



## Response of the EAA Financial Reporting Standards Committee<sup>1</sup> to the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*

We welcome the IASB's decision to give priority to updating and amplifying its conceptual framework. We also welcome the decision to consult broadly with national standard-setters through the Accounting Standards Advisory Forum as opposed to pursuing a unique project with the FASB.

The July 2013 Discussion Paper is organised in sections, with questions for constituents at the end of each section. We are therefore responding in the same format. Our submission contains a brief review of the research literature that relates to the section, followed by a discussion and then answers to the specific questions posed. We have extended the scope by including a discussion of the reporting entity.

### **Section1: Introduction**

We note that the role and function of a conceptual framework for financial reporting is something that was developed first in the United States. As a consequence, the FASB framework was written against a context of a number of assumptions, principally that financial reporting is primarily concerned with the functioning of the capital markets, and also that standards were best written by technicians who had been actors in that capital market. Zeff (2013) provides an account of the evolution of the US framework in this context.

The US conceptual framework has been widely used as a basis for the frameworks of the IASB and of standard-setters in developed Anglophone countries but not in mainland Europe. Individuals have made attempts to write versions for European nations which have a code law tradition of rule-making, but these have remained marginal. The European tradition in writing accounting rules is

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much older than the Anglophone one, owing its origins in the seventeenth century to a desire of the French government of the day to regulate the functioning of business so as to combat bankruptcies (Walton 1995, 5-6). The French rules were adapted by the Prussian government and over time this has led to a tradition in many European countries where accounting is part of a Commercial Code and is specified by government. No one particular group of interested parties is privileged, and generally the aim is to arrive at a consensus on a case by case basis. In many countries the rules are closely linked to taxation, and there is an emphasis on conservatism.

More recently the Accounting Standards Board of Japan has developed its own framework as also has the Accounting and Auditing Organisation for Islamic Financial Institutions. The International Accounting Standards Committee developed its framework based on the US model in the 1980s, although it may have been a little influenced by non-Anglophone traditions in that it addresses a wider group of users and includes a prudence requirement (SFAC 2 specifies 'neutrality' as part of reliability but the text does discuss conservatism). Aside from these differences of emphasis, a major difference from the US regulatory context is that the US framework is non-authoritative literature (deliberately excluded, for example, from the Accounting Standards Codification), while the IASB framework is embedded in IFRS: IAS 8 *Accounting Policies, Changes in estimates and Errors* refers to it as an authoritative source to be used by preparers and auditors in developing policies for which there is no applicable standard, and it is referred to in IAS1 (paragraphs 19 and 28).

The IASB's present framework ('Purpose and status' paragraphs) suggests a wide purpose, including use by preparers and auditors. The literature also supports a wide approach. Macve (1981, 9) wrote:

The role of a 'conceptual framework' is to provide a structure for thinking about what is 'better' accounting and financial reporting. It is a theoretical endeavour with the practical aim of clarifying the objectives of financial reporting, and how alternative practices are likely to help achieve those objectives. Whether as a company director, a chief accountant, an auditor or an accounting standard-setter, one cannot make a rational choice of accounting procedures without some framework of principle.

Carsberg (1984, 25) defines a conceptual framework as follows:

A conceptual framework comprises a set of basic principles that command general support and can be used to help with detailed decisions by increasing the likelihood of consistency and reducing the costs of analysis. In financial reporting, a conceptual framework is expected to help with decisions by standard-setters and others about how accounting measurements should be made, what information should be included in published reports, and how the information should be displayed.

Both these authors explicitly see a wider role for the conceptual framework than being only a guide for standard-setters. This view is shared by Gélard (2010) who adds that in a system of standards that are principles based, the framework is an important tool for preparers to guide in the interpretation of the principles.

#### **Question 1**

Paragraphs 1.25–1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

- (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and
- (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

- (a) We share the view that the conceptual framework has a wider application and is potentially relevant to all stakeholders. Therefore we think that the IASB's preliminary view as expressed in Question 1 should be expanded to acknowledge that the framework has applicability to anyone interested in working with IFRS. As written it is open to interpretation as meaning that the framework is relevant only to standard-setters. Given the DP's paragraphs 1.27/8, it may be that it is the question which is potentially misleading.
- (b) We do not think that it will necessarily be rare that 'an aspect' is departed from, given the conflicting nature of various principles, and the trade-offs inherent in the conceptual framework. We think it is important that there should be an established process for dealing with cases where standards are in conflict with the framework.

## **Section 2 Elements of Financial Statements**

### Relationship between the elements

It is clear from the Discussion Paper that IASB is minded to retain the existing so-called balance sheet approach to the definition of elements, under which assets and liabilities are defined first (in terms of economic resources and claims) and the definitions of income, expenses and equity rely on those definitions. (Equity is the residual interest in assets after deducting liabilities, and income and expenses are changes in equity.)

The FASB's reasons for adopting the asset/liability approach are documented in Storey and Storey (1998). The FASB's lead was followed by the IASC and also by several other accounting standard-setters. However, the approach has been challenged, for example, Kvitte (2008), Dichev (2008) and Sundem (2007). Some of the arguments in favour of and against such an approach are summarised in EFRAG *et al* (2013).

A reconsideration of the fundamental approach to the definition of elements is outside the stated scope of IASB's current work on the Conceptual Framework, which it sees as being merely to clarify and complete the Framework.

### Definitions of assets and liabilities

The existing and proposed definitions are summarised in DP2.11:

	<b>Existing definitions</b>	<b>Proposed definition</b>
Asset (of an entity)	a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	a present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.

### *Resources or rights?*

Although the new definition formally retains the notion of a resource, it has become ‘an economic resource.’ In turn the definition of an economic resource means that, in effect, an asset is defined in terms of ‘a right or other sources of value’.

The DP notes (DP2.13-2.14) that the proposed definitions clarify the distinction between the existing asset or liability and the flow of benefits that may result. For example, in the case of a call option, the option is the right to buy, not the property that would be acquired on exercise of the option; in the case of research, the asset is the know-how, not the benefits that may arise if the research is successful. This seems helpful.

One benefit of the proposed changes is that there may have been a tendency in the past to analyse transactions or events by first identifying resources (such as a machine, or a portfolio of mortgages) and subsequently attempting to identify whether the resource is an asset of the entity. The possible conclusions of such an analysis seem to be that either the entity should recognise the ‘resource’ or it should not. The new definitions instead focus attention on the rights (or other sources of value) that are held by the entity. This may make it easier to conclude, for example, that the entity has rights to use a machine (for example, under a lease) that qualifies as an asset, even if its rights fall short of those that the entity would enjoy if it owned the machine. (But see also the discussion of ‘control’, below.)

A move to ‘rights’ is not without precedent. As long ago as 1907 Charles Ezra Sprague wrote “every asset may be looked upon either as a “thing” or a “right”. Possession of a thing is merely the right to use it and control it.” Slightly more recently, the UK ASB’s *Statement of Principles for Financial Reporting* (1999) contains the following definition of an asset: “Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions and events”. This definition has proved useful in developing standards, for example FRS 5 ‘Reporting the Substance of Transactions’.

## *Other sources of value*

As noted above, the new definition admits 'other sources of value' that are capable of producing economic benefits as well as 'rights'. Examples of such economic resources are given in DP3.5(c). These are:

- (i) know-how;
- (ii) customer lists;
- (iii) customer and supplier relationships;
- (iv) an existing work force; and
- (v) goodwill.

Of course, some of these may not be recognised if they fail to meet the criteria for recognition, which are discussed below. It would seem clear that know-how and customer lists may be assets. They provide the entity with the ability to do something (e.g. manufacture a product or carry out a targeted marketing exercise) which may be advantageous and which it could not do in the absence of the asset. The remaining items seem more doubtful. A customer relationship, for example, does not give rise to a right to future business—only the hope of future business and it would be difficult to be sure that any such business will be on more advantageous terms than might have been secured without the previous relationship.

As pointed out in the DP, the IASB has concluded in IFRS 3 that 'core' goodwill is an asset, even if it is not clear that the rationale is convincing. Such goodwill includes (i) the excess of the value of the acquired business as a going concern over the fair value of its assets and liabilities, and (ii) the value of synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. It would seem that the factors in (i) represent the differences in values that would be attributed to assets and liabilities if they were accounted for differently, and (ii) represents possible assets and liabilities that are not identified and accounted for. A mere difference does not seem to be an asset, and the existence of other possible assets and liabilities does not show that the goodwill is, in itself an asset.

If the view is taken that the position in the DP on 'other sources of value' is too accommodating, it is not clear how the definitions (or supporting guidance) might be made more restrictive. One possibility is to require that an asset must provide the ability to do something that could be expected to result in economic benefit.

## *Probability*

Another significant change is that the new definitions do not require that future economic benefits are expected to flow to the entity for an asset to exist, and similarly it is not required that an outflow is 'expected' for an item to qualify as a liability. Instead, the proposal is that the item is capable of resulting in a flow of benefits.

There seem to be cases where an asset or liability exists, and yet it is not 'expected' (nor 'probable') that there will be any future flow. Examples include a lottery ticket and some derivatives, in some circumstances (DP2.14, see also 2.32). It would seem anomalous to deny that these are assets and liabilities (even if they cannot be sold or transferred), especially if they are acquired for consideration. Another example is an accident insurance policy from the standpoint of the policyholder: whilst one can argue that it provides the right to carry on business in a reasonably prudent manner (and perhaps whilst complying with relevant legislation) it seems easier and more

logical to justify the existence of an asset on the grounds that the policy gives the right to make a claim, even if the accident that would justify that claim is unlikely.

Some have questioned the use of the word 'capable'. They suggest that it is too vague: anything is 'capable' of producing economic benefits. (The customer relationship example may be on point: arguably a customer relationship is 'capable' of producing economic benefits, but perhaps its relationship to economic benefits is too remote to justify its inclusion as an asset.) However, no good alternative to 'capable' comes to mind.

## Definitions of income and expenses

The Discussion Paper notes that the IASB has identified few problems with the definitions of income and expense, except to clarify that an expense arises when an entity issues an equity instrument in exchange for shares (paragraphs 2.40, 2.41). It would therefore seem that IASB intends to retain the existing definitions, which are in terms of increases and decreases in assets (paragraph 4.25 in the 2010 edition of the Framework.) There are nonetheless some issues that should be considered.

### *Terminology*

The elements of 'income' and 'expenses' are the elements that fall to be reported in the income statement. They are very broad categories that include not only transactions in the ordinary course of activities, but (at least some) remeasurements of assets and liabilities and non-recurring items such as windfall gains and losses caused by expropriation of assets.

In general usage the terms income and expenses are generally used in a more restrictive sense. 'Income' carries associations of what may be distributed or is taxable and can be expected to recur from year to year: 'expenses' may be taken to refer to outlays voluntarily incurred in the expectation of benefit (see, for example, the debate about whether taxes on income are 'expenses' or 'distributions'). The UK ASB's Statement of Principles eschewed these terms, and used the terms 'gains' and 'losses' in their place. These seem to have the degree of generality that is necessary for the basic elements. If they were used as the basic elements, it would, of course, be possible to define 'income' and 'expenses' as gains and losses that meet certain additional criteria.

### *Basic problems with the definition*

Barker (2010) has drawn attention to the basic problem that the definition of income refers incorrectly to an increase in assets (which is a debit) rather than an increase in equity (which is a credit). As Barker demonstrates, this is not merely a semantic point, but leads to real confusions, because income must be understood conceptually as one component of change *within equity*, and not as a change in assets. For example, it is essential that the definition of income should exclude capital maintenance adjustments. Also, if recycling is to be required (in accordance with IASB's tentative views in Section 8), the definition of income and expenses needs to exclude items that will be reported outside of profit or loss, and include the recycling adjustments of items so reported in a previous period. It would seem unlikely that this can be satisfactorily achieved without a definition of 'profit'.

