

3 February 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: *A Review of the Conceptual Framework for Financial Reporting*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'DP').

EFRAG welcomes that the IASB has initiated a project on improving its Conceptual Framework. European constituents, including EFRAG, have over the years repeatedly called for this revision to take place, before any fundamental change to the underlying IFRS accounting model would be made. The view that the Conceptual Framework was the most important project the IASB should undertake culminated in the response to the 2011 IASB Agenda Consultation. We therefore agree with the high priority the IASB has given to this project and with the aim of completing the project within a few years. We appreciate the work that the IASB has done in analysing areas that have proven problematic in the past and we support the practical approach taken in the project. We also agree with excluding other forms of financial reports and explicitly limiting the scope of the project to financial statements.

While we broadly agree with the issues selected for the DP, we do not agree with all of the proposed solutions and think that some of the issues should be addressed on a more conceptual basis. This may partly be because many of the principles proposed have been generated from requirements in current Standards without their justification being debated conceptually. The revised Conceptual Framework should be based on the understanding of how clear objectives of financial reporting should be met in practice.

Our detailed comments and responses to the questions in the DP are set out in Appendix 1. In the following paragraphs we would like to provide some high-level comments in relation to:

- Amendments to Chapters 1 and 3 of the existing Conceptual Framework
- The role of the business model in financial reporting
- Elements of financial statements and recognition
- Distinction between liability and equity elements
- Disclosure
- Implications on existing Standards of amending the Conceptual Framework.

Amendments to Chapters 1 and 3 of the existing Conceptual Framework

The DP proposes not to undertake a fundamental reconsideration of the chapters of the Conceptual Framework that were published in 2010. Accordingly, the IASB will only make changes to these chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. We disagree with this approach as we do not support how the existing chapters deal with stewardship, reliability and prudence.

The existing Chapter 1 seems to state that providing information to help existing and potential investors assess the prospects for future net cash inflows is the primary objective of financial reporting. Providing information that is useful for assessing stewardship is in our view equally

essential. As the same information may not be the most useful for considering stewardship and evaluating prospects for future cash flows, the objective of assessing stewardship needs to be presented as a separate objective in Chapter 1 of the Conceptual Framework. Including this objective means that Standards should require, and financial statements include, sufficient information for assessing both stewardship and the prospects for future cash flows.

When the Conceptual Framework was amended in 2010, the term 'reliability' was replaced by 'faithful representation'. We disagree with that change. To meet the objective of providing useful information we think that 'reliability' should replace 'faithful representation' as a fundamental qualitative characteristic. The Conceptual Framework describes 'faithful representation' as something that can be achieved by disclosures. Before the 2010 amendments it was, on the other hand, acknowledged that there could be a trade-off in recognised amounts between relevance and reliability. In addition to reintroducing 'reliability', we think that verifiability should form part of reliability instead of just being considered an enhancing, and therefore unnecessary, qualitative characteristic.

Similarly, we believe that the concept of prudence should be reintroduced and explained in the Conceptual Framework. Prudence is evidently reflected both in Standards in force today and those being developed. We therefore believe that it is essential to articulate the concept of prudence clearly in the Conceptual Framework in order to ensure that it is applied consistently across both current and future Standards. In our view, prudence represents a degree of caution that generally recognises downside risks and strongly questions whether upside potential inherent in uncertain future events should be recognised. To highlight that prudence should be applied in standard setting in a manner that would not conflict with neutrality, the concept should be explained after neutrality (with both notions being defined and displayed, similarly to how it was done in the pre-2010 Conceptual Framework).

The role of the business model in financial reporting

We appreciate that the DP presents the preliminary views that financial statements can be made more relevant if the IASB considers how an entity conducts its business activities. We agree with this and think it is important that no Standard ends up preventing entities from reflecting their business models. We therefore also welcome the approach to measurement proposed in the DP, which we believe forms a sound basis for having an entity's business model reflected in measurement.

However, measurement cannot be considered in isolation. In order to achieve useful performance reporting, it is essential to consider how remeasurements are presented in the financial statements. For example, information may be most useful if some non-operational items are measured at a current value, but only if corresponding remeasurements are presented in other comprehensive income.

A definition/description of profit or loss

In relation to a general discussion on what is best presented in profit or loss and what is best included in other comprehensive income, we think that the Conceptual Framework should provide a definition/description of what profit or loss should depict, so that it plays its role of primary performance metric that is meaningful in financial communication. This definition/description would facilitate the distinction between profit or loss and other comprehensive income (OCI) and clarify when and how recycling should take place. In EFRAG's view an entity's business model should play a role in defining this primary performance.

Elements of financial statements and recognition

As noted above, we appreciate that the DP is dealing with issues that have been identified to result in problems. We also agree with the DP that the current definitions of assets and

liabilities are interpreted inconsistently. We therefore appreciate that the IASB is trying to address this issue and we generally agree with the proposed new definitions. However, in order to ensure that the proposed definitions are interpreted in a consistent manner, we recommend that the IASB tests possible interpretations.

Although we generally support the proposed definitions, we think that constructive obligations are defined too narrowly in the proposals. We do not agree with the DP that a constructive obligation only exists when an entity has a duty or responsibility to another party or parties that will benefit from the entity fulfilling its duty or responsibility. We favour an approach for liabilities where an obligation is present when it has arisen from past events and is practically unconditional. We think, however, that the term 'practically unconditional' should be replaced by 'no realistic alternative'.

We agree with the proposed definition of an asset but note that it may result in more assets being identified than under some interpretations of the current definition. We therefore think that probability thresholds for recognition should be considered on a standards level. The Conceptual Framework should provide guidance on how probability thresholds/recognition criteria should be constructed on a standards level by explaining how uncertainty affects reliability and relevance of recognising items.

Distinction between liability and equity elements

Another issue that the IASB has rightly identified as causing problems in practice is the distinction between liability and equity elements. We therefore welcome that the DP addresses this issue. We also support equity being defined as a residual, but do not support either of the approaches as described in the DP.

Both the strict obligation approach and the narrow equity approach have significant problems that we do not feel have been adequately investigated and were not identified in the DP.

In EFRAG's view the difficulties inherent in making the equity/liability distinction are such that any conceptual basis needs to be tested in how it could materialise and operate at standards level. Therefore, EFRAG recommends that the IASB does not attempt to provide the conceptual basis for a distinction as part of the current revision of the Conceptual Framework. Instead, the IASB should in parallel with the Conceptual Framework project undertake a more comprehensive discussion on what this distinction means and is attempting to portray.

Disclosure

There is a strong consensus in the financial community that disclosures in the notes to the financial statements have become unwieldy. The increasing length of the notes has done little to improve the quality of information; quality may have even decreased because of information overload. We therefore appreciate that the IASB is addressing disclosures in the DP. We also think that the proposals included in the DP are pointing in the right direction and acknowledge that the IASB will also address the issue in other projects. However, we think that the Conceptual Framework could go further than proposed in the DP in order to provide guidance that could introduce discipline on the issues in relation to the IASB's standard setting. The EFRAG, ANC and FRC Discussion Paper *Towards a Disclosure Framework for the Notes* and related feedback statements should be useful to this purpose

Implications on existing Standards of amending the Conceptual Framework

The DP proposes that 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 (specific definition or principle) of the revised Conceptual Framework. If this happens the IASB should describe the departure from the Conceptual Framework and the reasons for that departure in the Basis for Conclusions on that Standard.

We agree with this, but note that it is likely that the principles of the revised Conceptual Framework will conflict with some requirements in existing IFRS. We believe that these conflicts should be identified at the level of the Exposure Draft, so that constituents have a clearer understanding of the possible outcomes of the proposed changes. Conflicts between Standards and the revised Conceptual Framework could indicate flaws in those Standards. However, projects to amend individual Standards should only be undertaken if there is evidence that they do not work appropriately and the projects should follow the procedure for the IASB's agenda consultation.

Conflicts between Standards and the revised Conceptual Framework would also create uncertainty on how to apply the hierarchy described in paragraph 11 of IAS 8 (i.e. sources to consider in the absence of an IFRS that specifically applies to a transaction, other event or condition). The IASB should therefore explain how the revised Conceptual Framework should be used, or not used, in these cases.

Although amending the Conceptual Framework will not have any immediate consequences for how financial statements are prepared, it should have implications in the long-term.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer, Benjamin Reilly, Aleš Novak or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

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SECTION 1 INTRODUCTION

Question 1

Paragraphs 1.25–1.33 of the DP 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?

EFRAG's response

EFRAG generally agrees with the proposal on the purpose and status of the Conceptual Framework but does not understand why parts of the Conceptual Framework should be for the IASB's use only. EFRAG agrees with the proposal that the IASB could introduce requirements in Standards that could conflict with specific definitions or principles in the revised Conceptual Framework but EFRAG believes that future conflicts as well as existing conflicts should be identified and explained.

- 1 EFRAG thinks that it is important that the IASB has a Conceptual Framework to guide its standard setting activities. EFRAG believes that for financial reporting information to be useful, the guidance under which financial reports are based should be founded on clear general principles. Guidance that is not based on articulated general principles could be inconsistent and could result in financial reporting information not being understandable and comparable.
- 2 The DP proposes that some parts of the Conceptual Framework could only be used by the IASB. For example, it is intended that only the IASB should/could use the proposed guidance on when an item of income or expense could be presented in OCI. EFRAG understands that the IASB, by this restriction, tries to reflect the requirement of paragraph 88 of IAS 1 *Presentation of Financial Statements*, which states that an entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise. In other words, an entity is only allowed and required to recognise items of income and expense in OCI in the specific cases where the IASB has decided on that in a Standard. It thus seems to EFRAG that the IASB is afraid that the Conceptual Framework could be used to override requirements in Standards.
- 3 EFRAG does, however, not understand why it is necessary to limit the use of parts of the Conceptual Framework to the IASB in order to avoid the Conceptual Framework being used to override requirements in Standards. IAS 1 clearly specifies that only in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements, the entity can and shall depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.
- 4 EFRAG believes that all parts of the Conceptual Framework could be useful for preparers or the IFRS Interpretations Committee in the absence of an IFRS that specifically applies to a transaction, another event or condition or of a possible analogy to an existing requirement. Limiting the use of parts of the Conceptual Framework to the IASB may

confuse constituents, result in the Conceptual Framework being less understandable and may result in inconsistencies.

- 5 EFRAG agrees with the DP that the IASB, in a limited number of cases, would have to issue an IFRS that conflicts with specific definitions or principles in the revised Conceptual Framework, when this has been finalised. For example, in order to produce the most useful information it may be necessary to recognise a liability for deferred income although such item would not meet the definition of a liability.
- 6 EFRAG similarly agrees with the DP that departures from the revised Conceptual Framework should be thoroughly justified in the Basis for Conclusions to the relevant Standard or amendment. EFRAG would even go a step further as it thinks that the relationship between the Conceptual Framework and the main or controversial parts of a Standard should always be explained in the Basis for Conclusions of that Standard – even when there are no departures from the revised Conceptual Framework.
- 7 In addition to thoroughly justifying departures from the revised Conceptual Framework, the IASB should pay attention to departures as they could indicate deficiencies in the principles included in the Conceptual Framework.
- 8 Conflicts between Standards and the Conceptual Framework will not only arise as the IASB develops new or revised Standards. It is likely that the principles of the revised Conceptual Framework will conflict with some requirements in existing IFRS.
- 9 As a first step, EFRAG thinks that the IASB should explain (to the extent possible) the conflicts between existing Standards and the forthcoming Exposure Draft on the Conceptual Framework. This will enable the IASB's constituents to assess better the impact of the proposed principles (although changes in the Conceptual Framework will not affect existing Standards directly).
- 10 As a second step, when the revised Conceptual Framework has been finalised, the IASB should identify conflicts with Standards in force (to the extent possible). These conflicts could indicate flaws in IFRS. Accordingly, the IASB may choose to initiate a project to deal with any flaws. However, as noted in relation to the 2011 IASB Agenda Consultation, EFRAG thinks that projects to amend IFRS should only be undertaken if there is evidence that current Standards do not work appropriately (the mere existence of a conflict with the Conceptual Framework is not sufficient). In addition, any projects following from identified conflicts should follow the procedure for the IASB's agenda consultations.
- 11 Conflicts between Standards and the revised Conceptual Framework would also create uncertainty on what sources to consider in the absence of a Standard that specifically applies to a transaction, other event or condition or a Standard dealing with similar and related issues (paragraph 11 of IAS 8). The IASB should therefore provide some clear guidance on how the revised Conceptual Framework should be used, or not used, in these cases. For example, it may not be appropriate to draw upon the revised Conceptual Framework for guidance, but to base interpretations on the principles that drove the development of particular requirements.

