is important to clearly distinguish between what is useful for the statement of financial position and for the statement(s) of financial performance. We think that the EFRAG's view is consistent with our view.

¹¹ Paragraphs BC 4.150 and BC4.157 of IFRS 9.

Conclusion

23. Considering the history of this project, we strongly believe that the *Conceptual Framework* could be improved by addressing the following:

- As long as the statement of profit or loss is the primary source of information about an entity's financial performance, the *Conceptual Framework* should, at a minimum, describe the fundamental characteristics that information about profit or loss should possess.
- In order to calculate profit or loss that is useful, the measurement basis should be selected appropriately from the perspective of the statement of financial position and from the perspective of the statement(s) of financial performance, respectively. The *Conceptual Framework* should state that the measurement basis should first be selected from the perspective of the statement of profit or loss and that such measurement basis should possess the fundamental characteristics that information about profit or loss should possess, and in doing so it is necessary to provide a linkage between profit or loss and measurement.

Discussion Point

- The ASBJ thinks that the *Conceptual Framework* should, at a minimum, describe the fundamental characteristics that information about profit or loss should possess. Do ASAF members have any comments on the ASBJ's view?
- The ASBJ thinks that the *Conceptual Framework* should state that the measurement basis should first be selected from the perspective of the statement of profit or loss and that such measurement basis should possess the fundamental characteristics that information about profit or loss should possess, and in doing so it is necessary to provide a linkage between profit or loss and measurement. Do ASAF members have any comments on the ASBJ's view?