The Discussion Paper suggests that the Framework should identify categories of items that *might* be reported in other comprehensive income and then recycled, but not require that all such items should be. This is the reason for not providing definitions of 'profit' and 'OCI' (or similar terms). This does not appear to be satisfactory—but this needs to be considered in connection with Section 8.

## Revenue

Nobes (2012) has noted that a similar problem arises in connection with the definition of revenue—which is not an increase in assets but an increase in equity. The Framework should also clarify that revenue is a gross amount, but that not all gross amounts are revenue (for example, the receipt of cash for an account receivable) is not ‘revenue’. Also ‘revenue’ may arise where there is no net increase in net assets—as when inventory is sold to a customer for less than its carrying amount. There is now no definition of ‘ordinary activities’ in IFRS literature. Therefore, it seems inappropriate to use it as part of the definition of revenue. It is not clear to us what the IASB means by ‘ordinary’.

### Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. The IASB proposes the following definitions:

- (a) an asset is a present economic resource controlled by the entity as a result of past events.
- (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.
- (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

We note that there is no discussion of whether an approach to recognition based on defining assets and liabilities is appropriate or any consideration of alternative views, even though this has for centuries been a fundamental debate in financial reporting (Näsi et al 2014). We think that the conceptual framework should provide at least a rationale for this approach.

Setting aside that unasked question, we believe that the revised definitions of asset and liability are helpful. We support the point that the asset is not the future benefits. However, we disagree with the notion that assets and liabilities can only be recognised when their existence derives from some identifiable, related past event. We think this is an unnecessary qualification that is inappropriate at the conceptual level. It may be a necessary anti-abuse measure to be included in specific standards, but even at that level it is clear from Interpretation 3 and Interpretation 21 that it leads to counter-intuitive accounting in some cases.

### Question 3

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB’s preliminary views are that:

- (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is ‘expected’. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.
- (b) the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.
- (c) the recognition criteria should not retain the existing reference to probability.

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

We agree with the removal of the expectation of future inflows and outflows and think the revised wording is more helpful. We also agree that there should be no probability threshold. Such a threshold creates an on-off switch which is difficult to apply in practice and which may fail to provide useful information.

#### Question 4

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52.

Do you have any comments on these items?

Would it be helpful for the *Conceptual Framework* to identify them as elements of financial statements?

As noted above we think there is a need for a discussion about whether an asset/liability approach is necessarily superior to a Comprehensive Income/Equity approach. We note with interest the suggestion for providing more information within equity about transfers between equity holders, but are not sure how significant this is at an application level. As we will explain later, we think it would be useful to define the purpose of profit or loss and OCI.

### **Section 3 Additional guidance to support the asset and liability definitions**

#### *Control*

In addition to requiring that the entity control the resource, the current definition of an asset requires that future economic benefits will flow to the entity. In the new definition, this is covered by the concept of ‘control’, the proposed definition of which is:

*An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it. (DP 3.23)*

The normal dictionary meaning of control includes the concept of directing, but not of benefitting. However, as the Discussion Paper explains, its proposed definition is built on the requirements of IFRS 10 ‘Consolidated Financial Statements’ and the idea of control comprising both direction and benefit is also reflected in the IASB’s draft standard on revenue. There may, therefore be little prospect of the IASB changing this aspect of the definition.

DP 3.31 explains that an agent does not have an asset because it fails the benefit leg of the definition of control: the benefits of the resource accrue to the principal, not the agent. Perhaps this is not quite on point: the agent is only able to control the asset within the restrictions imposed by the agency agreement (and probably where there is any discretion could be sacked if the agent did not exercise control in accordance with the wishes or interests of the principal). Furthermore, the benefits that accrue to the agent by exercise of its control rights that it has would presumably be less than the total benefits that the underlying resource will yield: this would be reflected in measurement.

Perhaps this shows that there remains a tendency, despite the changes in the definition, to identify the asset first and then whose it is. This suggests that the change in thinking welcomed above has not been fully reflected in this part of the Discussion Paper.

The Discussion Paper does not discuss the position of a trustee and a beneficiary, where the issues would seem to be the same as those relating to agent and principal. It may be constructive to suggest that the Conceptual Framework would be more complete if it did.

#### *Constructive obligations*

The Discussion Paper ponders whether the notion of a liability should be restricted to obligations that are enforceable by legal or equivalent means, or whether it should also accommodate other



obligations, ‘constructive obligations’. The IASB’s tentative view is that constructive obligations should be included and that guidance on the latter should be added. IASB’s arguments for and against admitting constructive obligations are set out in DP3.60 and 3.61.

There is obvious attraction in limiting liabilities to those that are enforceable. This might promote certainty and hence comparability. However, it is probably a mistake to assume that it is always clear (even after taking legal advice) whether an obligation is enforceable. If liabilities had to be enforceable it would be necessary to consider how to deal with cases where, although there is a liability at law, the other party is unlikely to have recourse to the courts or other formal mechanism to enforce payment—for example where the amount ‘owed’ is small compared to the cost of legal action.

However, during the financial crisis it became clear that ‘reputational damage’ was an issue that directors thought they should take action to mitigate. That could be seen to be a constructive obligation and the risk of factors outside the entity causing damage might be seen as a potential liability in some transactions.

The guidance on constructive liabilities that is proposed to supplement the definition is set out in DP3.50. It is:

Additional guidance could emphasise that, for an entity to have a constructive obligation:

- (a) it must have a duty or responsibility to another party or parties. It is not sufficient that an entity will be economically compelled to act in its own best interests or in the best interests of its shareholders.
- (b) the other party or parties must be those who would benefit from the entity fulfilling its duty or responsibility or suffer loss or harm if the entity fails to fulfil its duty or responsibility. In other words, the other party or parties must be those to whom, or on whose behalf, the entity is required to transfer an economic resource.
- (c) as a result of the entity’s past actions, the other party or parties can reasonably rely on the entity to discharge its duty or responsibility.

There are a few potential problems with this guidance. Is it right that there will always be another party to whom the obligation is owed? The contrary view is suggested by DP3.34, which says: ‘If a liability exists for one party, an asset always exists for another party or parties, except perhaps for some obligations to clean up damage to the environment.’ What does ‘reasonably rely’ in (c) mean? Possible meanings are ‘rationally be confident that’ or ‘rationally consider itself entitled to assume that’. If the aim is to identify *obligations* rather than *expectations*, the latter meaning would seem to be more appropriate.

Finally, is it necessary that reasonable reliance should be based on the entity’s ‘past actions’. Obviously, history will often be helpful in considering whether a liability exists, but it does not seem conceptually right that the entity’s past practice of dealing with similar situations should be determinative. Or perhaps ‘past actions’ includes more than past practice, for example, undertakings given by the entity. Possibly it would be helpful if this were clarified.

### ‘Present’ obligations

The Discussion Paper notes that it is not always easy to distinguish a ‘present’ obligation from a possible future obligation, particularly when future events which are, at least arguably, within the control of an entity may affect whether an outflow of resources is required. It sets out three views:

- View 1            The obligation must be strictly unconditional.  
View 2            The obligation must be one that the entity has no practical ability to avoid.  
View 3            The obligation must have arisen from past events but may be conditional on the entity's future actions.

One of the examples given to illustrate the issue is that of a bonus payable to employees on completion of five years' service, of which only two years have elapsed. The bonus will not be payable if the employment contract is terminated by the entity. Under View 1, there is no liability until the completion of five years' service. Under View 2 there is a liability if the employer has no practicable ability to sack the employees. On View 3, a liability exists because the employer has already received two years' service.

If the employer can sack the employees without any adverse consequences then it may seem odd to conclude that a liability exists. But if this were the case, then the bonus would probably fail to achieve any economic purpose. Employees are unlikely to be motivated to remain with the entity if they have no reason to be confident that they will receive the bonus.

The Discussion Paper notes that further guidance would be needed to apply View 2. It suggests (paragraph 3.79) that such guidance (which might be given in standards rather than the Framework) might include conditions such as whether the entity could avoid the obligation only by ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets.

Several of the other examples in the Discussion Paper concern levies. Because they are (presumably) imposed by government, it is difficult to be clear what the payment is in exchange for—presumably externalities caused by operating in a particular industry. As with bonuses it may be noted that the levies seem to be predicated on the view that there is little or no opportunity for the entity to avoid the levy by leaving the industry or significantly reducing the scale of their activities. They would otherwise not achieve their purpose (unless the purpose is to encourage entities to leave the industry).

Under View 3, a liability exists where a past event has created an obligation that may require it to transfer an economic resource, or to exchange resources on more onerous terms than would otherwise be required. Thus a liability exists even where the entity can avoid it by taking future actions (for example, by leaving a specific market).

A consideration of which view is to be supported might start with Example 2 which concerns a train operator that has earned revenues in the first half of the year, and will have to pay the levy if (and only if) it earns significant revenues in the second half year. There seems little doubt that the levy will be payable. More to the point is the fact that, by virtue of a past event (earning revenues in the first half), the entity has a prospective obligation that would not be there if it had earned no revenues. As such it is 'worse off' as a result of events in the first year. Slightly more formally, it is subject to economic constraints that would not exist in the absence of past revenues. This suggests that View 1 should not be supported.

The main difference between View 2 and View 3 is that it matters whether the entity has the 'practical ability' to avoid the levy by reducing the amount of revenues it earns. If it does not have that ability, then there is a liability on both these Views: they differ only in the (perhaps unlikely) case that it can. However, it would seem that the ability to avoid the liability is distinct from its existence.

It was noted above (in connection with the employee bonus example) that it would seem odd to conclude that a liability exists if it can be avoided without any adverse consequences. It is, however, important to bear in mind that the issue is the existence of a liability: recognition and measurement remain to be considered. View 3 may well suggest that liabilities exist that, if recognised, would be measured at a low amount. These would include liabilities that do not matter much to entity because it has the ability to avoid them. Nonetheless, it is suggested that View 3 is the most satisfactory. That said, it should be acknowledged that the arguments are finely balanced.

If View 1 is rejected on the grounds that it is unduly restrictive, it would nonetheless be possible to suggest separate disclosure of obligations which could be avoided under certain circumstances (if the entity really wanted to do so). This would provide relevant information for those assessing an entity's liquidity risk.

### *Variable lease payments*

One of the examples given in the Discussion Paper in the context of a 'present' obligation is that of a lease on a retail unit under which the occupant is required to pay a variable rental of 1% of its revenues to the owner. In its discussion of Views 2 and 3, the Discussion Paper assumes that the occupant should show an asset equivalent to the value of occupying the unit without the requirement for the variable rental and a liability for the variable payment.

A footnote to Tables 3.1 and 3.2 acknowledges the view that the asset should be smaller—it is not the same as a right to occupy without the requirement for variable rentals—and no liability. This seems to be the correct analysis. However, it may not be considered that the issue is sufficiently central to the Conceptual Framework to raise the issue in a response to the Discussion Paper.

### *Reporting Substance*

Prior to the revisions made in 2010, the Conceptual Framework contained a paragraph (paragraph 35) that said it was necessary that transactions and other events are accounted for in accordance with their substance and not merely their legal form. The Discussion Paper proposes adding guidance to assist the identification of contractual rights and obligations: these are set out in paragraph 3.102 and seem very sensible. The following paragraphs discuss the notion of 'economic compulsion'. IASB's preliminary view (see paragraph 3.108) is not to add anything to the Framework on this point, but to consider it in the context of individual standards. This too seems sensible.

There are, however, some points that might be made on this discussion:

- (i) One of the examples used is that of economic compulsion that might result in an instrument being classified as a liability, and another is that of the 'liability' to pay the exercise price of a purchase option contained in a lease. Some consider that these are different: the first example is about recognition, while the second is about measurement of the liability under the lease. This is important because the legitimate role of economic compulsion may be different in the case of recognition and measurement.
- (ii) Paragraph 3.108 is puzzling. It discusses an instrument that contains an option for the issuer not to redeem it. It seems clear that (in the context of the example) if that option has substance, the instrument would not be a liability, but equity. However, the paragraph suggests that, even if the option has substance, the instrument still might be classed as a liability if there is 'economic compulsion' not to exercise it. So one is left with the impression that 'economic compulsion' does not affect the substance of the transaction (or instrument) but still might be determinative of whether a liability exists. It may be useful to suggest that the IASB clarify this.