SECTION 2 ELEMENTS OF FINANCIAL STATEMENTS

Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16 of the DP. 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?

EFRAG's response

EFRAG believes that the proposed definitions may be easier to understand than the current ones, but the IASB should perform field tests to ensure that this is the case.

- 12 EFRAG notes that some would consider the changes made to the definitions of an asset and a liability to be more than just clarifications as stated in the DP. In any case, as the current definitions have been interpreted differently, the proposed changes may have an impact on what users of the Conceptual Framework consider to be assets and liabilities. EFRAG considers that many items will meet the proposed definition of an asset, including items that some people would not consider to meet the current definition. Items such as a workforce and an improved market position (resulting from marketing efforts) seem to meet the proposed definition of an asset.
- 13 EFRAG believes that the proposed definitions may result in more consistent interpretations than the current ones, as EFRAG thinks that the proposed definitions are easier to understand. EFRAG welcomes the changes in this respect. For example, EFRAG considers that under the proposed definitions a reduction in future outflows would meet the definition of an asset. This is less evident under the current definition as it refers to economic benefits to flow to an entity.
- 14 Although EFRAG believes that the proposed definitions are easier to understand, we think that it should be further tested whether the proposed definitions are generally interpreted consistently or whether ambiguous wording in one area is just replaced by ambiguity in another area. For example, the test should ensure that replacing 'expected' in the definition of an asset with 'capable' in the definition of a resource does not just move a problem. EFRAG acknowledges that the DP includes some examples of items that meet the definitions of an asset and a liability and further examples of what an economic resource is. However, before publishing an Exposure Draft, EFRAG considers that the IASB should publish for comments a list of items it considers would meet the proposed definitions of an asset or a liability to test the consistency of interpretations. The IASB could in this regard consider the list of items assessed in the EFRAG/ANC staff paper on the definition of an asset published in 2010.
- 15 EFRAG agrees with the proposals that the definition of an asset (and a liability) should include the link to the entity. That is, the items defined should be assets and liabilities of an entity. We do not think it would be efficient first to define assets and liabilities without such a link and then establish the link to the entity afterwards. Accordingly, EFRAG does not think that fish in the open sea should meet the definition of an asset. Only when they are caught are they assets of a particular entity. For assets the link between the economic resource and the entity is established in the DP by stating that the economic

resource should be 'controlled by the entity'. For liabilities the link is established by stating that a liability is a present obligation 'of the entity'.

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 of the DP. 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?

EFRAG's response

EFRAG thinks that the definitions of assets and liabilities should not include probability thresholds. As explained in our answer to Question 8, EFRAG thinks that uncertainty related to inflows and outflows should be considered when making recognition decisions.

- 16 EFRAG agrees with the DP that the definitions of assets and liabilities should not include probability thresholds.
- 17 EFRAG thinks that it could be useful from a standard-setting perspective to distinguish between uncertainty in relation to existence and uncertainty in relation to outcome. In practice, however, EFRAG thinks that there can be cases where it is difficult to distinguish between the two types of uncertainties. One of the reasons is that the distinction may depend on the unit of account that is chosen. For example, if tax authorities disagree with an entity that a part of revenue is not tax free as the entity has claimed, it is not clear whether the uncertainty relates to the outcome of the total tax liability or to existence of a tax liability for the particular revenue.
- 18 While we agree with the DP that it can be useful to distinguish between uncertainty in relation to existence and uncertainty in relation to outcome, we do not think that the IASB should make statements in the Conceptual Framework about how frequent the different types of uncertainties would arise in practice. Therefore we disagree with stating that existence uncertainty only exists in 'rare cases' (paragraph 2.20 of the DP).

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 of the DP.

Do you have any comments on these items? Would it be helpful for the Conceptual Framework to identify them as elements of financial statements?

EFRAG's response

EFRAG supports that income and expenses are defined on the basis of changes in assets and liabilities. EFRAG believes it would be useful to define contributions to equity, and distributions of equity. However, EFRAG does not see any particular benefits in defining cash receipts and cash payments. Instead the IASB should consider what the statement of cash flows should communicate.

- 19 EFRAG believes that no primary financial statement should have primacy over the other primary statements. This means that the statement of financial position should not have primacy over the statement(s) of profit or loss and OCI. EFRAG is aware that some believe that defining income and expenses based on changes in assets and liabilities results in the statement(s) of profit or loss and other comprehensive income being secondary to the statement of financial position. EFRAG does not share this view, as further explained in the Bulletin on the asset/liability approach¹. Defining income and expenses based on changes in assets and liabilities does not conflict with the objective of producing useful performance figures and it does not mean that the statement of financial position is more important than the statement(s) of profit or loss and other comprehensive income.
- 20 As further explained in the Bulletin on the asset/liability approach, EFRAG thinks that the asset/liability approach has some merits compared to a matching approach. Focusing on changes in assets and liabilities, in EFRAG's view, provides greater clarity for the development of accounting Standards.
- 21 While EFRAG agrees that income and expenses should be defined on the basis of changes in assets and liabilities, we note that the definitions may have to be amended to reflect the decisions to be made by the IASB on recycling and distinguishing OCI from profit or loss.
- 22 EFRAG believes it would be useful to define contributions to equity and distributions of equity (and transfers between classes of equity instruments if the IASB decides that these should be shown). EFRAG notes that it is currently not always clear whether, for example, certain transactions with shareholders should be considered equity transactions or not.
- 23 On the other hand, EFRAG does not see any particular benefits in defining cash receipts and cash payments. Instead EFRAG thinks the IASB should consider what the statement of cash flows should communicate. In 2010, EFRAG performed outreach activities in relation to the staff draft of the Exposure Draft *Financial Statement Presentation*. Feedback from these activities suggested that cash flow statements, as currently defined, are of little value to the users of the financial statements of financial institutions, including insurance entities. The IASB may therefore need to reflect, on a conceptual level, on what information should be conveyed in these statements, including whether the information presented should be of the same type for all types of entities.
- 24 EFRAG's comments in relation to income and expense reported in profit or loss versus income and expense reported in OCI are provided in response to the questions relating to Section 8 of the DP.

¹ The Bulletin was issued by EFRAG together with the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC). Not all the partners issuing the Bulletin share the preliminary view of EFRAG on this issue. The different views are explained in the Bulletin.

SECTION 3 ADDITIONAL GUIDANCE TO SUPPORT THE ASSET AND LIABILITY DEFINITIONS

Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62 of the DP. 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 of the DP.

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

EFRAG's response

EFRAG agrees with the DP that the IASB should retain the existing definition of a liability which encompasses both legal and constructive obligations. However, EFRAG thinks that constructive obligations should be defined more broadly than what is proposed in the DP.

- 25 EFRAG agrees that the IASB should retain the existing definition of a liability which encompasses both legal and constructive obligations. EFRAG agrees with the arguments presented in the DP that excluding some constructive obligations could provide less relevant information to users of financial statements about the entity's future cash flows relating to past activities. In addition, EFRAG considers that excluding some constructive obligations would not result in a faithful representation.
- 26 However, EFRAG does not agree with the DP on how to consider constructive obligations. EFRAG agrees that a constructive obligation exists in cases where the criteria in paragraph 3.50 of the DP are met. EFRAG also acknowledges that the criteria in paragraph 3.50 reflect how some regard constructive obligations. EFRAG, however, thinks that constructive obligations could also arise in other circumstances where the entity has no realistic alternative than to incur future costs (that are not outweighed by accompanying benefits). According to the DP, the IASB has concluded that an entity does not have a constructive obligation to restructure a business, even if it has announced, or started to implement a detailed restructuring plan. The IASB explains that this is because the entity has no obligation to others and is not bound by its plan. However, EFRAG considers that if an entity has no realistic alternative to a restructuring plan, obligations following from this plan should be recognised as liabilities. Guidance on when an entity would have no realistic alternative would follow the guidance proposed in paragraph 3.79 of the DP on when an obligation is practically unconditional. Accordingly, an entity may not have realistic alternatives, if the alternative would involve the entity ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets.
- 27 EFRAG also notes that the criterion in paragraph 3.50 (c) states that 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 responsibilities. Although the reference to an entity's past history can be used in Standards to operationalise the principle that another party or parties can reasonably rely on the entity to discharge its duty or responsibility, EFRAG does not think that the principle itself should refer to the entity's past history.
- 28 The DP mentions that 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. We believe that a liability can exist even when a counterparty cannot be identified.

- 29 The question on the role of economic compulsion is closely related to the issue of constructive obligations. EFRAG provides some comments on this topic in its answer to Question 7.

Question 6

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63–3.97 of the DP. 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.

EFRAG's response

EFRAG thinks that a present obligation must have arisen from past events and be practically unconditional. Therefore EFRAG supports View 2. However, EFRAG notes that it had difficulties in understanding the exact consequences of the different views presented.

- 30 The DP includes some examples illustrating the outcome of the three views presented on how to determine whether a present obligation exists. EFRAG is in favour of an approach that will result in the same outcomes as those that are illustrated for the second approach. EFRAG considers that the first approach would sometimes identify liabilities too late. This is, for example, the case when a levy is based on the entity's revenue in one year, but where the obligation only becomes unconditional if the entity is still operating on a certain date the following year. On the other hand, EFRAG thinks that View 3 would probably result in too many liabilities being identified. For example, if an entity has promised its employees a total bonus of CU100 if the entity would have a profit of CU100,000 in year ten from now, EFRAG understands that View 3 would result in an obligation being identified even when the entity needs to grow considerably in order to meet the goal in ten years. EFRAG, however, notes that it and many of its constituents had some difficulties in understanding the various approaches proposed in the DP, and would recommend these being explained further.
- 31 EFRAG notes that under the second approach whether or not an obligation exists depends on *how* the amount of the obligation is determined. Accordingly, if:
- (a) In Jurisdiction A, a particular utility is required to pay a levy of two percent of its revenue of year 20x1 if it is in business on 1 April 20x2, EFRAG interprets the

proposal in a manner that would result in a liability for the utility in Jurisdiction A from January 20x1 when the utility starts generating revenue.

- (b) In Jurisdiction B, a particular utility is required to pay a levy of a 'fixed' amount announced on 1 April 20x1 if it is in business on 1 April 20x2, EFRAG interprets that no liability should be recognised until 1 April 20x2 as the amount of the liability is not directly linked to the entities performance (although the government may try to consider the performance of the utilities when determining the size of the levy, this would not be known with certainty).
- 32 EFRAG believes that reflecting the scenarios differently does make sense as it could be expected that there is some rationale behind how the jurisdictions in the examples above calculate the levies.
- 33 Unfortunately, the DP is not clear on what benefits received or activities conducted by an entity would result in a liability. For example, if a utility in Jurisdiction C is required to pay an amount on 1 April 20x2 that is determined based on various parameters such as: the average number of customers over the past ten years; the increase in revenue from 20x0 to 20x1; the estimated increase in customers over the following ten years; and the average asset balance of the past five years. It is not apparent from the DP whether the utility should recognise a liability from the start date of the calculation of the average number of customers.
- 34 Paragraph 3.66 of the DP states that activities conducted by the entity include that the entity is operating on a particular date. The fact that the entity has customers on a particular date could indicate that it has been operating. Paragraph 3.66 of the DP does, however, not seem particularly clear. It can even be read as an acceptance of different interpretations of the second approach suggested in the DP, as it states "a liability *can* be viewed...". In the view of EFRAG the IASB would have to specify in a clearer manner how the second approach should be understood by, for example, stating that "a liability *should* be viewed...".
- 35 EFRAG notes that the term 'practically unconditional' in View 2 is ambiguous as some believe it means 'virtually certain', while others believe it means 'unconditional in practice'. The term may accordingly lead to differing interpretations of View 2. As noted above in relation to Question 6, EFRAG thinks liabilities arise when the entity 'has no realistic alternative'. Accordingly, we also suggest this term be applied when describing View 2.
- 36 In EFRAG's view, the IASB should also further clarify when an obligation is unconditional in practice (or where the entity has no realistic alternative). The IASB could, among other things, consider referring to its discussions about economic compulsion and explain how practicality interacts with the going concern assumption.

Question 7

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

EFRAG's response

EFRAG supports the additional guidance. However, it notes that the definition of control may be different from how some currently interpret the term. In addition EFRAG considers that the Conceptual Framework should provide additional guidance on when economic compulsion should be considered when distinguishing between equity and a liability.

- 37 EFRAG supports the additional guidance to be included in the Conceptual Framework to explain the meaning of: 'economic resource'; 'control'; and 'transfer an economic resource'. It also supports the guidance provided on executory contracts.

- 38 However, EFRAG notes that some currently interpret 'control' in a different manner than what is proposed in the DP. Some are currently placing more emphasis on legal ownership, possession and ability to sell a resource rather than the ability to obtain the benefits from it. For these, the change may therefore result in different types of assets being identified.
- 39 The DP only considers economic compulsion inside a contractual arrangement. EFRAG does not generally support economic compulsion outside a contractual arrangement being considered a relevant factor when determining whether an entity has an obligation to deliver an economic resource and therefore recognises a liability. However, EFRAG believes that economic compulsion has a different role to play when it is part of a contractual arrangement.
- 40 As it appears from paragraph 3.108 of the DP, the IASB considers that even when an option not to redeem a financial instrument has some commercial substance, the overall substance of some financial instruments might still be that of a liability, not equity. The IASB's proposal that a contractual option should only be ignored if it 'lacks commercial substance' may therefore not be appropriate.
- 41 EFRAG considers that in the cases where an entity can only avoid redeeming a financial instrument by transferring an asset, liability or equity instrument that it would not have otherwise done, a liability exists. EFRAG considers that this could be formulated as a principle that could be included in the Conceptual Framework. We do not support the suggestion in the DP only to deal with the issue at a standards level.
- 42 Similarly, EFRAG considers that a cumulative dividend blocker often should result in an instrument being a liability. In most cases, however, EFRAG thinks that this would also be the result of considering the commercial substance of an option specifying that if an entity would not pay any amount to the holder of a particular instrument every year, it would not be allowed to pay any dividend to ordinary shareholders (until it would have paid the amount (eventually accumulated) to the holder of the financial instrument). EFRAG considers that profit oriented entities will generally not be established without an intention of providing returns (in the form of dividends) to the ordinary shareholders and therefore an option to not make a contractual payment, subject to a cumulative dividend block, would not have commercial substance.

SECTION 4 RECOGNITION AND DERECOGNITION

Question 8

Paragraphs 4.1–4.27 of the DP 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?

EFRAG's response

EFRAG agrees with the DP that relevance and faithful representation should be considered when deciding on recognition of assets and liabilities. While EFRAG agrees with the DP that the Conceptual Framework should not include probability thresholds, it thinks that the Conceptual Framework should provide guidance on how uncertainty affects relevance and reliability. This guidance should be used by the IASB when setting probability thresholds/recognition criteria in Standards and by others (including the IFRS Interpretations Committee) through paragraph 11 of IAS 8.

- 43 EFRAG agrees with the DP that in deciding whether an asset or liability should be recognised, relevance and faithful representation should be considered. In other words, an item that would meet the definition of an asset or a liability should not automatically be recognised.
- 44 EFRAG notes that the general requirement proposed in the DP is that an entity should recognise all its assets and liabilities. There are exceptions when this would not result in (sufficiently) relevant information and when it would not result in a faithful representation. EFRAG does not agree with this approach as it seems to suggest that recognition, without evidence of the contrary, would result in relevant and reliable information. EFRAG believes that the principles should be worded differently in order to make recognition criteria more effective and call for a genuine assessment of relevance and reliability, without the preconceived idea that recognition would result in relevant and reliable information.
- 45 EFRAG agrees with the proposals that the Conceptual Framework should not include explicit probability thresholds as it would not be possible to construct thresholds that would result in useful information for all types of assets and liabilities. However, we believe that the Conceptual Framework should clearly articulate that uncertainty is a potential impediment to relevance and reliability. We do not think this is sufficiently emphasised in the DP. Clarifying the role of uncertainty in the Conceptual Framework would provide guidance when introducing probability thresholds for recognition on a standards level, where such thresholds are considered useful. EFRAG therefore thinks that the Conceptual Framework should include further guidance that can be used by the IASB (and others through the reference in IAS 8) when considering how the recognition criteria/probability thresholds should be set in Standards (or when others than the IASB are using the guidance to determine whether an asset or liability should be recognised). This guidance should explain how uncertainty would affect the assessment of whether recognition of an item would result in relevant and reliable information. Parts of the guidance included in paragraph 4.26 of the DP could be used. However, the guidance should be sufficiently specific to ensure consistent recognition criteria in Standards.
- 46 Consistent with the preliminary views expressed in the Bulletin *Reliability of financial information*² and EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*, issued by the Canadian Institute of Chartered Accountants in 2012, EFRAG does not think that disclosures can compensate for large margins of errors in measurement, i.e. for the unreliability of measurement.
- 47 The IASB is explicitly discussing the cost constraint on useful financial reporting in relation to the recognition criteria. For the avoidance of doubt, EFRAG would like to state that it considers this constraint to be pervasive and should accordingly be considered in relation to all issues.

² This Bulletin was issued by EFRAG, ANC, OIC, ASCG and FRC in April 2013.

Question 9

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51 of the DP, 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?

EFRAG's response

EFRAG supports the proposals included in the DP, but thinks high-level guidance should be provided on the difference between a modification of an asset or liability and derecognition of an asset or liability and recognition of another.

- 48 EFRAG agrees with the DP that in most cases an asset or a liability should be derecognised when it no longer meets the recognition criteria (or no longer exists), or is no longer an asset or a liability of the entity. However, there may be cases where another approach may result in more useful information. It is our interpretation of the DP that the IASB acknowledges this, and we agree with this.
- 49 EFRAG therefore also agrees with the DP that when 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. In some cases, one approach could be to prohibit derecognition when there is no significant change in the entity's exposure to risks and rewards.
- 50 Although EFRAG agrees with the approach described in the DP for derecognition, we believe that the IASB should also include high-level guidance in the Conceptual Framework that could be used to distinguish modifications from derecognition of one asset or one liability and recognition of another asset or liability.

SECTION 5 DEFINITION OF EQUITY AND DISTINCTION BETWEEN LIABILITY AND EQUITY ELEMENTS

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 of the DP. 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) of the DP).
- (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?

EFRAG's response overview

EFRAG supports distinguishing between equity instruments and liabilities, but does not support either of the two approaches in the DP.

As a first step in deciding on how equity instruments are distinguished from liabilities it is necessary to decide whether financial reporting is from a proprietary or entity perspective. Only following that decision is it possible to decide upon an appropriate basis.

Although the strict obligation approach is consistent with an entity perspective and the narrow equity approach is consistent with a proprietary perspective EFRAG believes both of the proposals have significant and fundamental flaws.

Further work is required before arriving at a conceptual distinction between equity instruments and liabilities.

Overall comments

- 51 EFRAG does not support either of the two approaches as described in the DP. Both the strict obligation approach and the narrow equity approach have significant problems that we do not feel have yet been adequately investigated.
- 52 EFRAG supports addressing the distinction between liabilities and equity instruments at the conceptual level but based on our due process there is significant disagreement on how to distinguish equity instruments from liabilities. Before proceeding to an Exposure Draft containing a conceptual basis for distinguishing between equity instruments and

liabilities, the IASB should have a more comprehensive discussion on what this distinction means and is attempting to portray.

- 53 Additional issues that could be covered, that were not sufficiently included in the DP, include:
- (a) Depicting dilution;
 - (b) Rights to receive equity instruments;
 - (c) Whether the split between equity instruments and liabilities also needs to drive the definition of income and expense; and
 - (d) Whether a binary split of the statement of financial position is the most appropriate.
- 54 EFRAG's response to the various parts of Question 10 are presented below, as follows:
- (a) Question 10(a) – The definition of equity (paragraphs 55 to 65);
 - (b) Question 10(b) – Distinguishing between liabilities and equity instruments (paragraphs 66 to 90);
 - (c) Question 10(b)(i) – Obligations to issue equity instruments (paragraphs 91 to 100);
 - (d) Question 10(b)(ii) – Obligations that arise only on liquidation (paragraphs 101 to 103);
 - (e) Question 10(c) – Remeasurement of equity claims (paragraphs 104 to 119);
 - (f) Question 10(d) – If an entity has no equity instruments (paragraphs 120 to 124); and
 - (g) Other matters (paragraphs 125 to 129).

Question 10(a) – The definition of equity

EFRAG's response

EFRAG supports retaining a split between equity and liability claims and equity containing the residual
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- 55 EFRAG notes that the notion of equity as a residual is important because at least one element cannot be directly measured. For the statement of financial position to balance, this element is the residual of all of the other elements.
- 56 In current IFRS, this residual element is equity and the residual nature is the reason why once something has been recognised in equity it is generally not directly remeasured. Although the carrying values of some parts of equity, for example non-controlling interest, are updated, this is not a direct remeasurement: it simply reflects changes in the part of the residual (assets less liabilities) owned by non-controlling interests.
- 57 Both the current and proposed Conceptual Framework specifies income and expense in relation to changes in equity. Any increases (decreases) in equity, other than those relating to contributions from (distributions to) equity participants are defined as income (expense). A change in the definition of equity therefore also has consequences for performance reporting.
- 58 EFRAG believes that, in this context, the notion of residual has two important and distinct meanings as:
- (a) The part of the statement of financial position which is not directly remeasured; and
 - (b) A claim on the entity which is not a liability.
- 59 In respect of (a) EFRAG, in general, supports the notion of equity as the element of the financial statements that is not directly remeasured, but does not believe defining it as such is entirely consistent with some of the proposals in the DP, especially those with respect to the remeasurement of some equity claims. The effect of the proposals is that

only some equity claims (i.e. primary equity claims – as discussed later) are considered residual. EFRAG has a number of concerns regarding those proposals, which are set out later in this comment letter.

- 60 In respect of (b), EFRAG notes that this adds to the importance of an appropriate definition of liabilities.
- 61 EFRAG thinks the issues in paragraph 57 are distinct from each other and this should be stated in the Conceptual Framework. In addition, there are some entities (e.g. some cooperatives and historically the Trustee Savings Banks in the United Kingdom) which have equity in the sense of a residual amount after deduction of liabilities but where there is no claim on that equity. The application of the proposals to such entities should be clarified.

Does the statement of financial position need to be split between equity and liabilities?

- 62 The claims on an entity have numerous characteristics, including maturity (or lack of), rights to contribute to decision-making, ability to absorb losses and fixed versus variable return. There is no limit to how such characteristics could be combined in a single instrument. Therefore some believe that any split between equity and liabilities based on characteristics of an instrument portrays no more information on the nature of the claim than the chosen criteria.
- 63 EFRAG is aware of suggestions that the statement of financial position should depict and describe these various claims as a continuum rather than a split between equities and liabilities (described variously as a ‘no-split’ or ‘claims’ approach). Under such an approach, the statement of financial position would not be split between liabilities and equity, but would instead list the claims on the entity’s assets and disclose the characteristics of each claim in the notes. Any distinction between the different types of capital provided to an entity would be at the discretion of the user of the financial statements who could then make his/her own definition of equity according to his/her specific user needs.
- 64 However, at least one type of claim cannot be remeasured directly without remeasuring the entire entity³. If there were to be a class of claims that were not remeasured, then this would, implicitly, be accepting that some claims are different to others. It would be a liability/equity distinction, even if not called by that name.
- 65 Given that at least one category of claims cannot be remeasured directly, EFRAG supports explicitly splitting the claims side of the statement of financial position between liabilities and equity, and the retention of a definition of equity as the residual (in this sense) being retained. However, EFRAG notes that this definition of a residual is not consistent with the proposals in the DP for direct remeasurement of equity claims: under the proposals only primary equity claims are a residual.

Question 10(b) – Distinguishing between liabilities and equity instruments

EFRAG’s response

Before deciding on specific requirements for identifying equity, EFRAG believes it is important to decide if this is being done from an entity or proprietary perspective to financial reporting.

EFRAG does not support either the strict obligation or narrow equity approach and believes further work is needed before any revised conceptual distinction is adopted.

- 66 EFRAG does not support either the strict obligation approach or the narrow equity approach, as described in the DP.

³ Based on the statement in paragraph OB7 of the Conceptual Framework that the purpose of financial reporting is not to show the value of a reporting entity. Without this restriction all claims could be directly measured and something else, such as internally generated goodwill, could be the residual.

- 67 EFRAG believes that there are two basic approaches to determining how equity (as the residual claim on an entity) is defined:
- (a) Equity can be determined as the instruments held by the owners of the entity, and any claim that reduces the returns to these is a liability; or
 - (b) Equity can be determined based on the characteristics of the instruments issued by an entity.
- 68 These two approaches could be seen as being consistent with a proprietary perspective and entity perspective to financial reporting, respectively.