### *Executory contracts (and other forward contracts)*

A general comment in the Discussion Paper is that some of the material reads as a rationalisation of existing practice rather than a framework developed from first principles, which may assist in improving financial reporting in more fundamental respects than simply ensuring consistency. The discussion of executory contracts that concludes Section 3 of the Discussion Paper might be seen as an example of this.

The essence of the argument is that executory contracts are usually presented net either because:

- (i) they give rise to an obligation to exchange, rather than distinct rights to receive and obligations to transfer; or
- (ii) the assets and liabilities are offset.

There is no discussion of which rationalisation would apply in what circumstances: this seems to be seen as a part of the unit of account issue (see paragraph 3.13) which the Discussion Paper envisages will not be dealt with in the Framework, but at the level of standards (see paragraph 9.38). Possibly it is reasonable to agree that the question of whether there are distinct assets and liabilities is a unit of account issue, but offset perhaps is rather a question of presentation.

The key argument is that “if the contract was priced on arm’s length terms, the initial measurement of that contract would typically be zero because the rights of one party have the same value as its obligations to the other party” (paragraph 3.110). This raises questions about the concept of value. The argument may, however, seem persuasive from the perspective of the purchaser as, on performance, it will recognise the asset received in place of cash or a liability and equity will be unchanged. However, the seller will not report simply a change in its assets: typically it will report a gain as the value of the cash received (or receivable) will be greater than the inventory that is derecognised. Thus the ‘exchange of equal value’ argument does not work for the seller. A better justification for lack of recognition of an executory contract by a seller is that the seller would need to allocate the anticipated profit between that made on obtaining and that on performing the contract: and that such a split would be arbitrary and of doubtful usefulness.

#### **Question 5**

Constructive obligations are discussed in paragraphs 3.39–3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

We certainly think the definition of liability should not be narrowed. However, we are also aware that the constructive obligation limitation does not always provide an easily-justifiable dividing line – for example in the case of participating insurance contracts where the insurer has notional discretion. We cannot supply an alternative solution, however, and we believe one must accept that this is a boundary that will always prove difficult in practice.

#### **Question 6**

The meaning of ‘present’ in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting

period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

- (a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.
- (b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.
- (c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3. Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

As discussed above, we are not convinced that the requirement for there to have been a past event is useful in practice. We do not support view 1, but we think that the past event should be considered to be an important indicator, but not a necessary condition. We also think that the dividing line between view 2 and view 3 is highly judgmental, and it is inappropriate at a conceptual level to exclude an obligation that may arise from future avoidable actions. At an extreme, an entity could elect to cease business, so its future actions could prevent a liability, as in the case of Levies, but that runs counter to the purpose of the entity. At least we would suggest a version of view 3 that says a liability can be recognised even though an entity could avoid it, if in the normal course of business it would not avoid it.

#### **Question 7**

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

We would underline that we do not think restrictive, anti-abuse definitions are appropriate in the conceptual framework.

### **Section 4 – Recognition and Derecognition**

#### Recognition

The recognition criteria in the existing Framework state that an entity recognises an item that meets the definition of an element if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be reliably measured.

The DP proposes that the reference to probability should be deleted (for similar reasons as arises in connection with probability in the definition, discussed above) as will the reference to reliable measurement. The IASB's preliminary views on recognition (DP4.24-4.27) are that all assets and liabilities should be recognised, except that the IASB<sup>2</sup> might decide in developing or revising particular standards that an entity need not, or should not, recognise an asset or liability:

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<sup>2</sup> The preliminary view implies that the ability to use the exceptions will be reserved to the IASB: that is, a preparer who (under IAS 8) used the Framework for a transaction that is not the subject of a standard would not be able to use them to conclude that any assets or liabilities should not be recognised. Perhaps such a restriction on the use of the Framework should not appear in the Framework itself.

- (a) if recognising the asset (or liability) would provide users with information that is not relevant, or is not sufficiently relevant to justify the cost; or
- (b) if no measure of the asset (or liability) would result in a sufficiently faithful representation of the asset (or liability) and of changes in the asset or liability, even if all necessary descriptions and explanations are disclosed.

The main reason for deleting the requirement that the item to be recognised has a cost or value that can be measured reliably seems to be that given in DP4.16: *“Because the existing Conceptual Framework no longer defines reliability, the recognition criteria cannot retain that term.”* Some believe that reliability should be recognised in the Framework as a qualitative characteristic. But, without seeking to consider that view, it is questionable whether reliability of measurement should feature in the recognition criteria. Undoubtedly many of the assets and liabilities that should not be recognised in financial statements are very difficult to measure, but so are some where recognition is appropriate. It was probably once generally considered impossible to measure reliably pension deficits or liabilities under life assurance policies. If financial statements are to give any view of the effects of the acquisition of a mining company it may be necessary to assign a value—albeit highly unreliable—to the mineral reserves acquired.

There may also be examples where an item can (at least arguably) be measured reliably, but its relevance is questionable. It might be argued, for example, that some intangible assets acquired in a business combination and some liabilities, such as an agreement not to compete, could be measured reliably. It may be that lack of relevance (which might, as discussed below, include the idea of lack of reliable measurement) is a more powerful argument against the recognition of such items than the absence of reliable measurement alone.

The DP states (DP4.26) that the Conceptual Framework could provide further guidance as to when recognising an asset or liability might not provide relevant information. It provides some examples that the guidance could suggest may be indicators that recognition would not provide relevant information. (The following is a summary: the DP gives more detail.)

- (a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate: this might be the case in, for example, some major litigation.
- (b) if an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result.
- (c) if identifying the resource or obligation is unusually difficult: for example, this may be the case for some intangible assets.
- (d) if measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.
- (e) if recognising an asset is not necessary to meet the objective of financial reporting.

It would seem that these factors capture much—perhaps all—of the essential ideas of a low probability of flow and lack of reliable measurement, but without requiring that they would, in and of themselves, prevent a standard requiring recognition. One consequence of this is that questions of ‘how probable is probable?’ and ‘how reliable is reliable?’ will fall to be addressed in the context of individual standards. Some may see this as an advantage as these issues are likely to be more tractable at the level of standards. Others may consider that these should be dealt with in the Framework in order to secure greater consistency between different standards. It would seem that if the Framework is to give lack of relevance as a reason for non-recognition, it would be essential to include guidance along the lines given in paragraph 4.26.

## *Faithful representation*

As noted above, the second exception to the principle that all assets and liabilities should be recognised is that a standard may permit or require non-recognition if ‘no measure of the asset (or liability) would result in a sufficiently faithful representation of the asset (or liability) and of changes in the asset or liability, even if all necessary descriptions and explanations are disclosed.’ However, the DP also notes that: ‘Some believe that there are no circumstances when recognising an asset or a liability would provide information that is relevant but yet would not result in a faithful representation of that asset or liability and of changes in that asset or liability. Accordingly, in their view, there is no need for the recognition criteria to refer separately to faithful representation.’ (DP4.20). The DP does not give a reason for rejecting this view.

As described in the current Framework, faithful representation does not imply relevance. It gives the example (paragraph QC16, reprinted on page 201 of the DP) of an asset acquired for no cost (perhaps as a government grant) and is clear that a faithful representation can be given by reporting the asset at nil cost, but suggests that this would be ‘probably not be very useful’. The conclusion seems to be that any measurement basis could be ‘representationally faithful’ (if supporting disclosures are adequate). Given this, it is difficult to see how there could be a measurement basis that is capable of providing relevant information but would not be representationally faithful. It seems that, in including the notion of faithful representation as a recognition criterion, the IASB have been attaching to it a different sense from that given to it in the existing Framework. It would appear that, particularly if a recognition criterion relating to representational faithfulness is to be included, the discussion in the existing Framework should be clarified.

## *Derecognition*

Derecognition has played an important part in the debate on off balance sheet finance. Many arrangements in this area involve a sale: accounting for it as such involves derecognition of the asset and recognition of the cash. However, some question sale accounting if there are terms that may require the entity to repay the cash. This obviously involves consideration of whether the possible repayment is a liability, and also whether it is correct to derecognise the asset. The Discussion Paper notes that, where questions of derecognition arise, the challenge is to represent both the economic effect of the transaction (which may be small) and the resulting assets and liabilities—which may appear to be no different from those that could have been obtained by another route that results in only small assets or liabilities. For example, if debt is sold with recourse (and the proceeds used to repay an existing loan) the economic effect of the transaction is small, but the resulting assets and liabilities may be little different from those that would arise if the entity had merely guaranteed a portfolio of loans. Acknowledgement of the need to balance both conflicting objectives seems welcome.

The Discussion Paper addresses two questions:

- (i) the circumstances in which an asset should be derecognised in its entirety (full derecognition); and
- (ii) partial derecognition.

## *Control approach vs. risks and rewards*

Two approaches to full derecognition are explored in Discussion Paper, as follows:

- (i) *The control approach*. This is simply the mirror image of recognition. An asset or liability is therefore derecognised when it no longer meets the definition of an asset or liability and the recognition criteria.
- (ii) *The risks and rewards approach*. Under this approach an asset or liability continues to be recognised until the entity is no longer exposed to most of the risks and rewards generated by that asset or liability.

A consequence of the risk and rewards approach is that whether an asset or liability is reported may depend on whether it was previously recognised, rather than on the economic position of the entity. This would not be the case under the control approach. IASB's preliminary view is to favour the control approach, which does appear to be conceptually superior. It certainly seems difficult to support the notion that an entity should recognise as an asset an item that no longer meets the definition. However, the recognition criteria may need to be applied slightly differently.

#### **Question 8**

Paragraphs 4.1–4.27 discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

We think this approach would result in greater recognition of assets and liabilities and an increase in the information content of the financial statements. We note that some constituents appear to believe that this approach would result in recognition of many insignificant assets not currently recognised. We do not believe that is the case, as there would remain two hurdles - materiality and relevance.

#### **Question 9**

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;
- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

In general we support that view. We consider that whether recognition of a new, different asset is preferable to modification of the existing asset is likely to depend on the facts and circumstances, although we incline to the view that generally recognition of a new asset is likely to give better information.



## **Section 5 – Definition of equity and distinction between liabilities and equity instruments**

### Equity/Liability distinction

Few recent empirical papers are of interest here. The basic intuition behind these recent works is to look at how controversial instruments (e.g. preferred stock, stock-options, convertible debt) correlate with market-based measures of risk and return and compare these correlations with the correlations of standard instruments (pure debt or plain common share capital) with the same market-based measures. By doing this, we are able to determine how the market treats these instruments.

Examples of this approach are Barth et al. (2013) for employee stock-options, Cheng et al. (2007, 2011) for preferred stock and Carrizosa (2010) for convertible debt. The question here is whether the CF should admit this market based criterion as a way to determine the distinction between liabilities and equities.

Complex financial products are difficult to judge *ex ante* on a purely theoretical basis. Moreover, if we have evidence that a certain instrument is considered as equity by the market, no matter the accounting classification imposed, it is very likely that sophisticated users will reclassify it as equity even if it is reported as liability. So, once again, the empirical literature tells us that any classification proposed has to interact with the incentives of users and its usefulness will be crucially determined by these interactions.

The Discussion's Paper proposals on equity are discussed in Section 5. This is a lengthy section that gives rise to a large number of questions. The following comments relate to IASB's preliminary views, which are summarised in question 10. In a nutshell, the proposal is to retain the existing definition of equity, but to require further information about various classes of equity, including remeasuring them and reporting the effect of such remeasurement in a statement of changes in equity.

### *Retaining the existing definition of equity*

The existing definition ('the residual interest in the assets of the entity after deducting all its liabilities') articulates with the concepts of 'assets' and 'liabilities'. Alternative suggestions seem to lead invariably to additional complication, and create the risk of an instrument falling between the definition of a liability and that of equity. It therefore seems sensible to retain the existing definition<sup>3</sup>.