A proprietary perspective – the instruments held by the entity's owners are equity

- 69 If financial statements are being prepared from the proprietary perspective, it appears necessary to identify the instruments that convey an ownership interest and proceed from there: such instruments are equity, and all other claims are liabilities. One way of doing this is set out as the *Narrow Equity Approach* in the DP. We note that the FASB Preliminary Views document *Financial Instruments with Characteristics of Equity* (FICE) started from a basis of identifying an instrument that conveyed a 'basic ownership interest.'
- 70 EFRAG believes that an approach to distinguishing between liabilities and equity on the basis of ownership interest as equity has a number of attractive features. For example, it would provide a conceptual basis to solving classification problems that have arisen in relation to a number of instruments, including puttable shares, non-controlling interests and puts/forwards over own equity.
- 71 However, if such an approach to distinguishing liabilities and equity were to be taken, instruments with the same characteristics could be classified differently by different entities, reducing comparability. Some of the roles equity has traditionally been perceived as fulfilling, including as a buffer against losses by holders of less-subordinated claims (such as bond-holders), would also not necessarily be compatible with a notion of equity based on a proprietary approach. As noted in the DP, if such a distinction between equity and liability were to be adopted, it would also require a subsequent change to the definition of a liability.
- 72 EFRAG also believes that such an approach would raise significant issues in relation to relevance with respect to some corporate structures, for example entities in which the basic ownership instrument is a demand deposit.
- 73 Within such an approach, there remain a number of significant unanswered questions on how to identify what instruments contain an ownership interest. EFRAG does not believe an approach based on limiting this to the 'most residual' instrument – as suggested in the DP – of an entity is appropriate, because:
- (a) The instrument that is most residual may change depending on other instruments (including those issued later);
 - (b) Different instruments may be the most residual depending on how residual is defined, particularly whether it is defined with respect to participation in ongoing returns, subordination or participation on liquidation; and
 - (c) It is unclear how the concept of residual interest applies in a group context, given the potential extent of structural subordination. For example, in the case of the insolvency of the parent of a group, equity holders in subsidiaries may have a higher claim on underlying net assets than the creditors of the parent (who would merely have a claim on the shares held by the parent).
- 74 One potential way of avoiding these difficulties would be to allow entities a free choice of which instrument is designated as the basic ownership instrument.
- 75 If only a basic ownership instrument were defined as equity there would be some instruments that, despite not imposing any obligation on the entity to transfer an

economic resource, would be labelled as liabilities. As liabilities are measured directly, these instruments would be directly measured (on a basis such as at fair value) and changes in the carrying value taken through comprehensive income.

- 76 Therefore, the following would be the result:
- (a) Shares in subsidiaries held by non-controlling interest would be recognised as liabilities, the carrying value updated at each reporting date and changes in this carrying value taken through comprehensive income;
 - (b) Other classes of ownership instruments (such as other classes or types of shares including perpetual interest bearing, deferred or preference shares; or the interests of limited partners) would be recognised as liabilities, the carrying value updated at each reporting date, and changes in this carrying value taken through comprehensive income.
- 77 EFRAG is not convinced that this would provide meaningful information to users of financial statements, but believes it would be consistent with an approach in which equity is determined by reference to the class of instruments held by owners.
- 78 During the FICE project two possible approaches were explored that would result in equity being defined wider than the basic ownership instrument. These, the *ownership-settlement* approach and the *revised expected outcomes* approach were not pursued further, partially due to the level of complexity required to determine whether any particular instrument was equity.
- 79 These difficulties were in a US GAAP context of identifying equity in a single legal framework. EFRAG believes that identifying appropriate principles to distinguish which instruments are ownership instruments would be even more difficult in IFRS given that these principles would need to apply across a wide range of legal and regulatory systems.
- 80 As such, EFRAG believes further work would be required to identify principles that could be used, in the context of a proprietary perspective, to identify what instruments, other than a basic ownership instrument, would also be classified as equity.

An entity perspective to identifying equity

- 81 An alternative basis to distinguish between equity and liabilities is to distinguish based on the characteristics of the instruments issued, an approach which may be considered to be consistent with an entity perspective.
- 82 There are a number of characteristics that could be used, including ability to direct the entity, the presence or absence of an obligation to deliver economic resources and loss absorption. Although the DP suggests using presence, or absence, of an obligation to issue economic resources as the distinguishing factor EFRAG believes that using other characteristics would be similarly consistent with an entity perspective: deciding upon an entity perspective to distinguishing equity does not necessarily lead to the suggestions set out in the DP.
- 83 An approach of distinguishing between equity and liability instruments based on the presence, or absence, of an obligation to deliver economic resources, as is basically the case in current IFRS and the approach suggested by the DP, has a number of advantages. These advantages include:
- (a) Consistency with the current and proposed definitions of a liability in that an instrument would not be able to be both simultaneously a liability and equity⁴;
 - (b) Relative simplicity;
 - (c) Consistency with the accounting identity of assets equalling liabilities plus equity;

⁴ However, a single legal contract could contain multiple financial instruments, and thus require separate recognition of each component.

- (d) Consistent depiction of an entity's leverage;
- (e) Consistency with a view of equity as a 'buffer' that protects holders of less subordinated claims from loss; and
- (f) Comparable application across a broad range of instruments and legal/regulatory environments.

84 EFRAG also notes that, although the principle is relatively simple, experience with current IFRS requirements has identified that application of these principles is not without difficulties. In particular, the role of economic compulsion and settlement options with limited or no economic substance have proven to be difficult issues to address in current requirements.

Other potential approaches

85 EFRAG believes that there could be other, perhaps more appropriate characteristics, used to distinguish between equity and liabilities. In particular, EFRAG notes that the current requirements have led to financial reporting that many believe is counter-intuitive for a number of instruments. These instruments include:

- (a) Puttable shares;
- (b) Derivatives over own equity including NCI Puts;
- (c) Perpetual instruments that entitle holders to discretionary payments that are fixed or determinable; and
- (d) Instruments that require an entity to distribute an amount based on a proportion of profit or revenue.

86 The 2008 Proactive Accounting Activities in Europe (PAAinE) Discussion Paper *Distinguishing Between Liabilities and Equity* identified a loss absorption approach as one way to distinguish based on the characteristics of instruments. Although this approach was more complex than the current approach in IFRS and did not depict an entity's leverage EFRAG believes that it better depicted the ownership structures of the wide range of entities required to report under IFRS in Europe. As such it, and other similar approaches, should be investigated further.

87 EFRAG believes that relying solely on the presence or absence of an obligation does not always result in appropriate classification of the basic ownership instruments in some corporate structures common across Europe, including partnerships and other structures involving puttable instruments. EFRAG believes that it is important that the Conceptual Framework contains appropriate guidance for the development of Standards that would result in useful information for users, including the holders of these ownership instruments. If the IASB continues with the strict obligation approach.

88 If the IASB continues with the strict obligation approach EFRAG has identified two important factors that it believes should be included in the Conceptual Framework to assist in producing Standards that result in useful information:

- (a) The logic expressed in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* should be repeated at the conceptual level. The logic of IFRIC 2 is that there is a unit of account issue to equity. Even within the strict obligation approach it is not sufficient to determine whether an individual instrument is a liability or an equity instrument, but it must also be assessed to what extent an obligation exists overall.

In assessing the extent of this overall obligation all of the terms and conditions of a financial instrument, including relevant local laws, regulations and the entity's governing charter are relevant. EFRAG believes that it is important guidance for determining whether and to what extent an obligation exists. As such, this or similar guidance should be included in the Conceptual Framework.

- (b) The Conceptual Framework should acknowledge the important role of basic ownership instruments, even within the context of financial reporting where equity is defined based on the characteristics of instruments and should lead to the development of Standards that acknowledge the importance of these instruments. One way in which this could be done would be through disclosure. For example, a future revised Standard on the presentation of financial statements could contain an optional disclosure of a statement of financial position and statement(s) of profit or loss and other comprehensive income where the distinction between equity (as the class of claims not directly remeasured) and liabilities was on the basis of what the entity chose to identify as its basic ownership instruments. These may be similar to those currently contained in Examples 7 and 8 of IAS 32 *Financial Instruments*.

- 89 This would result in the presentation of information from the perspective of the holders of these basic ownership instruments that would have the status of GAAP, but also preserve the comparability and principles-based financial reporting of the primary statements. If such an approach were taken, it would be important that the XBRL taxonomy reflected this.
- 90 EFRAG also believes that the ideas being developed in the *Financial Statements Presentation* project (for example separating the operating performance of an entity from its financing activities) were highly relevant to this discussion, and that the content of the final Conceptual Framework should not limit future developments in this area.

Question 10(b)(i) – Obligations to issue equity instruments

EFRAG's response

EFRAG does not support the strict obligation approach as classifying obligations to issue equity instruments as equity may not result in the most relevant financial reporting. EFRAG believes that primary and secondary equity claims are fundamentally different, and that the Conceptual Framework should reflect this.

- 91 EFRAG does not support the strict obligation approach as classifying all obligations to issue equity instruments as equity may not result in the most relevant financial reporting. We are not convinced that remeasuring equity claim is conceptually sound or always practically possible, as further discussed in paragraphs 104 to 119 below.
- 92 Nonetheless, EFRAG has the following comments to make with respect to the strict obligation approach.

Primary and secondary equity claims

- 93 EFRAG believes that primary equity claims (as described in paragraph 5.7 of the DP) are fundamentally different from secondary equity claims: secondary equity claims involve an enforceable right or obligation for the entity to receive or deliver something.
- 94 A primary equity claim, however, does not, by definition, contain any obligation on the entity to deliver anything.
- 95 Secondary equity claims involve an entity's contractual obligation to deliver, or contractual right to receive, equity instruments. These include options, warrants and forwards. These enforceable rights and obligations can be measured as if they were financial assets and liabilities. A secondary equity claim is an obligation to deliver (or receive) equity instruments, unlike a primary equity claim which is a claim on the entity without obligation. Secondary equity claims can be remeasured without requiring remeasurement of the entire entity.
- 96 One possible way for the Conceptual Framework to make clear the differences between primary and secondary equity claims would be to amend the definitions of assets and liabilities to include obligations to receive or deliver own equity (similar to some requirements in current IFRS). However, EFRAG notes that this results in an

inconsistency, particularly with respect to treasury shares: the right to receive them would be classified as an asset, but upon settlement would be recognised as a debit within equity.

- 97 Holders of secondary equity claims do not have a current unconditional claim on the residual net assets of an entity, but have a potential claim that may or may not result in an eventual claim.
- 98 EFRAG notes that the DP also explains (in paragraph 5.18) how these two types of claims are different from each other, but believes that the Conceptual Framework should explicitly acknowledge this.

Consequences of the strict obligation approach

- 99 There are a number of consequences of adopting a strict obligation approach that are not apparent from the DP. If the IASB decides to proceed with the strict obligation approach, EFRAG thinks it is important that these consequences are appreciated in advance. These consequences include:
- (a) instruments with settlement options would be classified as equity, even if they were expected to be settled in cash; and
 - (b) almost any transaction could be structured to achieve equity treatment (and thus not be remeasured through comprehensive income).
- 100 These are natural consequences of the strict obligation approach. Including anti-abuse provisions at the level of individual Standards to avoid these consequences and require certain instruments or transactions to be classified as liabilities would conflict with the Conceptual Framework and be indicative of problems with the basic conceptual distinction.

Question 10(b)(ii) – Obligations that arise only on liquidation

EFRAG's response

EFRAG generally supports the proposal that obligations that arise only on liquidation of the reporting entity not be classified as liabilities, given that financial statements are prepared on a going concern basis but believes it is important to appropriately distinguish instruments that are, in substance, liabilities.

- 101 EFRAG supports the proposal in the DP with respect to obligations that will arise only on liquidation of the reporting entity – as this is consistent with a going concern basis to financial reporting – but believes it is important to appropriately distinguish instruments that are, in substance, liabilities.
- 102 With regards to obligations that will only arise on liquidation of a consolidated subsidiary, EFRAG believes there is an important link to the notion of control, as expressed in IFRS 10 *Consolidated Financial Statements*. For an entity to consolidate a subsidiary it must control it. If it controls a subsidiary, the liquidation of such a subsidiary would be at the discretion of the reporting entity; in such a circumstance EFRAG believes it would be appropriate that obligations that arose on liquidation of the subsidiary not be classified as liabilities.
- 103 However, if the entity has contractually committed itself to liquidation of such a consolidated entity (for example by inclusion in the contractual arrangements of a special purpose vehicle) and as a result is obliged to transfer an economic resource, EFRAG believes it would be appropriate for such a contractual obligation to be classified as a liability.

Question 10(c) – Remeasurement of equity claims

EFRAG's response

EFRAG does not support the notion of 'wealth transfer' and has identified a number of problems with the proposals in the DP.

EFRAG does not support the proposals with respect to remeasurement of equity claims and has significant concerns regarding the proposal to classify obligations to issue equity instruments as equity.

104 EFRAG believes remeasuring certain classes of equity has the potential to address some long-standing problems but would at the same time create other problems.

105 Given the overall definition of equity as a residual, EFRAG is not convinced that remeasuring certain equity claims is conceptually sound. It may also not always be practically possible to arrive at meaningful measurements because the eventual outcome of many claims will depend on discrete events and/or future management decisions. As such, the remeasured amounts may not be sufficiently reliable or relevant.

Wealth transfers

106 EFRAG believes that the proposal to use a notion of wealth transfers would significantly increase the complexity of financial reporting, reduce understandability and lead to information necessary to understand an entity's performance, including some of its trading, borrowing and investing activities, being reflected in the statement of changes in equity rather than in the statement(s) of profit or loss and other comprehensive income.

107 EFRAG therefore does not support the notion of wealth transfers.

Other problems not addressed by the proposals

108 As noted in paragraph 99 and 100 the proposals would introduce additional problems and anomalous presentation. They would also not provide a basis for addressing the following problems:

- (a) depicting potential dilution; and
- (b) puttable instruments.

Depicting potential dilution

109 EFRAG is not convinced that the proposals in the DP would provide enough information for holders of equity instruments to understand how they may be diluted, as is implied by paragraph 5.37 of the DP. Furthermore, EFRAG believes that what is important about dilution is potential dilution in the future, not the amount of dilution that had occurred at the reporting date.

110 In particular, EFRAG notes that two important sources of potential dilution would not be portrayed at all under the IASB's proposals:

- (a) Dilutive instruments that are liabilities; and
- (b) Instruments that dilute the claims of holders of equity instruments on the occurrence of an event that is determined to be within the control of the entity.

Dilutive instruments that are liabilities

111 Some instruments that dilute the returns to holders of equity instruments would be classified as financial liabilities and the potential dilution due to these would not be portrayed. Such instruments include:

- (a) Convertible bonds;
- (b) Instruments where the entity is required to transfer either cash or an equivalent value of equity instruments at the option of the holder; and
- (c) Instruments that convert to equity only if a regulator/supervisor requires them to.

- 112 As these would meet the definition of financial liabilities under the proposals in the DP, it is not clear how, or if at all, the potential dilutive effects of these would be portrayed.
- 113 While it may be relatively simple for instruments such as convertible bonds to be split into equity and liability components⁵, other such combined instruments are not so easily split at initial recognition. The proposals do not appear to effectively portray the dilutive effect of such instruments.

Instruments that dilute on the occurrence of events within the control of an entity

- 114 No liability is recognised for obligations that will only arise for situations within an entity's control, and presumably no secondary equity claim would be recognised for these obligations. The obligation to deliver equity instruments could crystallise on circumstances such as:
- (a) An Initial Public Offering;
 - (b) A takeover; or
 - (c) The disposal of a portion of the entity.
- 115 These may include obligations that result in significant dilution of the claims of the holders of equity instruments, and the proposals in the DP do not appear to portray them.

How should dilution be portrayed?

- 116 EFRAG does not believe that dilution, and more importantly potential dilution, can be portrayed effectively in a single statement of changes in equity. Such a statement would necessarily reduce the dilutive effects of multiple scenarios to one dimension, which would not accurately or reliably portray economic substance.
- 117 It may be more appropriate to portray (potential) dilutive effects through disclosures. Through discussions with users of financial statements, EFRAG has identified potential ways in which this could be done:
- (a) Scenario analysis, depicting the instruments in issue and their rights and/or payoffs in various material scenarios; and/or
 - (b) The provision by the entity of financial models showing the rights holders of various instruments have on net cash inflows, and how the number and types of these instruments may change.

Puttable instruments

- 118 The proposals in the DP would also not provide a conceptual solution to what some see as the counter-intuitive accounting in comprehensive income for puttable instruments, including puts on shares held by non-controlling interests ('NCI puts'). Current IFRS requires a liability to be recognised for a puttable instrument at the present value of the amount the entity may be obliged to pay. Paragraph 23 of IAS 32 applies that requirement even if the put option is contained within a separate contract. Changes in the carrying value of such a liability are recognised in comprehensive income.
- 119 For an instrument puttable at fair value, as the entity performs better the liability increases and an expense is recognised. Under the IASB's proposals, the entity's right (upon the put being exercised) to receive the share would presumably be reflected as a wealth transfer: resulting in volatility in both the statement(s) of profit or loss and other comprehensive income and the statement of changes in equity.

⁵ A convertible bond can be shown to be identical to a financial liability and a written call option.

Question 10(d) – If an entity has no equity instruments

EFRAG's response

EFRAG appreciates the difficulties presented by situations where an entity has issued no instruments that are purely equity, but is not convinced that the approach proposed is the best one.

- 120 EFRAG finds the IASB's proposal somewhat confusing in that it appears to contradict the key decisions taken with respect to the definition of equity. The IASB appears to be proposing that all financial statements be prepared with a definition of equity consistent with an entity concept, unless this would result in no equity, in which case a proprietary perspective is appropriate.
- 121 While EFRAG supports this explicit recognition that the proposed definition of equity does not always result in appropriately classifying the basic ownership instruments in some corporate structures common across Europe, EFRAG believes that this merely reflects the problems inherent in the definition and is not persuaded that an approach of reclassifying the most residual instrument is appropriate. This is especially the case as it would result in different classification in consolidated and separate financial statements of subsidiaries.
- 122 The requirements of paragraphs 16A to 16F of IAS 32 have led to significant implementation issues and confusion, as evidenced by requests to the IFRS Interpretations Committee. In particular, as noted above, there may be practical difficulties in identifying the most residual instrument.
- 123 EFRAG believes that a more appropriate approach is to allow entities to present additional information which has the status of IFRS as set out in paragraph 89 above. This would allow entities to present information that defines equity from a proprietary perspective, while preserving the comparability and relevance of an entity perspective. Such an approach provides important information to the holders of basic ownership instruments.
- 124 Furthermore, the IASB can always override the Conceptual Framework in an individual Standard. EFRAG does not understand why this needs to be stated explicitly for this particular issue.

Other matters

- 125 Previous debates on the equity/liability distinction and questions to the IFRS Interpretations Committee have resulted in a number of additional issues that EFRAG believes should also be addressed at the conceptual level. These are:
- (a) The role of economic compulsion (which EFRAG has discussed above in paragraphs 37 to 42);
 - (b) The boundaries of the entity in determining whether an obligation exists; and
 - (c) The nature of instruments that oblige an entity to transfer (or distribute) an amount determined by reference to profit, revenue or cash flows.

Boundaries of an entity

- 126 EFRAG does not believe the DP adequately addresses the issue of the boundaries of the entity, particularly with respect to the relationship with holders of ownership instruments.
- 127 There is no clear conceptual basis provided for determining whether an entity's Annual General Meeting (or any meeting of the holders of a class of instruments) is part of the entity or not. The importance of this is if (for example) the attendees could require declaration of a dividend in excess of that proposed by directors. If the meeting were to be determined to not be part of the entity, it would be an obligation outside the control of

the entity and a liability recognised for the amount the entity could be compelled to distribute.

- 128 EFRAG does not believe this would provide useful financial reporting and believes the issue should be addressed at a conceptual level.

Instruments that oblige an entity to transfer (or distribute) an amount determined by reference to profit, revenue or cash flows

- 129 EFRAG believes that the current financial reporting requirements, derived from paragraph 24 of IAS 32, do not always result in useful information. This is particularly the case with respect to instruments that oblige the entity to distribute a portion of net income each year. EFRAG believes that it would be more appropriate for any liability in these instruments to be recognised at the same time as the revenue or net income out of which they require distribution. This would result in a more relevant economic depiction of the entity. EFRAG also notes that this is linked to Section 5 of the DP, and an approach of recognising a liability concurrent with the revenue or net income would be consistent with Approach 2 ('A present obligation must have arisen from past events and be practically unconditional') described there.

SECTION 6 MEASUREMENT

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 of the DP. 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?

EFRAG's response

EFRAG broadly agrees with the IASB's preliminary views on measurement. EFRAG however believes that the business model should also play an important role in selecting the appropriate measurement basis, and therefore helps implementing the proposed principles in a reliable manner. EFRAG also believes that limiting the number of measurement bases could conflict with the objectives of financial reporting.

Measurement objective, relevance and faithful representation

- 130 EFRAG agrees that the objective of financial reporting and the fundamental qualitative characteristics of useful financial information should provide the basis for the objective of measurement and the supportive guidance. Nevertheless, EFRAG believes that any measurement objective the IASB develops should not merely repeat the general objective of financial reporting.
- 131 In addition, EFRAG believes that relevance of information can be judged from different perspectives. As noted in EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*, issued by the Canadian Institute of Chartered Accountants in 2012, empirical evidence seems to indicate that the information that is most relevant for estimating future cash flows may not be the most relevant for assessing stewardship. A Conceptual Framework would therefore have to provide a basis for balancing these different objectives.
- 132 Measurement affects both the statement of financial position and the statement(s) of profit or loss and OCI and thus both need to provide relevant information for users. Selecting measurements by considering either the statement of financial position alone or the statement(s) of profit or loss and OCI alone will not usually produce the most relevant information for the users of financial statements.
- 133 Therefore, EFRAG supports the view that when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI. In addition, EFRAG believes that the business model should also play an important role in selecting the appropriate measurement bases (see also paragraphs 248 to 266 below).
- 134 The DP suggests that there is no single measurement basis that always provides the most useful information. In other words, the DP is proposing that some assets (and liabilities) could be measured using a historical basis while others could be based on a current basis. Similarly, different types of income (and expenses) could be based on historical measures while others would be based on current measures. EFRAG supports the view that a single measurement basis for all assets and liabilities will not provide the most relevant information for users of financial statements. EFRAG believes that, on balance, a mixed measurement model provides the most useful information.
- 135 Nevertheless, EFRAG believes that having different measurement bases for the statement of financial position and the statement(s) of profit or loss and OCI has a direct link to the meaning of the 'bridging item' concept and the use of OCI as discussed in the Section 8 *Presentation in the statement of comprehensive income—profit or loss and other comprehensive income* of the DP. Consistency among measurement and presentation would be of significant importance. In addition, EFRAG believes that using two different measurement bases is only warranted if both measures provide sufficiently useful information about different facets of the entity's financial position and financial performance. In this case, only disclosing a different measurement basis in the notes would not be sufficient. As the use of two measurement bases would result in additional costs and might make the financial statements less understandable, the IASB would need to justify that the benefits of the additional information on the face of primary financial statements would outweigh those disadvantages.

- 136 In order to create a common understanding as to what the IASB aims to accomplish, EFRAG recommends that the measurement section should state clearly the linkage with the presentation section. This linkage is particularly important when the cash flows from one item are contractually linked to the cash flows from another item. In the cases when assets and liabilities are related in some way, using different measurements for those assets and liabilities can create a measurement inconsistency (sometimes referred to as an 'accounting mismatch'). Measurement inconsistencies can result in financial statements that do not faithfully represent the reporting entity's financial position and performance.

Choosing a measurement basis

- 137 EFRAG supports the view that the selection of a measurement for a particular asset should depend on how that asset contributes to future cash flows and for a particular liability should depend on how the entity will settle or otherwise fulfil that liability. The DP notes (paragraphs 6.75–6.96) that the way an asset will ultimately contribute to cash flows will often not be certain. For most assets there are choices, and choices may change.
- 138 EFRAG believes that considering the business model (i.e. how the asset contributes to future cash flows and for a particular liability and how the entity will settle or otherwise fulfil that liability) for measurement purposes would help users to better understand the financial performance of an asset (or a group of assets) in comparison with the expected outcome. For more information and analysis on the role of the business model for measurement, please refer to Bulletin *The Role of the Business Model in Financial Reporting*, which was issued in June 2013 by EFRAG, the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Italian Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC); and paragraphs 254-265 below.

Relevance of a particular measurement basis

- 139 EFRAG supports the IASB's preliminary view that 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.

Understandability and other enhancing characteristics

- 140 Understandability has an important implication for setting measurement requirements. Users need to be able to understand the measurements used. Changes in the types of measurement used for particular items will make it more difficult for users to understand how measurement bases interact to depict the entity's financial position and financial performance. EFRAG agrees that unnecessary changes in the types of measurement used for a particular item should be avoided; and clear explanations of the reasons for necessary changes and their effects should be required.
- 141 Nevertheless, EFRAG does not think that a change of measurement basis subsequent to the initial recognition considerably reduces the understandability of financial reporting and therefore is against the principle in paragraph 6.24 of the DP that the subsequent measurement should always be the same as, or at least consistent with, the initial measurement. For example, at initial recognition IAS 39 and IFRS 9 require entities to measure their financial assets at fair value, while subsequent measurement may be based on amortised cost. EFRAG supports those measurement principles. Therefore, EFRAG believes that the principle from paragraph 6.24 of the DP should not artificially limit the IASB's possibilities of meeting the objectives of financial reporting and/or measurement.
- 142 In EFRAG's opinion, the IASB's preliminary view that the number of different measurements used should be the smallest number necessary seems to suggest that the IASB would like to predetermine the number of measurement bases to be used. EFRAG believes that limiting the number of measurement bases could conflict with the objective of financial reporting – to contribute to the faithful representation of relevant

information about the resources of the entity, claims against the entity, performance of the entity, and stewardship. In addition, EFRAG does not expect that excluding this limitation from the Conceptual Framework would cause a proliferation of measurement bases.