### *Remeasuring classes of equity*

The IASB's preliminary view is that an entity should update the measure of each class of equity claim at the end of each reporting period, and recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim. The method of remeasurement (which might be a 'direct measure' or an allocation of equity) would be prescribed by accounting standards, not by the Framework. Remeasurement seems sensible, and the proposed

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<sup>3</sup> One might quibble, however, about the word rather than the definition. Arguably 'equity' implies sharing in profits and losses: this does not apply to preference shares who have only a restricted interest in profits. For this reason, the UK ASB's Statement of Principles uses the term 'ownership interest' rather than 'equity'.

statement of changes in equity should give useful information. However, it would seem to be necessary to distinguish between (i) those cases where the instrument is stated at a market value (or, in the absence of a market, an estimated market value); and (ii) cases where the measure is an allocation of equity. The split between these would seem to correspond to that between secondary equity claims (rights to receive or obligations to deliver another equity claim) and primary equity claims (a present right to share in distributions).

For both classes, the term 'wealth transfer' seems inappropriate, as it implies that the wealth of the period has accrued first to ordinary shareholders and subsequently been transferred to other classes of equity.

- (i) For a primary equity claim (such as non-controlling interest), this is not the case: the profits of the period have been earned by all equity holders; some accrue to holders of the non-controlling interest and some to shareholders of the parent.
- (ii) The term is equally inappropriate for secondary claims: while an increase in market value may in part reflect the profits earned in the period, it is also the result of all factors that influence the market. Because the financial statements do not purport to reflect the wealth of the ordinary shareholders, there is no sense in which an increase in the value of a secondary claim can be said to reflect a transfer in wealth to the holders of the secondary claim.

#### Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB's preliminary view:

- (a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.
- (b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:
  - (i) obligations to issue equity instruments are not liabilities; and
  - (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).
- (c) an entity should:
  - (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.
  - (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.
- (d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Our views are:

10(a) We agree. As indicated above, we would prefer to see a greater discussion of this question.

10(b) We believe that insistence on a clear line between equity and liabilities is profoundly unhelpful and leads to many resource-consuming debates without outcome. We prefer a ranking of equity and liabilities in relation to obligations in the event of liquidation. The issue of what is 'interest' for tax purposes should be left to the tax definition in each jurisdiction.

10(c) As indicated above, we are not aware that this is a significant issue.

10(d) In our view this underscores our view that the equity/liability distinction is irrelevant.

## **Section 6 – Measurement**

### Literature review

The use of historical cost (HC) for the measurement of assets has been required in various jurisdictions at various dates. It was the long-run requirement under German law (*Handelsgesetzbuch*) before and after its amendment by the EU's Fourth Directive on company law in 1985. In the USA, HC was one of the first requirements of the SEC after it was founded in 1934 (Zeff, 2007). Even in countries which lacked any legal instructions on the matter (e.g. the UK until 1981), HC was the natural basis for accountants to adopt, since it flows from the transaction-based system of double-entry bookkeeping. There have been some academic advocates of the theoretical advantages of HC (e.g. Ijiri, 1971). Our literature review of empirical studies also includes those which show that HC has information content, in some cases nearly as good as that of current value.

Nevertheless, in times of rapidly rising prices, academics and practitioners are catalysed into considering alternatives to HC. Referring to German hyperinflation, Sweeney (1927, 1936) proposed indexation of accounting (general price level adjustments, GPLA), which has been one stream of thought. A quite different idea - specific price adjustments or replacement costs (RC) - was proposed in Germany by Schmidt (1930) for income statements and in the USA by Bonbright (1937) in the context of insurance valuations. MacNeal (1939) advocated current market selling prices; as reviewed by Zeff (1982).

The 1960s was the golden age of 'general normative theories' which were designed to replace HC. Chambers (e.g. 1966) advocated a system of continuously contemporary accounting in which all assets would be measured at current cash equivalents. This would have the advantage of logical additivity of assets. It had the effect of valuing some "assets" (e.g. goodwill) at zero and specialist assets at amounts much below their cost or "value to the business". Sterling (1970) largely agreed with Chambers.

Edwards and Bell (1961) analysed 18 measurement bases, which result from the dimensions of (i) past/current/future prices, (ii) entry/exit prices, and (iii) original/present/ultimate form. HC is a past/entry/original basis; net realisable value (NRV) is a current/exit/present basis; discounted cash flow (DCF) is a future/exit/ultimate basis. Although the IASB's "fair value" is said (in IFRS 13) to be an exit value (a current/exit/present basis), it would not be so according to Edwards and Bell because it is gross of selling costs. Edwards and Bell concluded generally in favour of RC.

A more complex, compound measurement system was proposed by Baxter (1975 and 2003). In this "deprival value" basis, an asset should be measured at how much worse an entity would be without the asset. This comes down to the following rule: lower of RC and recoverable amount (which is the higher of DCF and NRV). Parker and Harcourt (1969, pp.15-19) summarise this system. Gee and Peasnell (1976) investigate the practical importance of the six possible arrangements RC, DCF and NRV. For most assets, the deprival value system leads to RC. The term "value to the business" is equivalent to deprival value. The term "value in use" is equivalent to DCF.

Whittington (1983) reviews the debate about accounting and rising prices. The practical application of these theories can be seen in various forms. The GPLA approach was used in practice extensively in South America from the 1970s and in the UK sporadically in the early 1980s in response to a provisional accounting standard (PSSAP 7). The RC approach was used by several large Dutch companies from the 1930s (Zeff *et al.*, 1992, pp. 77-8, 224-8). It was also advocated around the

English-speaking world by governments who were opposed to various economic dangers of indexation. There was some brief practice in the UK and other countries in the early 1980s. Mumford (1979) detected a cycle comprising repeated versions of the following: inflation develops, accountants propose GPLA, governments propose RC, inflation falls.

Nobes (2001) analyses the measurement bases found in UK and IASC standards, noting a bewildering mixture of many of the above simple and compound bases. For example, the impairment approach of IAS 36 owes something to deprival value, with the major caveat that the prime basis is HC not RC. This analysis includes “fair value” (FV), which is a modern term not found in any of the above literature. By that stage, there was considerable practitioner and academic (e.g. Horton and Macve, 2000) opposition to the use of FV. However, CICA (2005) proposed that all assets and liabilities should initially be measured at FV. Van Zijl and Whittington (2006) attempt to reconcile deprival value and FV.

There is not such a long history of writings about the measurement of liabilities. Indeed, in much of the above literature, liabilities are not even mentioned. However, papers on the theoretical aspects of the measurement of liabilities include: Baxter (1975 and 2000), Kulkarni (1980), Kerr (1981), Lennard (2002), Nobes (2003), IASB (2010), IPSASB (2010), Horton *et al.* (2011), and Nobes (2011).

Baxter, Kulkarni, Kerr and Horton *et al.* argue in favour of (or explicate) relief value (RV), which is the analogy to the deprival value of an asset. RV generally leads to measuring a liability at its current net replacement consideration. However, all the authors have doubts about applying this to certain types of liabilities. Lennard (2002) is one of those who argue in favour of relief value. IPSASB (2010) outline many measurement bases, including RV.

Nobes (2011) argues for the lowest exit value, which would normally be the DCF of expected outflows, but would sometimes be a gross transfer value or a gross cost of release. Interestingly, the IASB (2010), in an abandoned exposure draft to revise IAS 37, had proposed something similar for measuring provisions.

The empirical literature very rarely talks of “measurement”. This word is more often used by theoretical research. The empirical literature focuses on alternative “valuation” methods and their effects.

We would like to question the use of the word “measurement”. It suggests that the accounting process can “measure” accounting items as we “measure” height, weight, temperature. We strongly believe that this is wrong. Once we have applied all the necessary conversions from one system to the other if we are presented with the question “how long is that wall?” we can “measure” it and give an answer that the vast majority of people around the world will accept. The degree of subjectivity of the answer is extremely low. However, when we are presented with the question “How much was the net income of Apple last year?”, many possible answers can be given and a lively discussion would arise among different people about because the answer is fundamentally linked to our forecast of the future of the company (e.g. economic life of its assets, riskiness of its receivable etc...). The degree of subjectivity is quite high. So to call accounting numbers “measures” is highly misleading and should be avoided in the CF. The pitfalls for IFRS resulting from not making a distinction between measurement and estimation are explored in Barker and McGeachin (2013).

The empirical literature that has attempted to evaluate the positive and negative effects of alternative valuation methods for assets, liabilities, revenues and expenses is huge. The overall conclusion of this literature is that it all depends on the purpose of accounting and on the nature of the item being valued, which is basically what the DP says.

A recent interesting piece is Christensen and Nikolaev (2013) and its discussion by Linsmeier (2013). The standard approach to studying empirically the properties of alternative valuation methods consists of using a regulatory change as an event that creates the possibility to compare the two methods in a similar sample and in a similar context. However the choice of the method is often mandated. This type of literature is of little help in setting criteria in a CF to be used to choose a measurement/valuation method for a particular item. But the mixed results of this literature support the view expressed in the DP that no single measurement/valuation model should be imposed by the CF for all items.

Christensen and Nikolaev (2013) take advantage of the FV option for non-financial assets available under IFRS to test this choice from the demand side. They find out that this option is very rarely chosen for non-financial assets (except for investment properties). Hence preparers seem to find the benefits of Fair Value for non-financial assets to be quite low and do not perceive a sufficiently strong pressure from the market to adopt this valuation method. As stated in paragraph 6.7, the DP adopts clearly a decision-usefulness (users) approach. The results of Christensen and Nikolaev (2013) show that “options” may not lead to the desired result because preparers will choose the option that maximizes their perceived benefits and this option may not be the preferred ones for users. So maybe the CF should add “clarity of guidance” as a criterion to adopt while choosing a measurement method.

Linsmeier (2013) in his reply makes an important distinction between “income-based” relevance and reliability and “balance-sheet based” relevance and reliability. But he also raises the question of how each measurement method is presented. The adoption of FV can be combined with the provision of HC information as well in the income statement. An income-based approach may give a different perspective than a balance-sheet based approach. So Question 11 c) is possibly not realistic, and the CF should recognize that, when choosing a measurement/valuation method, it is possible that one statement has to be privileged over another. Then, the CF should explain how we should take this decision.

#### Our response to the DP

In its para. 6.13 (b), the DP suggests that some users find cost-based information more relevant than current-price information for PPE that is used in operations. This turns out later to be a vital point, which has a major effect on the DP’s conclusions about measurement. We, therefore, think that the point needs more justification.

As we have noted in G.1, apart from a few exceptions, the great bulk of academic literature casts doubt on whether cost-based information can be more relevant than current value information. For example, for which decisions would it be useful to know the cost (or the depreciated cost) of a building purchased in 1970? For which decisions would it be useful to know the depreciation expense of a machine purchased in 1990? The literature suggests that HC is not a relevant measure of value consumed when assets are used up or given up, because it is not current value and is not comparable across entities.

It would be possible to argue in favour of cost-based measures on other grounds:

- cheaper,
- more verifiable,
- is not much less “value relevant “ under some circumstances,
- the remeasurement gains and losses on not-to-be-sold assets are difficult to interpret.

However, these arguments do not amount to saying that cost-based information is more relevant. The point occurs again in the DP's para. 6.16 (b). Assuming that prices are changing, it is not clear why past margins are relevant. If prices are not changing, then there is little to talk about.

By the time we arrive at para. 6.79, we find that cost-based measures are "normally" more relevant. We did not notice the proof of that. The arguments against cost (in the DP's para. 6.82) look strong. We conclude that HC might be acceptable in some circumstances, but only as a low-cost (to the preparer) proxy at low levels of price change.

A major conclusion, with which we agree, is that a uniform basis is not appropriate (6.14). This runs counter to much academic theorising (as reviewed above). For example, Chambers argued strongly that balance sheet items should be capable of being added up. However, we accept that a balance sheet is not supposed to show the value of an entity. Intelligent users know that different assets/liabilities have different qualities and ways of leading to cash flows. Further, current values vary in their ease of measurement and verifiability, depending on the asset/liability.