- 143 The three enhancing characteristics of useful financial information other than understandability – timeliness, verifiability, and comparability – need to be considered when establishing measurement requirements. EFRAG agrees that comparability implies using measurements that are the same between periods and between entities. However, it is important that the measurement is the same for items which contribute to future cash flows in a similar way. EFRAG believes that measurement considering the business model would enhance comparability. Having the same accounting requirements for assets, which are used differently and contribute to future cash flows in a different way, would effectively diminish the comparability of financial statements; thereby, the events or transactions may not be faithfully represented. As noted above, for more information and analysis on the role of the business model for measurement, please refer to the Bulletin *The Role of the Business Model in Financial Reporting*.

Cost constraint

- 144 EFRAG supports the IASB's preliminary view that the benefits of a particular measurement basis to users of financial statements need to be sufficient to justify the cost for the preparers. Consistent with EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*, issued by the Canadian Institute of Chartered Accountants in 2012 (e.g. paragraph 55) EFRAG believes that cost constraints should be considered in selecting the appropriate measurement basis. That would also be consistent with the general cost constraint of useful financial reporting (QC35 of the existing Conceptual Framework) that reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Faithful representation

- 145 Consistent with the EFRAG's comment letter on the research paper *Toward a Measurement Framework for Financial Reporting by Profit-Oriented Entities*, issued by the Canadian Institute of Chartered Accountants in 2012 (please see paragraph 56) EFRAG believes that measurement for financial reporting purposes should be capable of reasonable substantiation and also that disclosures should be considered when assessing whether an economic phenomenon is faithfully represented. That is, we think that in some cases it may be necessary to provide disclosures in relation to verifiable figures in order to achieve a faithful representation. However, EFRAG does not think that disclosures can compensate for inherent measurement uncertainty. For further details on the relationship between faithful representation and reliability, please refer to Section 9 *Other Issues*.

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 of the DP. 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.

EFRAG's response

EFRAG broadly agrees with IASB's preliminary views expressed under Question 12.

- 146 EFRAG believes that classifying assets into four categories (as set out in the DP) is reasonable because the ways in which cash flows are generated differ significantly depending on the categories. However, EFRAG believes that the Conceptual Framework should not be conclusive about what situations fall under the respective categories. Such generalisation is difficult and the IASB should assess each situation in light of the measurement objective and the supportive guiding principles.

Using assets

- 147 EFRAG generally agrees with the view that cost-based measures would provide relevant information for assets that are used in (a) purchasing, producing, marketing, or delivering assets or services the entity sells and (b) administration, treasury or any other function necessary to keep the entity operating. EFRAG also supports the IASB's arguments that a current measure and the resulting unrealised gains and losses due to asset price changes may not be relevant for assets the entity is using, unless they indicate impairments or reversals of impairments.
- 148 However, EFRAG disagrees with the arguments that a current measure would provide better information for assessing how efficiently and effectively an entity's management and governing board have used the entity's resources. That would effectively mean representation of opportunity costs that management and governing board were missing and reflect 'what if' scenarios, which are (in the framework of the entity's business model) seldom possible and thus seldom relevant.
- 149 EFRAG believes that changes in an asset's capacity to generate cash flows (i.e. adding value through the value chain) through time can be effectively reflected through cost-based 'adjustments' such as depreciation/amortisation expense, impairment losses and reversals of impairment losses. In addition, EFRAG finds it unfortunate that the notions of impairment and depreciation/amortisation are not considered as part of discussion on subsequent measurement in the DP.

Selling assets

- 150 There are various situations in which assets are being sold. Therefore, each selling situation would need to be separately analysed in order to find an appropriate measurement basis. If an entity holds an asset with the purpose of selling it in the near future and generating a profit from fluctuations in a market price, the fair value (i.e. current exit price) measurement would be relevant so as to predict future cash inflows for the entity, despite the fact that this measurement would result in unrealised gains (or losses) being reported in comprehensive income. These assets are usually fungible and since it is likely any assets held at the end of a reporting period will be sold in the next reporting period, this measurement represents the likely future cash flows.
- 151 Current exit prices are readily available when deep, liquid markets exist and in this case the measure is also verifiable and can be provided in a timely manner. When a current market price is not readily available, it may be necessary to estimate this. EFRAG believes that as current financial accounting Standards require the use of estimates in many other situations (e.g. impairment, contingent liabilities and retirement benefit liabilities), it would therefore also be possible to use estimates for current exit prices.

Sometimes such estimates might be very uncertain. Consequently, if this uncertainty is properly explained (e.g. in the notes), the information would still be useful.

- 152 However, an entity that manages a portfolio of financial assets within the 'liability driven hold and sell' business model, where financial assets are managed to match stable liabilities, may be seen as holding financial assets for the long-term investment horizon. In these cases fair value (i.e. current exit price) measurement could be seen as a relevant measurement basis for the statement of financial position, due to the long-term investment horizon. However, reporting unrealised gains (or losses) in profit or loss would not be an appropriate primary measure of performance. The nature of assets might be seen as very different in those two cases.
- 153 In addition, for inventories, the DP argues that a current market price is less relevant as the sale usually requires the seller to undertake significant activities to identify purchasers (the DP states that this is not the case for most financial instruments or commodities). Furthermore, it is argued that the assessment of prospects for future cash flows from sales of inventories is usually based on expectations about future margins that are derived from cost-based information about past sales, cost of sales, and other recurring components of profit or loss. The use of current market prices could obscure this information. EFRAG welcomes this measurement consideration since we generally believe that current exit prices are inappropriate for entities that buy and sell items in different markets.
- 154 EFRAG also believes that what is more important is that inventories are actually not a homogenous group of non-monetary assets. EFRAG notes that IAS 2 generally requires inventories to be measured at the lower of cost and net realisable value. However, IAS 2 includes an exception to this general requirement that allows commodity broker-traders to measure their inventories at fair value less costs to sell with changes in fair value less costs to sell recognised in profit or loss. The Standard justifies the different treatment for broker-trader inventories because those inventories are principally acquired with the purpose of selling in the near future and generating a profit from fluctuation in prices and trade margins (IAS 2, paragraph 5). This is similar to financial instruments which are actively traded, which would therefore justify a similar accounting treatment. The benefit in terms of relevant representation of the performance and expected future cash flows is also the same. In EFRAG's opinion fungibility of an asset could thus also play a role in measurement. EFRAG also believes this a good example where the business model was in the past implicitly used in an IFRS.
- 155 EFRAG believes that it is difficult to generalise the discussion about the appropriate measurement basis; each situation should be assessed in light of the measurement objective of the statement of financial position as well as the statement(s) of profit or loss and OCI and the supportive guiding principles. In order to create a common understanding as to what the IASB aims to accomplish, measurement should explicitly recognise the linkage with presentation, the use of OCI and the concepts underlying the use of OCI. Consistency among measurement and presentation would be of significant importance, when having different measurement bases for the statement of financial position and the statement(s) of profit or loss and OCI.

Holding assets for collection according to terms

- 156 EFRAG generally agrees with the statement that cost-based measurement provides relevant information for assets held for collection according to terms. In addition, we believe that floating rate financial assets should, despite possible significant variation in cash flows, be eligible for cost-based measurement due to the fact that this variation does not cause a change in the fair value of such instruments. EFRAG also agrees that current market prices are likely to be the most relevant measure for assets with significant variability in either cash flows or net value flows, such as derivative instruments.

Charging for rights to use assets

- 157 EFRAG recommends that the IASB takes advantage of the discussion on the Conceptual Framework to refine the definition of the right-of-use, distinguish this right from the other rights which are bundled in the asset, consider the implications of the unbundling of the leased asset in the lessor's accounts and refine the guidance to identify what activities convey the ability to direct the use of an asset and how this links with the business models of lessors (providing finance or managing assets).

Question 13

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

EFRAG's response

EFRAG broadly agrees with the IASB's preliminary views expressed under Question 13.

Liabilities without stated terms

- 158 The IASB's DP states that it is impossible to measure liabilities without stated terms at cost as the liability does not have a cost. It is therefore argued that a cash-flow based measure other than estimates of current prices may be the only possible options for such liabilities.
- 159 EFRAG believes that applying a cash-flow based measure could be used to estimate a current value or cost, therefore it would also be possible to measure liabilities without stated terms, such as liabilities arising from torts or violations of laws or regulations, at a current value or cost. EFRAG therefore believes that the cash-flow measurement discussion does not address properly which measurement attribute the cash-flow measurement is aiming to achieve.
- 160 The DP includes a list of issues that should be considered when deciding, on a standards level, how to construct a cash-flow based measure (see paragraphs 6.112–6.130 of the DP). However, EFRAG notes that due to the lack of a precise objective about what measurement attribute the cash-flow base measurement is aiming to achieve, the DP does not provide any preliminary views on how a cash-flow based measure for liabilities without stated terms should be constructed (e.g. how to deal with uncertainties about the amount of cash flows, i.e. the most likely amount or the expected probability-weighted value; whether the view of market participant or reporting entity's perspective should be reflected etc.). Therefore, it is not possible to assess the consequences of that proposal.

Liabilities with stated terms but highly uncertain amounts

- 161 The DP also concludes that a cash-flow based measurement (other than one that functions to estimate current prices) provides the most relevant information for liabilities

with stated terms but highly uncertain amounts. The argument provided is that for liabilities of this type, a cost-based measure is unlikely to provide relevant information and current market prices may be difficult to determine.

- 162 EFRAG believes that circumstances in which current market prices are difficult to determine first call into question whether the measurement objective should be to represent current market prices. For example, EFRAG recommended early on in the *Insurance Contracts* project that an entity-specific settlement value measurement objective was more relevant than a current market price objective, as current market price estimates would be highly hypothetical and transferring insurance liabilities was not a characteristic of the business model of an insurer. The absence of observable market prices should call into question whether a market exists and therefore whether a transfer scenario is probable. If, after further analysis, a current measurement objective is confirmed as a fair representation of an entity's business model or of the underlying economics of a specific transaction, cash-flow-based estimates should be used. EFRAG also believes that whenever cash-flow based measurements are used it should be clear whether current value from the perspective of the entity or current value from the market perspective will be obtained.

Liabilities with stated terms that are settled by cash or by delivering other assets according to the terms

- 163 EFRAG believes that the use of a cost-based measure could be appropriate for a liability that is expected to be settled by an entity through the payment of cash or delivering other assets according to its terms.
- 164 EFRAG believes that if the obligation is expected to be fulfilled by the payment of cash or delivering other assets according to the term, a cost-based measure would be the appropriate measurement basis for both the statement of comprehensive income and the statement of financial position, because it would reflect future cash outflows from an entity. Nevertheless, EFRAG believes that, contrary to the proposals in the DP, there are some liabilities that will be settled according to their terms but without inherently highly uncertain amounts, as for example lease obligations, where a 'cost-based' measurement will not be appropriate because cash-flow based measures may provide more useful information.
- 165 Our position on lease liabilities described above demonstrates the need for the Conceptual Framework to clarify whether cash-flow based measurement (other than one that functions to estimate current prices) is a distinct measurement basis or is solely a technique/method to obtain certain cost-based, i.e. non-current measurement bases.
- 166 For example, if a financial liability cannot be transferred then measuring that liability at a current market price reflects, in comprehensive income, changes in market prices that cannot be realised. Consequently, these liabilities are viewed as analogous to assets held for collection. EFRAG agrees with IASB's preliminary view on this issue.
- 167 On the other hand, liabilities that are derivatives should generally be measured at a current market price or another measure that varies according to the cash flows required by the contract. EFRAG believes such a measure is generally a much better indicator of ultimate cash flows than a cost-based measurement. However, EFRAG believes that some derivatives create risk exposures similar to some combination of non-derivative financial instruments (for example, simple interest swaps compared to loans and deposits with netting agreements). In those instances, derivatives should be measured consistently with those similar non-derivative instruments.

Liabilities with stated terms that are settled by being transferred to a third party without negotiating for consent of the creditor

- 168 EFRAG agrees with the argument in the DP that the most relevant measure of a liability that will be settled by being transferred would be a current market price, or a current market price plus transaction costs, because that is an estimate of the cash that will be paid to induce another party to assume the liability.

Liabilities with stated terms that are settled by performing a service or paying others to perform services

- 169 EFRAG believes that an appropriate measurement basis for those liabilities would differ depending on whether (i) an entity performs the services or (ii) an entity pays others to perform services.
- 170 If an entity performs the services, a cost-based measure starting with the proceeds received (in some cases with interest accretion) is likely to be appropriate for such obligations, especially if the services are a recurring revenue-generating activity, because it provides information about recurring components of profit or loss. That information can be used to derive expectations about future margins.
- 171 However, the current market price of the services may be more relevant information if the entity will pay others to perform the services.

Question 14

Paragraph 6.19 of the DP 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 (i.e. the asset or the liability is highly leveraged).

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

EFRAG's response

EFRAG agrees with the IASB's preliminary view expressed under Question 14

- 172 Derivative instruments have contractual terms, but are subject to significant variability in either cash flows or net value flows. As it was already stated in paragraphs 156 and 167 above, EFRAG agrees that current market prices are likely to be the most relevant measure for assessing prospects for future cash flows of derivative instruments. However, when current market prices are not available and the inputs to cash-flow based measurements are not verifiable, then the historical cost may provide the most useful information. Therefore, EFRAG believes that Conceptual Framework's arguments in favour of cost-based measures should generally be based more on cost-benefit considerations and verifiability rather than on superior relevance.
- 173 On the other hand, EFRAG notes that there is no substantial difference between a simple interest swap and a loan and deposit with netting; therefore there should be no justification for any measurement differences.

Question 15

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

EFRAG's response

- 174 EFRAG suggests that the term 'measurement' in the DP is replaced with the more precise term 'measurement basis'.
- 175 EFRAG thinks the DP requires a fuller debate on the relevance and usefulness of different measurement bases, especially on entity-specific versus market-based measurement basis and entry versus exit prices. EFRAG also believes the Conceptual Framework should provide a rationale for the circumstances in which Standards should require a measurement basis that takes account of price changes.
- 176 EFRAG believes that the discussion of cash-flow measurement for liabilities without stated terms does not address properly which attributes a cash-flow measurement is aiming to reflect. Consequently, the DP does not provide any preliminary views on how a cash-flow based measure for liabilities without stated terms should be constructed (for example, how to deal with uncertainties and whether the view of market participant or reporting entity's perspective should be reflected). EFRAG believes that the IASB should always clarify at the Standards level which measurement attribute the applied cash-flow measurement is aiming to reflect and on that basis justify its components.
- 177 EFRAG also thinks the Conceptual Framework should contain substantial discussion of the notions of expected value, i.e. outcome versus best estimate, the notions that surface in almost each new Standard.
- 178 EFRAG strongly believes the Conceptual Framework should contain principles on how to estimate cash-flows and the discount rate. The IASB should clarify the objectives for the use of the discount rate and therefore Conceptual Framework should contain a sound conceptual basis for all elements included into the discount rate, including the entity's own credit risk when relevant.

SECTION 7 PRESENTATION AND DISCLOSURE

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 of the DP), 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.

EFRAG's response

EFRAG agrees with the proposals, but thinks that more guidance is needed for some areas.

- 179 EFRAG agrees with the proposals, but thinks that more guidance is needed for some areas in order to address the issues raised by constituents during the IASB *Agenda Consultation 2011*.
- 180 In particular we think more guidance is needed on how to 'provide a structured way to review the need for disclosure', which was one of the issues respondents to the Agenda Consultation identified as an area that should be developed. The DP indicates some subjects of information: the reporting entity, amounts in the primary statements, unrecognised amounts, nature and extent of risks, methods and assumptions; but it does not explain how the IASB should select from different types of disclosure. The DP simply states that 'the IASB can consider different forms of disclosure (e.g. disaggregation, descriptions, roll-forwards, sensitivity analysis) depending on the nature of the item in question.' EFRAG considers this too generic a statement that does not introduce

- sufficient discipline in the IASB's process of deciding on disclosure requirements at a standards level.
- 181 EFRAG thinks that the Conceptual Framework should provide more guidance in order to provide a structured way to review the need (and develop the appropriate requirements) and to enable preparers to understand the rationale behind disclosure requirements and hence guide them in the application of these requirements. EFRAG considers that the discussion paper *Towards a Disclosure Framework for the Notes* (issued by EFRAG, the French Autorité des Normes Comptables (ANC) and the UK Financial Reporting Council (FRC)) and the related Feedback Statement, which presented the comments of constituents, could be useful in that regard.
- 182 *Towards a Disclosure Framework for the Notes* suggests that notes should fulfil the following categories of users' needs:
- (a) what the components of a line item are;
 - (b) for disaggregated amounts, information on:
 - (i) what the item is;
 - (ii) how the item fits into the entity's operation and financial structure;
 - (iii) how the item has been accounted for.
- 183 Accordingly, as a starting point, standard setters should require information on relevant terms and conditions for understanding an item when one of these indicators exists – but not in other cases (and entities should provide the information if it is material).
- 184 The DP provides a list of disclosures the IASB would normally consider requiring. This list includes information about: the reporting entity; the amounts recognised in its primary financial statements; and the nature and extent of its unrecognised assets and liabilities. However, the list also requires information about the nature and extent of risks arising from an entity's assets and liabilities; and the methods, assumptions and judgements and changes in those methods. EFRAG considers that the first three requirements relate to the elements on which an entity should provide information; the latter two requirements relate to the type of information an entity should provide. EFRAG considers that a distinction should be made between these two types of requirements.
- 185 EFRAG notes that a consequence of the proposals of the DP on forward-looking information is that non-adjusting events after the reporting period should not be disclosed in the notes. EFRAG considers that if note disclosure-overload should be limited by provision of principles for what information the notes should contain, it would be very difficult to set the principles so that all current requirements that are considered useful would be within those principles. EFRAG therefore accepts this consequence and notes that information about non-adjusting events can be provided elsewhere in a financial report or the IASB could treat this information as an exception to the principles on presentation and disclosure.
- 186 On a more detailed level, EFRAG notes that the DP suggests requiring disclosures about risks with indication of the nature and extent of risks arising from the entity's assets, liabilities, equity, income, expenses and cash flows. Risk may be interpreted in different ways and EFRAG is concerned that information about risk could encompass almost any type of information. In addition, it is not specified what the information should be about which make the list of possible disclosures close to endless.
- 187 In the view of EFRAG, the categories of information that are useful for assessing risk in relation to the financial position and financial performance of an entity are:
- (a) measurement (and recognition) uncertainty;
 - (b) impact of a potential change in operating objectives (for example when measurement reflects the entity's business model);
 - (c) exposure to market conditions or other external factors; and

- (d) information on an entity's risk appetite.
- 188 EFRAG therefore considers that information about risks should be limited to these categories, which are further explained in *Towards a Disclosure Framework for the Notes*.
- 189 EFRAG notes that the DP states that the IASB may choose to require offsetting when such a presentation provides a more faithful representation of a particular position, transaction or other event. EFRAG considers that the IASB may also choose to require offsetting when such a presentation results in more relevant information.

Question 17

Paragraph 7.45 of the DP 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?

EFRAG's response

EFRAG thinks that more general guidance on materiality could be included in the Conceptual Framework.

- 190 The IASB has chosen to direct the Conceptual Framework towards its own standard setting. The IASB's choice not to consider materiality further in the Conceptual Framework is consistent with this choice, as the assessment of materiality is mostly relevant for preparers, auditors and regulators and less relevant when preparing Standards.
- 191 However, as mentioned above, EFRAG considers that the Conceptual Framework should also be useful for others (e.g. preparers). It could therefore be useful to include the general guidelines mentioned in paragraph 7.46 of the DP in the Conceptual Framework. More specific guidance should, however, be provided somewhere else in order to avoid the Conceptual Framework becoming an accounting textbook. In addition, including guidance in Standards results in the appropriate authority of the requirements.
- 192 EFRAG agrees with the DP that additional guidance on the application of materiality could be provided by amending Standards or by providing educational material. The most useful way, may be a combination of both. In the discussion paper *Towards a Disclosure Framework for the Notes*, EFRAG, the ANC and the FRC have developed some indicators for materiality for different types of information. EFRAG considers that these indicators could be a useful basis for developing some concrete guidance on the issue.

Question 18

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

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?

EFRAG's response

EFRAG agrees that communication principles should be part of the Conceptual Framework and generally agrees with the principles suggested.

- 193 EFRAG agrees with the DP that communication principles should be part of the Conceptual Framework. Financial statements are aimed at communicating financial information to users. While the content of the notes is of utmost importance to achieve relevance and faithful representation, poor communication hinders the quality of information, especially within lengthy reports.
- 194 As the notes form part of 'telling the story' of an entity's financial performance and position, it is difficult to establish anything other than high-level generic principles that can be used when presenting information in the notes. In *Towards a Disclosure Framework for the Notes*, EFRAG, the ANC and the FRC developed principles which are broadly similar to those suggested in the DP. EFRAG generally agrees with the high-level generic principles suggested in the DP. In addition to the proposed principles, EFRAG suggests including also that information should be concise and use consistent terminology.

SECTION 8 PRESENTATION IN THE STATEMENT OF COMPREHENSIVE INCOME—PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (OCI)

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 of the DP.

Do you agree with this preliminary view? 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?

EFRAG's response

EFRAG agrees that the Conceptual Framework should require profit or loss to be presented. The Conceptual Framework should explain the objective of presenting profit or loss.

- 195 EFRAG agrees with the view that users from all sectors incorporate profit or loss in their analyses, either as a starting point for analysis or as the main indicator of an entity's performance. EFRAG also considers that profit or loss is the primary measure of an entity's performance. Therefore, EFRAG believes that profit or loss is an essential number that supports users' needs and agrees that the Conceptual Framework should require profit or loss to be presented.
- 196 EFRAG does not agree with the arguments by some that splitting items between profit or loss and other comprehensive income will prevent users from seeing and evaluating all items of income and expense. EFRAG believes that providing a profit or loss will provide greater transparency and help a user better assess the entity's performance and prospects for future net cash inflows.
- 197 EFRAG believes that if profit or loss excludes some items of income and expense resulting from changes of current measures of assets and liabilities (remeasurements), the profit or loss total has more predictive value than total comprehensive income. Nevertheless, EFRAG would strongly oppose shifting cost-based 'adjustments' such as impairment losses and reversals of impairment losses to OCI.

- 198 Furthermore, EFRAG believes that the Conceptual Framework should provide a definition/description of what profit or loss should depict, so that it plays its role of a primary performance metric that is meaningful in financial communication. This would provide a rationale and meaningful communication tool for what profit or loss should depict and would facilitate its distinction from OCI. EFRAG also thinks an entity's business model should play a role in defining primary performance.

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; i.e. recycled, is discussed in paragraphs 8.23–8.26 of the DP [which are summarised below in paragraphs.

Do you agree with this preliminary view? 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?

EFRAG's response

EFRAG thinks that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss. EFRAG also believes that a clear objective of profit or loss is needed to be able to robustly determine when recycling of OCI items provide relevant information.

- 199 EFRAG believes that discussions on recycling are closely related to those on the objectives or purposes of profit or loss and OCI. If the objective of profit or loss would be clearly identified then it would be much easier to determine for which items of OCI recycling would provide relevant information.
- 200 In the absence of an objective of profit or loss, EFRAG's view is that the Conceptual Framework should require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss (i.e. recycled). Accordingly, EFRAG is not persuaded by the arguments against recycling (Approach 1) presented in the DP. As noted in paragraph 195 above, EFRAG thinks that the Conceptual Framework should require profit or loss to be presented in the financial statements and in the view of EFRAG this would mean that recycling would be needed. Otherwise it would not be possible to provide the correct depiction of an entity's performance, which is primarily reflected in profit or loss.
- 201 If there were to be no recycling, the Conceptual Framework would not need to specify whether an entity should present profit or loss, or any other total or subtotal. The decision whether to require or permit profit or loss, or any other total or subtotal, would be one that the IASB could take when it developed or revised particular Standards.
- 202 EFRAG thinks that when an item of income and expense is presented in OCI, it should automatically qualify for recycling, unless recycling would not result in relevant information in profit or loss, the primary measure of an entity's performance.
- 203 EFRAG finds a lot of appeal in the simple principle that items initially presented outside of profit or loss need to be recycled into it when the reason for initial exclusion no longer applies. However, we recognise that it is not that simple to make such a high level principle operational in practice.

Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in the OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78 of the DP) and a broad approach (Approach 2B described in paragraphs 8.79–8.94 of the DP).