We agree with the DP (its para. 6.15) that, it is important to consider income as well as the balance sheet. The point could be expanded, as follows. For some assets and liabilities, measurement at fair value involves estimation. This does not mean that the measurement is not relevant, especially if the estimation issues are disclosed. However, *changes* in fair value are (in percentage terms) very much more prone to estimation error. Furthermore, for not-to-be-sold assets, these gains are difficult to interpret, as noted above. Therefore, such gains/losses might need to be treated very differently from others.

We do not understand para. 6.19. It purports to be giving arguments against cash-flow-based measures for certain assets/liabilities. However, its examples (a) and (b) refer to the disadvantages of cost. Its example (c) appears to be a disadvantage of market prices. Somehow, the conclusion is that market prices are most relevant. We agree with the conclusion, but the arguments are confused.

In the paragraphs on "cost" (6.38 – 6.44), the DP occasionally refers to "proceeds" as the basis for measuring liabilities. This is useful because clearly (some) liabilities have proceeds, which is the opposite of costs. We suggest more use of the word. For example, at the start of para. 6.40, it could say "costs or proceeds" rather than just "costs". Similarly, in para. 6.44, it would be better to refer to "amortised cost or amortised proceeds". A similar point applies to para. 6.103.

Para. 6.38 says "if there were an analogous definition for a liability". We believe that there should be.

Despite the enormous literature on deprival value, we agree with the DP's summary (paras. 6.42/3) about its disadvantages. However, we note that the disadvantages of historical cost would become overwhelming again (as they did in the 1970s) if general or specific price changes became larger and sustained.

We disagree with the conclusion that "initial measurement issues are rarely significant" for exchanges of equal value (para. 6.61). This rests on the assertion that cost is the same as fair value (para. 6.63). However, in IFRS, "cost" includes transaction and other costs (e.g. in IASs 2, 16, 38, 40). Para. 6.64 (b) eventually admits that the two "can differ". We expect that they *usually* do, and often importantly (e.g. buying property). Thus paras. 6.61 – 6.64 hide the problem by sleight of hand.

Related to the above, we are not clear why gross cost or net proceeds is not equal to (as opposed to “could be considered equal to”) the fair value of the consideration given/received (para. 6.66). Relating to (a), we would expect it to be commonplace for an entity to pay less for an asset than its initial recoverable amount. Presumably, entities would not buy an asset unless they thought that DCF exceeded gross cost. On other occasions, management makes a mistake, and buys an asset whose DCF is lower than gross cost. It is not clear why it is good accounting to set cost aside (for initial measurement), if the arguments in para. 6.13 (b) are to be followed. The argumentation in para. 6.66 (b) is about doing accounting properly, rather than departing from cost.

The arguments in 6.65 to 6.69 seem to be saying that “cost” is not the right answer for assets, even if the assets contribute indirectly and are not to be sold. If cost is not the right answer when cost is zero or “unfair”, why is cost the right answer when it is “fair”? Is cost still the right answer when it is significantly higher than fair value (because of transaction costs)?

We think that the answer to these questions is related to our point above. That is, there are arguments for cost but only as a convenient proxy. That is why cost must be abandoned in these cases; because it strays too far from the proxy. Related to this, we suggest that para. 6.69 should come to a firmer conclusion than “zero may not provide relevant information”.

There is another point about accounting for inventories (para. 6.80): measuring inventories at current prices would undermine the whole basis of centuries of accounting by merchants, which is to recognise profit on sale or, in modern terms, when control of the inventory passes to the customer. Perhaps, the DP could connect this to the earlier point about remembering the effect on income (para. 6.15).

Of course, this does not make current value information irrelevant. Suppose that an entity buys inventory for CU100 and later sells it for CU120, when the replacement cost is CU118. In our view, the apparent profitability of the entity is overstated by ignoring the holding gain of CU20, which might also have occurred in a previous period.

The paragraphs on “selling assets” (6.83 – 6.85) are confusing. Paras. 6.84 – 6.85 are about investment properties. However, these are not “to be sold”. Presumably, investment properties fall under “Charging for rights to use assets” later.

Incidentally, it is not at all clear why the argumentation of para. 6.85 could not be used even more powerfully against the use of cost-based measures for a factory. Factories are even less homogeneous and even less frequently sold than investment properties. The cash flows from a factory are harder to assess than for a rented investment property. So, does this not mean that cost-based measures are unsuitable for factories?

We do not understand para. 6.94. Why is the answer different for large groups of low value items? We can see why cost might be more sensible but not on grounds of *relevance*.

We are even less convinced by the DP’s arguments for measuring at proceeds (for liabilities) than we are for measuring at cost (for assets). We agree with the argument in para. 6.102 against a gross transfer value. However, we disagree with para. 6.103 that a proceeds-based measure is the most relevant for liabilities to be settled according to terms. This would seem to mean that lease liabilities and pension obligations should not be measured at DCF. In our view, given that the DP proposes to select measurement bases relating to the effects on cash flows, then the most relevant basis for these liabilities is the future expected cash outflows. The whole of the sub-section (paras. 6.102 to 6.106) does not even mention this most obvious basis.

It is not clear what conclusions to draw from the DP's sub-section on how to do cash-flow-based measurements. We agree with the conclusions in 6.113 to 6.115, but we are not sure what the DP is recommending with respect to para. 6.122. Similarly, we are not sure what the DP is recommending on an entity's own credit risk (paras. 6.128 – 6.130). More clarity would be useful.

#### Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35.

The IASB's preliminary views are that:

- (a) the objective of measurement is to contribute to the faithful representation of relevant information about:
  - (i) the resources of the entity, claims against the entity and changes in resources and claims; and
  - (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;
- (c) 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;
- (d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:
  - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
  - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

We agree with the DP's preliminary views here. We have discussed most of these issues above.

#### Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96.

The IASB's preliminary views are that:

- (a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.
- (b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.
- (c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.
- (d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

The DP's conclusions here are too abbreviated to allow simple agreement. For example (b) refers to assets being sold, but we suspect that the IASB intends to exclude most assets that are sold (i.e. inventories). In (d), as mentioned earlier, although we could see some argument for using cost for low-value items, that would *not* be on the grounds stated, i.e. relevance.



### Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109.

The IASB's preliminary views are that:

- (a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.
- (b) a cost-based measurement will normally provide the most relevant information about:
  - (i) liabilities that will be settled according to their terms; and
  - (ii) contractual obligations for services (performance obligations).
- (c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

We agree with (a) and (c). However, we strongly disagree with (b). The DP did not consider the arguments properly, as explained above.

### Question 14

Paragraph 6.19 states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

- (a) if the ultimate cash flows are not closely linked to the original cost;
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

Do you agree with this preliminary view? Why or why not?

This question is confused. The first sentence makes a counter-intuitive statement against cash-flow measurements. Then, the alleged example refers to the disadvantage of cost-based information. We therefore do not agree with this preliminary view.

### Question 15

Do you have any further comments on the discussion of measurement in this section?

We have commented above.

We have some queries about details:

- (a) In the fifth line of the DP's para. 6.16 (c), should the "carrying amount" be the "current market price"?
- (b) In para. 6.52 (b), it might be clearer to say that there "was" no cost or proceeds.
- (c) In line 6 of para. 6.56, plural and singular are mixed.

## **Section 7 – Presentation and disclosure**

### **Section 8 – Presentation in the Statement of Comprehensive Income**

The issues discussed so far in this paper concern recognition and measurement, and therefore the determination of amounts recognised in the financial statements. In contrast, Sections 7 and 8 of the DP, which we will address together, concern presentation and disclosure, and therefore how best to communicate these recognised amounts.

Looking at the broad question of how best to communicate raises two further questions. The first concerns location. To some extent, the definition of elements dictates location: assets are reported in the statement of financial position, expenses in the income statement. Yet there are also further conceptual distinctions to be drawn, between those financial statements which are primary and those which are not, and between information that falls within the scope of financial reporting (and so should be disclosed in the statements or their notes) and information that is outside scope. Second is the question of how information should be categorised and separately displayed, both on the face of the primary financial statements and also in the notes, as well as whether and how the categories used in one location correspond to those used elsewhere. Broadly, these two questions concern what information belongs in a set of financial statements and how it should be displayed.

These distinctions are summarised in the two columns in Table 1. There are also two rows, (corresponding to issues of presentation, which concern where information is displayed and in what structural form), and disclosure (which concern how much information is displayed and of what type). This summary suggests four distinct issues that the Framework should address: 1a (location and presentation), 1b (location and disclosure), 2a (categorisation and presentation) and 2b (categorisation and disclosure). Each of these is addressed in turn below.

<b>Table 1</b>	<b>(1) Where should information be located?</b>	<b>(2) How should information be categorised and displayed?</b>
<b>Presentation</b>	<b>1a</b> Which financial statements should be primary, and why?	<b>2a</b> What determines the aggregation of information, and the method by which categories of information are related to one another, within and across the financial statements and notes?
<b>Disclosure</b>	<b>1b</b> What is the scope of information that should be contained in the notes to the financial statements?	<b>2b</b> At what level of materiality should categories of information be disclosed?

1a (location and presentation)

The DP points out (para. 7.14) that IFRS does not currently use the term ‘primary financial statements.’ We welcome the introduction of the term and we agree with the set of statements identified in the DP: namely, the statements of financial position, cash flow, changes in equity and ‘income statement(s)’.

It is disappointing, however, that there is no conceptual discussion in the DP in this area: there is no explanation for what makes these financial statements primary. There is therefore no principle or concept to guide decision-making. This matters because, if there is not a conceptual basis for presenting some information as primary and others as secondary, then the distinction cannot be used in helping to think through issues of financial statement presentation. In this respect, the DP misses an opportunity.

In this context, the empirical literature provides evidence that the reaction to accounting information, even of expert users, varies with the way in which this information is presented in each of the primary statements, or even within different sections of the same statement. An extensive review of these results can be found in Libby et al. (2002 and 2014). To present a certain value in OCI is not the same as presenting it in the statement of financial performance or in the notes. The CF should state the criteria to use in deciding what goes where. The statement that all the primary statements are of the same importance is simply not supported by the empirical literature, or at least is not enough to guide standard setting.

The difficulty here arises most clearly in the case of the 'income statement'. It is clear from the discussion elsewhere in the DP, for example on the distinction between debt and equity (and the display of changes in equity) and in particular on the nature of OCI and recycling, that conceptual issues concerning the nature of the 'income statement' remain unresolved. As drafted, this absence of resolution is embedded in the DP, which simply adopts the description of the 'income statement' that has resulted from the evolution of practice, as opposed to seeking to set out a conceptual case for why the information contained in the statement (and/or statements) is primary. The resulting terminology is rather tortuous: 'the statement of profit or loss and OCI (or the statement of profit or loss and the statement of comprehensive income).' This implicitly adopts two different notions of the bottom line, as well as ambiguity over whether there is one primary statement or two.

Drawing, for example, on the work of Penman (2009, 2010), there could be a constructive, conceptual discussion here on the (primary) role of the 'income statement' in reporting value changes from an equity investor's perspective. This discussion would include, for example, reasons for items of OCI being primary, because they too form part of 'clean surplus' earnings, and for the statement of changes in equity being primary, relating to its role in capturing the entirety of the interface between holders of equity and the company. (Such an approach would, however, be difficult to reconcile with the practice of recycling - see below - which is arguably premised on the income statement being given primacy over items of OCI.)

#### 1b (location and disclosure)

While the scope of information to be included in each of the primary financial statements is determined by the definitions of elements, and by associated recognition and measurement practice, the same is not true for the scope of the notes. The question here is one of disclosure: how much information, and of what type, should be located within a full set of financial statements, in addition to that which is disclosed on the face of the financial statements?

In this context, there are important decisions to be made, yet these are for the most part not discussed in the DP. It is unclear, for example whether the notes should be constrained to information that amplifies and explains only amounts disclosed on the face of the primary financial statements or, if not, how their scope should alternatively be defined. Such a constraint is suggested in Paras 7.33a and 7.39, because these discuss disclosure with respect to recognised elements only.

In contrast, the reference in para 7.36 to ‘key drivers’ and ‘key risks’ suggests an invitation for broader disclosure, while para 7.35c refers specifically to ‘unrecognised assets and liabilities.’

In a similar manner, there is ambiguity in para 7.37, which states that ‘information about management’s view of the entity’s performance, position and progress in the context of its stated plans and its strategies for achieving those plans belongs outside financial statements.’ Yet financial reporting is necessarily replete with the exercise of management judgement and estimation, with stated plans and strategies being inseparable from valuation questions affecting impairments, provisions and other accruals, and with certain aspects of financial reporting being by design through the eyes of management. Overall, the point here is that the DP as written does not make conceptual distinctions that could guide the IASB in future decision making with respect to the scope of the notes. This is important, because a central question in the context of disclosure has to be one of how much information, and of what type, should be disclosed.

## 2a (categorisation and presentation)

Perhaps the most conceptually challenging issues of presentation concern the aggregation of information, and the method by which categories of information relate to one another, within and across the financial statements and notes. The underlying problem is that accounting data comprise a very large number of individual transactions and events, and that some form of aggregation into discrete categories is essential in order for accounting information to be intelligible. This is acknowledged in paras 7.20-7.28.

A straightforward observation is that the DP would benefit from a clearer definition of terms. At present, the DP uses a range of different terms to cover similar or related concepts, for the most part without setting out how these terms correspond with one another (these terms include: classification, characterisation, presentation, aggregation, summary, line items, subtotals and totals). An exception is that the central concept of ‘classification’ is defined well (‘the sorting of items based on shared qualities’), and we note here that there is considerable empirical evidence (see below) that investors respond differently to categories of information with different information properties.

A more substantial observation is that classification is only part of the story, and conceptual guidance is also needed with respect to the layout of classified information within each financial statement, which concerns both the conceptual coherence of individual statements and the relationships across statements. In this respect, the DP falls short of its purpose when it states, in para 7.10, that ‘we have used the term ‘presentation’ as meaning the disclosure of financial information on the face of an entity’s primary financial statements.’ This approach mistakenly conflates presentation and disclosure. On this view, information is either disclosed on the face or in the notes, and there is nothing to distinguish the notion of presentation from that of disclosure. Instead, the concept of presentation should be associated with notions of format and structure. Information is not simply disclosed in any given statement, it is instead organised, with underlying concepts making distinctions that underpin the method of organising.

The most striking application of these issues arises in the ‘income statement’, which is the subject of Section 8 of the DP. The distinction between profit or loss and OCI is raised here as an important issue of classification, which thereby requires articulation of the ‘shared qualities’ that are the conceptual basis for the classification. In addition, the relationship between items reported in each location raises further issues of presentation, concerning for example whether OCI items should remain ‘below the line’ or whether they should instead be recycled.

In seeking to make a distinction between profit or loss and OCI, it is entirely defensible that 'profit or loss is treated as the default category' (para 8.35). We know from Beaver and Demski (1974) and others that comprehensive income is not a comprehensive measure of change in equity value, and that it should therefore not be relied upon to measure 'performance'. It follows that if we define and exclude certain components of comprehensive income, the residual cannot have a tight economic meaning; profit or loss is simply what is left of comprehensive income after certain items have been excluded.

Having taken this position, the DP should be consistent in maintaining it. The focus should be on defining and justifying conceptually items that are *excluded* from profit or loss, rather than on seeking to describe the residual that remains within profit or loss. The DP does not do this. Rather, it sets out in para 8.20 a discussion of the merits of items *included* in profit or loss, arguments that 'the IASB is persuaded by' (para 8.22).

These arguments in favour of retaining a profit or loss total or subtotal (para 8.20) are, in essence: first, a measure of profit or loss is needed to understand 'the entity's capacity to pay dividends and to meet its obligations,' which seems to imply some form of all-inclusive bottom line (either without or via recycling); second, 'the profit or loss total or subtotal has more predictive value than total comprehensive income' because of the exclusion of remeasurement gains and losses that are unlikely to persist; third, 'profit or loss can be more closely aligned to an entity's business model than total comprehensive income,' which suggests some form of operating versus non-operating distinction, albeit with a stated purpose relating to 'how the entity's resources have been used,' as opposed to a predictive purpose, concerning how they will be used. Of these arguments, the second finds the greatest support in the empirical literature, where the relationship that valuation theory predicts (Ohlson, 1995) between persistence and value-relevance is in general shown to hold (Kormendi and Lipe, 1987; Collins and Kothari, 1989; Jones and Smith, 2011).

These three arguments (in favour of retaining a profit or loss total or subtotal) are not the same as one another. Each could in principle lead to a different outcome in any specific case, and each raises distinctive practical challenges of application. It is therefore inadequate to claim that 'the IASB is persuaded by the arguments set out in paragraph 8.20 for retaining a concept that would require profit or loss to be presented as a total or subtotal on the statement(s) of profit or loss and OCI.' This claim is inadequate because the IASB cannot in principle be persuaded simultaneously by three arguments that lead to different conclusions.

To be clear, the difficulty here is not with the claim that some form of profit or loss subtotal is useful, nor indeed that users also benefit from other such aggregations and subtotals on the face of the financial statements, such as gross profit (Bloomfield et al., 2013; Elliott et al., 2011). In general, the notion is well established in the literature that different categories of information are used in different ways, not least because they have different value-relevance, and in general the literature supports the type of distinction that is currently made between 'earnings' and comprehensive income (Dhaliwal et al, 1999; O'Hanlon and Pope, 1999; Barton et al., 2010; Young, 2014).

Rather, the difficulty is that the DP does not set out concepts on which its distinction is demonstrably based, and that most likely this is because the creation of a 'bright line' distinction is unrealistic (Barker, 2004; Thinggaard et al, 2006; Rees and Shane, 2008). However defined, there will always be items 'below the line' that are value-relevant (Linsmeier et al, 1997; Chambers et al, 2007) or otherwise conceptually similar to items 'above the line'. This unavoidably imprecise nature of the dividing line invites earnings management (Hirst and Hopkins, 1998; Hunton et al, 2006; Tarca et al, 2006; Doyle et al. 2013; Young, 2014). While the literature supports the notion that different components of comprehensive income vary in their decision-relevance for users, it does not support

the notion of a clean, definable, standardised distinction that would enable a bright-line divide between profit and OCI.

The difficulty here is compounded by the discussion of recycling that follows. The arguments in favour of recycling are presented in para 8.24. These are arguments that the IASB broadly accepts in para 8.26, although it is unwelcome that the DP does not set out and discuss the analysis with which the IASB 'considered the arguments.' This is especially the case because none of the arguments corresponds directly with any of the three conceptual justifications that are offered for recycling later in Section 8 (i.e. bridging items, mismatched remeasurements and transitory remeasurements). Moreover, the arguments are in conflict with the abnormal earnings valuation models, which rely upon clean surplus earnings (Ohlson, 1995).

The first argument is that 'recycling protects the integrity of profit or loss ... because all items of income and expense would be recognised in profit or loss at some point.' There are two flaws with this argument. The first is its incompatibility with the argument presented in para 8.20 that a profit or loss subtotal should be retained because it has greater predictive value; both arguments cannot be accepted simultaneously. The second flaw is that the argument is one for not presenting OCI in a separate statement in the first place: if there were no profit/OCI distinction, there would be no items of income and expense unrecognised in profit or loss.

The second argument is that 'recycling can provide users of financial statements with relevant information about the transaction or events that occurred in the period (for example, realisation or settlement).' Again, there are two problems here. The first is inconsistency with at least two (predictive value, operating versus operating), and possibly with all three, of the arguments presented in para 8.20 for a profit or loss subtotal. The second is that there is an unsupported claim that realisation or settlement is 'relevant' and that, further, the statement of profit or loss is the appropriate place for such information to be presented.

The third and final argument is somewhat self-defeating. If 'recycling can enhance the comparability of profit and loss in some situations where IFRS permits or requires similar items of income and expense to be recognised in either profit or loss for OCI,' then the obvious solution is not to make a bright-line distinction between profit or loss and OCI in the first place.

In view of the difficulties described here, it is unsurprising that there are also difficulties in the subsequent discussion in Section 8 of alternative approaches to profit or loss and recycling. As the DP acknowledges in para 8.34, these approaches require answers to the questions of, first, what distinguishes OCI items from those in profit or loss and, second, which items (if any) should be recycled from OCI into profit or loss. The helpful summary in Table 8.1 highlights the considerable difficulty in addressing both of these questions. The summary reinforces the discussion above, concerning the unrealistic ambition to identify a single conceptual criterion that could be applied consistently in making a distinction between profit or loss and OCI. Moreover, of the six criteria discussed, three imply 'no basis for recycling' (non-recurring, non-operating and outside management control) and only one supports recycling unambiguously (unrealised). Overall, the IASB is surely correct to believe that 'no single attribute can operationally and meaningfully distinguish between those items should be recognised in profit or loss and those that should be recognised in OCI' (para 8.38). This comes close to saying that OCI cannot be defined. This being the case it is difficult to understand why the DP continues to attempt to draw such a bright line, and even more difficult to understand the attempt to rationalise recycling from one side of this line to the other.

These difficulties are not resolved in the possible alternative approaches to OCI that are discussed in the DP. The first of these approaches comes closest, because it entertains the possibility that

recycling should be prohibited. The discussion of this approach in the DP is too brief, however, and it conflates two issues. The first is whether a distinction between profit or loss and OCI could be made in the absence of recycling. The answer is that it could, notwithstanding that para 8.30 appears to reach the opposite conclusion. The second is whether recycling should be prohibited. On this issue, the DP raises the important and anomalous issue of cash flow hedge accounting, which does deserve consideration as a special case for recycling, but otherwise the DP has almost nothing to say on the subject. This is disappointing, not least because the absence of recycling would be consistent with the objectives that are endorsed elsewhere in the discussion of presentation and disclosure, for example the emphasis on predictive value and on a distinction between operating and non-operating activity. The DP seems to have ‘decided’ that recycling is the desired outcome and so seeks to find conceptual justification for it, without giving serious consideration to the alternative.

The second approach (‘narrow approach to OCI’) is based upon three principles that are designed to distinguish profit or loss from OCI. The first of these principles is redundant, because all that is needed to make the distinction between profit or loss and OCI is the second principle, namely that an item should be reported in OCI if doing so enhances profit or loss. Principle 3 is internally inconsistent because it states that an item recognised OCI ‘must’ be recycled but then it also adds the condition ‘when the reclassification results in relevant information,’ which suggests instead that an item recognised OCI ‘may’ be recycled. Principles 2 and 3 both refer to ‘relevance’ without explaining what is meant by this term; neither principle is therefore applicable in the absence of some additional, undefined concept.

It is unclear how the application of these three principles leads to the identification of ‘bridging items’ and ‘mismatched remeasurements’ as the only two groups of items that would be eligible for recognition in OCI. The discussion of these two items is an important and worthwhile element of the DP, but there would be no obvious loss from deleting all previous discussion of the three principles.

A difficulty with the discussion of ‘bridging items’ is that no reason is given for why ‘the IASB may occasionally decide that an asset or a liability should be re-measured, but that information in profit or loss should be based on a measurement that differs from the one used in the statement of financial position’ (para 8.55). If such a decision is made, there is necessarily a difference between profit or loss and comprehensive income, meaning that a distinction is necessarily made between profit or loss and OCI. Viewed from the perspective of a conceptual discussion of presentation and disclosure, this is putting the cart before the horse, because a decision is made about presentation in the financial statements without consideration of whether and why information in profit or loss differs from that in OCI. There is therefore little here on which to comment.

The concept of ‘mismatched remeasurements’ offers the strongest conceptual basis for recycling, at least in the case of cash flow hedge accounting, because the whole point of allowing cash flow hedge accounting in the first place is that the effect of the accounting mismatch is to misrepresent profit or loss, and the natural solution is to ‘hold’ the mismatched item until such time as it is matched. This is a special case and it should be recognised as such; it should not be viewed as the basis for a general principle.

The discussion of applying the narrow approach to OCI, from para 8.70 onwards, is to be welcomed, not least because it demonstrates the infeasibility of constructing conceptual support for the current treatment of OCI in IFRS. This is a very good illustration of the purpose that a conceptual framework ought to serve. In particular, para 8.73 identifies that the remeasurement of a net defined benefit pension asset or liability is neither a mismatched remeasurement nor a bridging item. In contrast, the ‘broad approach to OCI’ illustrates that if the conceptual framework is weakened, by means of introducing vague additional concepts, then it can no longer be applied in making principles-based

distinctions. Specifically, the 'broad approach' seeks to draw a line somewhere between the short-term and the long-term, between items that are volatile and those that are not, and between remeasurements that enhance the relevance and understandability of profit or loss and those that do not (para 8.88). Such distinctions are deemed to give rise to 'transitory remeasurements' which may, or may not, subsequently be recycled. And so the outcome is that we now have three distinct types of OCI, with the possibility of recycling left open for each. If the test of an effective principles-based approach is that it can readily be explained, justified and applied, then surely this outcome falls short.

## 2b (categorisation and disclosure)

A practical question, distinct from all other aspects of presentation and disclosure discussed so far, concerns the point at which disclosure of a given item ceases to be relevant for decision making. This is the question of materiality. Here, the conclusion in para 7.45 appears to be sound, namely that 'the concept of materiality is clearly described in the existing conceptual framework.'

It is important, however, to challenge the common perception that disclosure under IFRS is 'too voluminous.' Any given user of the financial statements will be provided with information that he or she does not need and perceives to be immaterial or irrelevant. Feedback to the IASB on the question of the level of disclosure is therefore likely to emphasise a preference for clearing away unwanted clutter. Taking the perspective of users as a whole, however, it is by no means obvious that the same conclusion would be reached: information that is not useful to one user may nevertheless be useful to another (Barker et al., 2013). This is especially important in view of the general purpose nature of financial statements, whereby information is provided to a wide range of users who would otherwise remain uninformed.

### Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

- (a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and
- (b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8), including:
  - (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;
  - (ii) amendments to IAS 1; and
  - (iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the *Conceptual Framework* on:

- (a) presentation in the primary financial statements, including:
  - (i) what the primary financial statements are;
  - (ii) the objective of primary financial statements;
  - (iii) classification and aggregation;
  - (iv) offsetting; and
  - (v) the relationship between primary financial statements.
- (b) disclosure in the notes to the financial statements, including:
  - (i) the objective of the notes to the financial statements; and
  - (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the *Conceptual Framework*.



We broadly support the IASB's preliminary views in these areas, with the caveat that they are on the whole insufficiently developed at present. For example, we support the designation of the primary financial statements but would welcome analysis of what makes these statements primary and why. Likewise, we support guidance in the Framework on classification and aggregation but would welcome tighter definitions and analysis. At present, while there is little to disagree with in these areas, there is also too little that passes the test of providing a meaningful, discriminatory decision-making guide for the IASB; too much is left open and vague.

We question the statement made by the DP in 7.36 that "...the objective is not to have entities provide information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements". Why exclude this? This could be a very important feature of notes in order to help users' decision making.

#### **Question 17**

Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

Do you agree with this approach? Why or why not?

The Framework definition of materiality is clear enough. What appears to be a problem is persuading preparers and auditors to apply it realistically. We note that it is likely that preparers, auditors and users have different thresholds.

#### **Question 18**

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52.

Do you agree that communication principles should be part of the *Conceptual Framework*? Why or why not? If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

We do not think it is useful to include a discussion of communication in the *Conceptual Framework*. There needs to be a debate about the purposes and usefulness of disclosure before moving into how to communicate information.

#### **Question 19**

The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22.

Do you agree? Why or why not? If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or revising particular Standards?

We are aware of the long history of abuse of, and difficulty in defining, an 'operating profit' sub-total. We think that distinguishing the results of transactions from external value changes is useful, but are aware from the IASB's earliest work in the area that this is difficult to achieve. The literature generally supports the usefulness of a sub-total, but we think it is probably conceptually clearer and operationally more practical to define what is excluded than what is included.

## Question 20

The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23–8.26.

Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not? If you do not agree, how would you address cash flow hedge accounting?

Our views are divided on this issue. The discussion shows that none of the alternatives proposed has a sound conceptual basis, and there remain only subjective views about which alternative is least undesirable.

## Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78) and a broad approach (Approach 2B described in paragraphs 8.79–8.94). Which of these approaches do you support, and why? If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

Our members are divided on this issue as well.

## Section 9 – Other issues

### Revision of Chapters One and Three

While we understand the reluctance of the IASB to review the *Objectives* and *Qualitative Characteristics* chapters of the Framework, given that they were exposed and revised very recently, we do feel, however, that circumstances have changed. The 2010 revisions were done in the context of a convergence programme with the US, and it is likely that this fact will have influenced voting by IASB members on precisely the topics mentioned in this section – stewardship, reliability and prudence. We take the view that the decision framework is now different, especially as it looks highly unlikely that the US will adopt IFRS as a replacement for US GAAP, and consequently the IASB should reconsider the issues here.

We recall that in the debates with the FASB there was very strong opposition to including stewardship. However, the convergence strategy is at an end and we believe the issue should be revisited. We would suggest that it makes sense to introduce the word 'accountability' (if stewardship is thought too difficult) as an objective. The 2013 Discussion Paper acknowledges generally that accountability is a significant aspect of financial reporting, and so it seems difficult to understand why it is not more explicitly acknowledged in Chapter One.

We also understand the reluctance to perpetuate confusion surrounding the word 'reliability' and think that the new arrangement of representational faithfulness and verifiability is a step towards clarity. However, we note, as discussed by Pelger (2013) that the literature assigns more than just two meanings to reliability. There is, in particular, a strand of thinking that suggests reliability when applied to estimates means that the preparer is more likely to slightly under-estimate an asset and over-estimate a liability (or one might say that the outturn of an estimate is not likely to be value negative for the entity) This aspect of reliability is often addressed in relation to the notion of prudence, and is reviewed in a European standard-setters bulletin (EFRAG 2013).

Chairman Hoogervorst has addressed the subject in public speeches, and appears to believe that prudence is implicitly built into standards. We believe that there should be a wider debate about whether and how it should be reflected in the Framework. The issue is significant for practitioners, and should be addressed, rather than be swept under the carpet in the name of dogma.

The relevant empirical literature here is the one of conservatism and its effects. This empirical literature reviewed by Watts (2003a, 2003b)). There is no point in repeating here the review contained in that paper. It is important to keep in mind the following:

- (a) Empirically conservatism can be proxied in many ways
  - (i) Balance sheet approximations that aim at measuring how Net Assets are undervalued. This is often done by using Feltham-Ohlson models of valuation
  - (ii) Income statement approximations that aim at measuring the different speed at which gains and losses are recognized. Here a crucial role is played by so called conditional conservatism regressions where stock returns are used as a way to show that bad news are recognized more quickly than good news.
- (b) No matter which approach is adopted conservatism in accounting has been widely documented and possibly it has increased over time
- (c) The reason why conservatism is present in accounting could be different. Litigation, contracting, taxation, regulatory concerns are those mentioned by Watts (2003)

By looking also at LaFond and Watts (2008), Khan and Watts (2009) and Watts and Luo (2012) we can conclude that there evidence that conservatism is a way of dealing with risk and uncertainty and could help in reducing it. We could be talking about agency related risk of manipulation, litigation risk, information asymmetry. They all seem to be reduced by conservatism.

#### Business model

We are aware of the growth of opinion that financial reporting should reflect the entity's business model. We incline to the view that this is simply an old argument, that of uniform statements versus entity-specific information, which has been discussed since financial reporting as we know it started to evolve. The business model argument can be seen as a plea for reporting that reflects the specificities of the individual entity, as reflected, for example in the work of the Basle Committee's Enhanced Disclosure Task Force which suggested that financial institutions should concentrate on clarifying how they make their money, what are the risks inherent in such practices, and what the entity does to manage risk. The alternative view is that comparability between entities is enhanced by uniform financial reporting.

#### Capital maintenance

It seems strange to write a chapter on measurement without considering capital maintenance, which was at the heart of debates in the 1980s on inflation accounting. However, on further reflection, we believe that essentially capital maintenance is related to the objectives of reporting, and the objective of maintaining the capital of the entity (in whatever form) is not one of the fundamental objectives as set out in Chapter One. We think the final framework should be explicit on that point – physical or financial capital maintenance can be a main objective in financial reporting, but is not the main objective in this case.

#### Question 22

*Chapters 1 and 3 of the existing Conceptual Framework Paragraphs 9.2–9.22 address the chapters of the existing Conceptual Framework that were published in 2010 and how those chapters treat the concepts of stewardship,*

reliability and prudence. The IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters. Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the *Conceptual Framework*.

We believe that the 2010 revisions were voted on by the IASB with a convergence objective. We think it is at least possible that had that not been the case, different decisions would have been reached. We also believe that the issues of stewardship and the related issues of reliability and prudence are important to a significant number of non-US constituents and should be re-examined.

We think that stewardship (or accountability) should be explicitly recognised in Chapter One. We do not believe that this will necessarily change constituents' accounting, but it will give them more confidence that the Framework reflects the financial reporting world as it really is, and not a hypothetical construct.

We think the 2010 decisions did not succeed in finally clarifying the reliability confusions. We would prefer that the Framework also included a discussion on reliability as it bears upon prudence in making estimates. As before, we think people actually exercise prudence in the form of reasonable caution in making estimates, and inclusion of this notion in the Framework would bolster the perceived accuracy and legitimacy of the Framework. Obviously there is a clash with neutrality, but we think that neutrality is not something humans can achieve anyway, so it is hypothetical and its presence in this form damages the credibility of the Framework.

#### **Question 23**

##### *Business model*

The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not? If you agree, in which areas do you think that the business model concept would be helpful? Should the IASB define 'business model'? Why or why not? If you think that 'business model' should be defined, how would you define it?

We believe that the current debate is simply a new formulation of an old debate between giving preference to entity-specific information and privileging comparability through uniformity. We believe analysts are split on this issue. Our preference is to emphasise the need to reflect how the company creates wealth. We do not believe companies are essentially comparable in the first place, and therefore uniform reporting creates only a spurious comparability.

#### **Question 24**

##### *Unit of account*

The unit of account is discussed in paragraphs 9.35–9.41. The IASB's preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information. Do you agree? Why or why not?

We agree. We think that designating the unit of account should be part of assessing how to provide a faithful representation of particular facts and circumstance.

#### **Question 25**

##### *Going concern*

Going concern is discussed in paragraphs 9.42–9.44. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity). Are there any other situations where the going concern assumption might be relevant?

We agree with the DP.

#### **Question 26**

##### *Capital maintenance*

Capital maintenance is discussed in paragraphs 9.45–9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change. Do you agree? Why or why not? Please explain your reasons.

We are aware that in its deliberations the IASB decided simply not to address this area, on the grounds that it would significantly delay publication of the discussion paper. Had the IASB considered it, it might have come to the conclusion that capital maintenance is a competing objective of financial reporting that has direct impact on measurement but it is not just a measurement issue. Having come to the view that financial reporting is to provide decision-useful information to capital providers, one might come to the view that capital maintenance is potentially relevant, but should not override the ability to predict future cash flows. It is, rather, something that capital providers should consider in evaluating the quality of those predicted cash flows, rather than being built into measurement.

#### **Additional section: the reporting entity**

The 2013 DP on the conceptual framework does not include any discussion or questions on the reporting entity. Instead it refers to the IASB's previous work in this area and says this will be brought into the exposure draft that should normally follow the July 2013 DP. An appendix brings in material from the earlier work on the reporting entity, which consisted of a DP (May 2008) followed by an ED (March 2010). Given that the exposure draft that follows the 2013 Discussion Paper will address the reporting entity, we are taking the opportunity to include some material that may be relevant.

The 2008 DP did not seek to define an entity as such, nor did it discuss the nature of an entity, but focused on the *reporting* entity and came to the conclusion that the key question was one of control. The definition eventually offered in the ED was:

RE2 A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

RE3 A reporting entity has three features:

- (a) economic activities of an entity are being conducted, have been conducted or will be conducted;
- (b) those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and
- (c) financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

These features are necessary but not always sufficient to identify a reporting entity.

RE4 Identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities that are being conducted, have been conducted or will be conducted. The existence of a legal entity is neither necessary nor sufficient to identify a reporting entity. A reporting entity can include more than one entity or it can be a portion of a single entity.

This does not appear to go very far. A (possibly simplistic) reading of it suggests that a reporting entity is any set of business activities that can be separately identified and for which it would be useful for providers of capital to have information. Applied to a multinational corporation, that would imply that producing a set of consolidated statements identifies the reporting entity, but there are conceivably many smaller reporting entities contained within that scope and there might also be larger entities of which it is a part.

It seems to us that this approach is rather unsatisfactory. It does not in effect define an entity, and leaves it that a reporting entity in an IFRS context is anything about which external providers of capital might be interested to have a report. We think it is more appropriate to discuss the nature of an entity, and then move on to how one might report on that, and what impact the process of reporting has on the picture of the entity that can be represented.

#### Literature review

The management literature, and in particular that on organisation theory, abounds in theories and analysis of organisations, but does not especially use the term 'entity'. Kieser (1985) quotes Buchanan (1977) as saying that 'organisations can be defined as resource pools'. Kieser goes on to say:

They come into existence when individuals place the resources available to them ... under some sort of central control, rather than using them individualistically. Organisations must establish certain rules for the use and distribution of their resources. These rules may be based on an autocratic-hierarchical principle, whereby one person assumes the role of coordinator, or they may be co-operative-democratic, in which case all members participate in co-ordinating and distributing decision-making. Most organisations fall somewhere between these two extremes. (p566)

Sorge (2002) says an organisation is 'a particular social unit or collectivity' (p4909). He goes on to elaborate that organisations have goals ('specific targets towards which action in the organisation is targeted'). They also have 'techniques, technologies, physical capital (buildings, machinery, offices), knowledge and strategies to achieve their goals.'

The draft framework for integrated reporting (IIRC 2013) takes the position that a business entity's objective is value creation. However its first fundamental principle sees the value creating entity as dependent on its environment:

<IR> (integrated reporting) recognizes that value is not created by or within an organisation alone, but is:

- Influenced by the external environment (including economic conditions, technological change, societal issues and environmental challenges), which creates the context within which the organization operates
- Created through relationships with others (including employees, customers, suppliers, business partners, and local communities)
- Dependent on the availability, affordability, quality and management of various resources. (p10)

This is a much wider view of the entity, which posits that the entity can only function through a series of inter-relationships, and therefore the implication is that the boundaries of the entity are much more fluid and difficult to identify with certainty.

Given the international vocation of the IASB, it seems appropriate to consider diverse forms of entity. A more complex form of organisation is the *keiretsu*, a Japanese phenomenon (but which has its counterpart in the Korean chaebols), which as Morris (2002) notes 'consists of between 20 and 50 member companies'. He says (p3616) 'These groupings are unique in that there is no holding company or controlling stock interests'. He adds that while there is no controlling ownership interest, there are usually considerable cross-holdings between members and a high degree of intra-group sales. He says: 'Coordination is achieved through information sharing at monthly meetings of member companies' presidents and top officials'.

Bailey (1988), offering a generic description of socialist economies, wrote:

In the socialist country the central authorities ... determine the activities of each enterprise. The socialist enterprise is not autonomous and, in principle, its corporate plan is a component of the national economic plan. State ownership of the industrial enterprises in the socialist economy leads naturally to the conception of a common accounting system embracing all these enterprises. In effect, the national economy, or its industrialised segment, becomes the accounting entity and the individual enterprise is represented as an accounting sub-entity. (p10),

Contrasting capitalist and socialist accounting, Bailey draws the conclusion: 'The practice of accounting is necessarily utilitarian, being conditioned by the requirements of the society in which it is conducted. The framework of political and economic institutions of a given society influences the practice of accounting.' (p6)

If we consider the entity to be an organisation, its characteristics, based on the above, would be that it is a pool of resources, organised around a common objective, and having rules and systems to moderate its functioning. The IASB only considers for-profit entities, so for IASB framework purposes, the objective would be profit or value creation. The organisation does not need to have unified control, only to be focused on a common objective.

Moving on to the accounting literature, *The Corporate Report* (1975), a publication of the UK profession that approximated to a conceptual framework, talked simply about an 'economic entity' specifying that it was referring to 'every sort of organisation in modern society'. It suggested that the

need to report was a result of public accountability because 'economic entities compete for resources of manpower, management and organisational skills, materials and energy, and they utilise community-owned assets and facilities. They have a responsibility for the present and future livelihoods of employees, and because of the interdependence of all social groups, they are involved in the maintenance of standards of life and the creation of wealth for and on behalf of the community.' (p15) The use of the word 'organisation' implies that it is an identifiable unit, and 'economic' is defined as competing for resources and involved in the creation of wealth.

If we narrow the focus to financial reporting of the entity, Hines (1988) offers an analysis that suggests that (a) financial reporting is unlikely to be able to encompass the whole of the entity, (b) what is reported will be determined by recognition and measurement rules, and (c) these create a 'reality'. Her article takes the form of a discussion between a master (of reporting) and an acolyte as they walk round a paper factory.

The master says:

We communicate reality: that is the myth; that is what most people believe. It is even what most of us believe. And, in a sense, we do communicate reality. There is something there: bricks and people and soon ... But what is 'the full picture'? There is no full picture. We make the picture. That is what gives us our power: people think and act on the basis of that picture! (254)

The paper illustrates the point by noting that a river runs through the factory, and the water is used, free of charge, in the paper-making process. The river does not belong to the organisation so is not reported, but it is a key part of the production process. If the organisation were sold, a buyer would pay a premium for access to the free water, so the river would be recognised in the acquirer's accounts – but as goodwill.

The recognition and measurement rules used for financial reporting in effect define what can be reported, and therefore what is perceived as the entity. We can draw from that the likelihood that the 'reporting entity' or indeed the 'reported entity' represents a sub-set of the organisation which is capable of having financial measurements assigned to it and does not recognise other elements. Related to this is the distinction between financial statements and financial reporting. In the financial statements the entity is reported using monetary amounts. To be reported, the elements of the entity must be capable of being measured in a meaningful way. However, in financial reporting, which includes the possibility of using non-quantitative information, more of the entity could be reported than can be measured.

Hines' argument is that the recognition and measurement rules determine what aspects of the entity are reported, so the reported entity is defined by the recognition and measurement rules. Recognition and measurement are considered elsewhere in this paper, so they will not be further explored here, except to point to another conceptual issue: that of the proprietary approach and the entity approach.

A recent paper by Hsu et al. (2012) seems to be relevant here. It compares the usefulness of a majority-based notion of consolidation versus a control-based approach. According to their results, the control-based approach provides information that is more useful for market participants.

Van Mourik (2010) provides a recent analysis of the evolution of entity and proprietary theories of reporting. She says (p213) 'Equity theories were a popular topic of journal articles from the 1930s to the 1960s' but notes: ', in the 1970s equity theories started collecting dust in accounting theory



textbooks or disappeared altogether from most accounting academics and practitioners' frame of reference'. She explains: 'Equity theories provide different views in answer to the question whose point of view should be taken in the accounting process of companies. The point of view taken in the accounting and reporting process determines the perspective from which accounting transactions are analysed and the way in which they are recorded and accounted for.' This means that the position taken by the standard-setter impacts recognition and measurement rules and therefore what is reported.

As Van Mourik makes clear, there is a rich literature which offers a considerable variety of different positions. However these are oriented round two basic propositions: under proprietary theory the report is being prepared for the owners and focuses on their interest; under entity theory, the report does not distinguish between different stakeholders. The impact on financial statements is mostly on the financing side of the balance sheet and the income statement. The distinction between debt and equity is more significant under a proprietary approach, and interest is treated as an expense under that approach whereas under an entity approach it might be treated as a distribution to stakeholders, assimilable to a dividend.

The existing conceptual framework does not take a position on this, although the issue was aired in the development phase of the revisions to the objective and qualitative characteristics chapters, but subsequently dropped. The objective chapter says the aim is to give providers of capital information that is useful for decision-making. This would imply an entity approach, but the elements chapter focuses on resources and the claims from non-owners, treating equity as a residual, which seems to be a proprietary approach. Interest is shown as a deduction from revenue, which also leans to the proprietary approach.

Another issue that bears upon recognition and measurement is that of capital maintenance. The IASB DP mentions this, but defers discussion until some future date. Capital maintenance features in the literature that discusses how to reflect the effects of inflation upon financial reporting. It is explored in Lee (1975) amongst others, who was writing at a time when inflation was significant in many industrialised countries. The basic issue is whether one's recognition and measurement rules should focus on the value of the operating capacity of an organisation (physical capital maintenance) or on the value of the owners' equity (financial capital maintenance). The fundamental is that the cost of replacing productive capacity is unlikely to be changing at exactly the rate of the general purchasing power of the monetary unit (as also discussed elsewhere in this paper).

In this section our analysis of the literature suggests (a) that the entity or organisation is a pool of resources, organised around a common objective, and having rules and systems to moderate its functioning; but (b) that the view of the organisation that is reported is constrained by the recognition and measurement rules used for reporting, and these in turn are influenced by the objective of the financial reporting.

#### Questions to respondents

The 2010 Exposure Draft on the Reporting Entity included four questions for respondents, and the 2013 DP says the responses to these questions will be considered in moving to a new Exposure Draft, and therefore it seems pertinent to offer further input. The questions were:

1 Do you agree that a reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions

about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided? If not, why?

2 Do you agree that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements? Do you agree with the definition of control of an entity? If not, why?

3 Do you agree that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity? If not, why?

(4 The IASB and the FASB are working together to develop common standards on consolidation that would apply to all types of entities. Do you agree that completion of the reporting entity concept should not be delayed until those standards have been issued? If not, why? *Question now irrelevant, but included for completeness*)

#### R esponses

Q1. It seems to us that the two most significant issues in this area are identifying the boundary (i.e. how does one identify what is the circumscribed area?) and the perspective from which a report being prepared. Although the business world tends to think of an entity as being a legal entity, the aim here is surely to address a coherent economic organisation that goes beyond the bounds of legal ownership. It also seems that the existence of an organisation, as a 'circumscribed area of economic activity', is not dependent on whether anyone has a legitimate claim to receive a report. However, if the organisation exists, with its common objectives, resources and rules, it is always highly likely that information about it will be necessary. The usefulness of the information to particular stakeholders should not determine what is the organisation, but once an organisation is observed would provide one focus for the recognition and measurement rules.

Q2. We do not think that this question is relevant. If you define the organisation as a coherent economic unit, there is no need to address the consolidation issue when the organisation consists of a number of separate legal entities, since if it is a coherent economic unit it will automatically include all the sub-units that together form the whole. The fact that this question is asked, seems to underline that there is a legal entity notion underlying the discussion, even though this is denied.

Q3. Our view is that while any organisation may consist of a number of sub-organisations, and there may be reasons to prepare reports on sub-organisations, a *general purpose* report should include the whole of the organisation. It is generally accepted that the reports of individual companies that are controlled by other companies may be misleading because they do not necessarily reflect economic linkages between members of the same group. Other reports would be special-purpose or limited purpose reports.

12 January 2014

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