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.

EFRAG's response

EFRAG supports Approach 2B and believes an entity's business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI. Therefore, the Conceptual Framework should not artificially limit the IASB's possibilities for defining the primary performance, reflected in profit or loss.

Principles in Approach 2A and Approach 2B

- 204 EFRAG agrees with principle 1 on the basis that presenting items separately in profit or loss and OCI clearly identifies different components of the return an entity has made on its resources during a period and hence provides useful information for assessing the prospects for future cash flows arising from them. EFRAG agrees with the use of the term 'primary' in principle 1, as it reflects the prominence of profit or loss while at the same time acknowledges that items presented outside profit or loss may still provide relevant information for the user to assess the performance of the entity.
- 205 In EFRAG's opinion OCI items are unjustifiably treated by many as pieces of information of really minor relevance. OCI contains relevant information for the assessment of the entity's overall performance.
- 206 EFRAG agrees with principle 2. It also agrees with the reasoning in the DP that presenting in OCI items of income or expense resulting from cost-based measurements, including amortised cost (depreciation and amortisation; accrual of interest, accretion of a discount, or amortisation of a premium; impairment of assets or increases to the carrying amount of liabilities that have become onerous) would not enhance the relevance of profit or loss. EFRAG also believes that OCI should be limited to items of income and expense resulting from changes in current measures of assets and liabilities (remeasurements).
- 207 EFRAG disagrees with the application of Principle 3 from Approach 2A that prevents the recognition of item of income or expense in OCI if subsequent recycling would not result in relevant information in profit or loss.
- 208 Since Principle 3 from Approach 2B states that an item that has previously been recognised in OCI should be reclassified (recycled) to profit or loss *when, and only when*, the reclassification results in relevant information, EFRAG supports Principle 3 from Approach 2B. That principle is aligned with EFRAG's preliminary view expressed under Question 20 that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss.

Applying the principles in Approach 2B

- 209 Based on the three principles described above, Approach 2B proposes that three groups of items would be eligible for recognition in OCI. These are labelled as 'bridging items' (at the moment only changes in the discount rate of the financial assets measured at fair value through OCI from *IFRS 9 2012 ED* and changes in the discount rate of insurance contracts from *Insurance Contracts 2013 ED*), 'mismatched remeasurements' (for

example net investment in foreign operations from IAS 21 *The Effects of Changes in Foreign Exchange Rates*) and ‘transitory remeasurements’, which are discussed below.

Bridging items

- 210 The ‘bridging items’ concept should, in EFRAG’s opinion, be used only when this presentation (reporting two measurements) best reflects the entity’s financial position and performance in the specified circumstances, based on the entity’s business model (please see paragraphs 244 to 265 below).
- 211 EFRAG agrees that using two different measurement bases is only warranted if both measures provide sufficiently useful information about different facets of the entity’s financial position and financial performance. Those measures need to be determined consistently with the measurement concepts as described in Section 6 *Measurement of the DP*. As the use of two measurement bases would result in additional costs and might make the financial statements less understandable, the IASB would need to justify whether the benefits of the additional information would outweigh those disadvantages.
- 212 In line with EFRAG’s view expressed above, bridging amounts in OCI (i.e. the difference between the two measurement bases) should be recycled to profit or loss *unless* recycling would not result in relevant information in the statement of profit or loss. For example, if a debt instrument is measured at fair value in the statement of financial position, but recognised in profit or loss using amortised cost, then amounts previously reported in OCI would generally be recycled.

Mismatched remeasurements

- 213 ‘Mismatched remeasurements’ arise when one of the items (or part of an item) within a linked set of items is regularly remeasured, while the linked item is not remeasured or is not recognised until later. For example, when all derivatives are measured at fair value and the derivative is used to hedge a forecast transaction, changes in the fair value of the derivative arise in a reporting period or periods before the income or expense resulting from the forecast transaction. To the extent that the hedge is effective and qualifies for hedge accounting, in accordance with Standards, an entity reports in OCI the gains or losses on the derivative, and subsequently recycles those gains or losses into profit or loss when the forecast transaction affects profit or loss. That enables users of financial statements to see the results of the hedging relationship.
- 214 EFRAG supports the concept of mismatched remeasurements to define additional group of items (other than bridging items) which are eligible for presentation in OCI. When an item of income and expense is delinked from a set of items to which it relates, the item provides little relevant information about the return the entity has made on its economic resources in the period. In this case amounts in OCI related to mismatched remeasurements would be recycled into profit or loss only when they can be presented with the transactions with which they are linked.

Transitory remeasurements

- 215 In addition to only two groups of items eligible for recognition in OCI under Approach 2A (bridging items and mismatched measurements), Approach 2B introduces ‘transitory remeasurements’ as an additional category of OCI items. This category is based on the view that remeasurements of some long-term assets or liabilities are best reflected outside profit or loss. Presentation of a remeasurement (or components of a remeasurement) in OCI in these circumstances may provide more transparent information about how the asset is likely to contribute to future cash flows or how the liability is likely to be settled.
- 216 EFRAG supports the concept of transitory remeasurements under which additional items of income and expense would qualify for presentation in OCI. The inclusion of the transitory remeasurements concept will help avoid mechanical application of OCI recognition and recycling requirements.

EFRAG's position on Approach 2A, Approach 2B and recycling

- 217 To summarise, EFRAG supports Approach 2B as suggested in the DP, based on the bridging items, mismatched remeasurements and transitory remeasurements concepts. EFRAG believes the business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI. Therefore, the Conceptual Framework should not artificially limit IASB's possibilities for defining primary performance, reflected in profit or loss, which may be the outcome if Approach 2A were adopted.
- 218 As already expressed under question 20, EFRAG thinks that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss. Therefore some bridging items (i.e. the difference between the two measures) that should, according to the DP, always be recycled to profit or loss, could be exempted from recycling. EFRAG believes that IASB should in this case set out why it does not think recycling would provide relevant information in profit or loss when developing each Standard (most likely in Basis for Conclusions).
- 219 In the case of mismatched measurements, EFRAG supports the concept itself and the related recycling principle: the amounts in OCI related to mismatched remeasurements would be recycled into profit or loss only when they can be presented with the transactions to which they are linked. For EFRAG's comprehensive view on recycling please refer to paragraphs 199-203.

SECTION 9 OTHER ISSUES

Chapters 1 and 3 of the existing Conceptual Framework

Question 22

Paragraphs 9.2–9.22 of the DP 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.

Notes to constituents

EFRAG's response

EFRAG thinks that the first chapters of the Conceptual Framework should be revised. Reliability and prudence should be reintroduced. In addition, EFRAG believes that it should be clear from the first chapters that the objective of assessing stewardship is as important as assessing the prospects for future cash flows.

- 220 EFRAG believes that a fundamental discussion is needed on the Chapters 1 and 3 of the Conceptual Framework on stewardship, reliability and prudence. EFRAG's views on these issues are further explained in the following paragraphs.

Stewardship

- 221 Paragraph OB4 of the existing Conceptual Framework states:

To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have

- discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.
- 222 Accordingly, the existing Conceptual Framework acknowledges that financial reporting should provide information that would be useful for assessing stewardship.
- 223 However, paragraph OB4 of Conceptual Framework seems to:
- (a) State that providing information to help existing and potential investors assess the prospects for future net cash inflows to an entity is the primary objective of financial reporting. Providing information that is useful for assessing stewardship is just something that could be useful for assessing future cash flows.
 - (b) Assume that information about stewardship is useful for estimating future cash flows. In other words, information that is useful for assessing stewardship is also useful for estimating future cash flows.
- 224 As explained in the Bulletin *Accountability and the objective of financial reporting*, EFRAG disagrees with both of these assertions⁶.
- 225 Indeed it may be helpful to consider at this point whether stewardship is exactly the same as accountability. Arguably it is not in that a dictionary definition of stewardship – 'the careful and responsible management of something entrusted to one's care' – is potentially wider than accountability both in the level of authority given and the focus on how something is managed rather than the outcome of that process.
- 226 EFRAG thinks that providing information that is useful for assessing stewardship is as important as providing information to assess the prospects for future net cash inflows to an entity. EFRAG notes that academic literature shows that information most useful for estimating future cash flows is not always the most useful for assessing stewardship⁷. Accordingly, EFRAG believes that the objective of providing information useful for assessing stewardship should be presented as separate objective in the Conceptual Framework instead of being subsumed in the objective of providing information to assess future cash flows. Although information useful to assess stewardship may be different from information to assess future cash flows, EFRAG thinks that it is possible to ensure that sufficient information to assess both stewardship and future cash flows can be provided in the financial statements. This should be acknowledged in the Conceptual Framework. For example, if a particular measurement basis is providing the most useful information for assessing future cash flows, disclosures can provide additional information for assessing stewardship.
- 227 EFRAG notes that the Conceptual Framework only deals with financial reporting. In order to avoid doubt, EFRAG would, however, specify that it does not think that financial information is the only means by which stewardship should be assessed.

Reliability

- 228 EFRAG acknowledges that the DP suggests that an entity should not recognise an asset or liability if no measure of the asset (or liability) would result in a faithful representation of a resource or obligation of the entity, or of a change in its resources or obligations, even if all necessary descriptions and explanations are disclosed.
- 229 EFRAG agrees with this suggestion. Academic literature suggests that reliability is at least equally important as relevance, and that disclosure of the process and inputs into an estimate cannot always compensate for measurement uncertainty.

⁶ The Bulletin was issued by EFRAG, ANC, ASCG, OIC and FRC. Not all the partners issuing the Bulletin share the preliminary view of EFRAG on these issues. The different views are explained in the Bulletin.

⁷ EFRAG and ICAS has issued a literature review of studies on capital providers' use of financial statements.

- 230 Although EFRAG agrees with the suggestion to consider faithful representation when recognising assets and liabilities, it thinks that this should also lead to some changes in how faithful representation is explained in Chapter 3 of the current Conceptual Framework. In the view of EFRAG the most appropriate would simply be to replace the term with 'reliability'. 'Reliability' should be defined in the same way it was in Conceptual Framework before 2010. That is, 'reliability' would, as a starting point, mean that information:
- (a) should be free from material error and bias.
 - (b) can be depended upon by users to represent faithfully that which it either purport to represent or could reasonably be expected to represent. This also means that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
 - (c) is prepared under the exercise of prudence (see below).
 - (d) is complete.
- 231 EFRAG acknowledges that besides including the reference to prudence (which is further considered below) and specifying that transactions and other events should be presented in accordance with their substance, the elements of 'reliability' are similar to those used to describe 'faithful representation' in the current Conceptual Framework. However, EFRAG thinks that when the term was changed in 2010 from 'reliability' to 'faithful representation', there was also a change in the context in which reliability should be considered. EFRAG is of the opinion that before the change in 2010, there was a trade-off between relevance and reliability which should be reintroduced. That is, information could be relevant without being reliable and vice versa. After the changes all reference to this trade-off have been removed. EFRAG thinks that reintroducing the trade-off would also be consistent with the proposal in the DP that an entity should not recognise an asset or liability if no measure of the asset (or liability) would result in a faithful representation. If the IASB thought that assets and liabilities should not be recognised when they could not be measured reliably because this would not result in relevant information, the IASB could just have referred to relevance in the recognition criteria. By referring to faithful representation in addition to relevance, it seems as if some assets and liabilities could be relevant to recognise – but recognition would not result in reliable information.
- 232 In order to reflect its decision on the recognition criteria, the IASB should also amend the wording of paragraphs QC15 and QC16. These paragraphs note that 'if the level of uncertainty in an estimate is sufficiently large, that estimate will not be particularly useful'. However, they also state that 'a representation of [an] estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate' and that 'if there is no alternative representation that is more faithful, that estimate may provide the best available information'. Without any clarification, EFRAG does not believe the latter would reflect EFRAG's view and the IASB's suggestion in the DP as noted in paragraph 228 above.
- 233 In addition to replacing 'faithful representation' with 'reliability' as defined in the pre-2010 Conceptual Framework, EFRAG considers that verifiability should form part of reliability instead of just being considered an enhancing qualitative characteristic. In the description of verifiability, the meaning seems weak as it requires only a consensus between different knowledgeable and independent observers, rather than a reasonable level of certainty over the measurement of the financial effects of the item.

- 234 EFRAG's view on reliability is further explained in the Bulletin *Reliability of financial information*⁸.
- 235 No matter whether the IASB chooses to replace faithful representation with reliability or not, we think that the IASB should better explain the relationship between this term and relevance. EFRAG notes that different interpretations exist, as many consider that information cannot be relevant if it is not reliable.

Prudence

- 236 On prudence, EFRAG agrees with the DP that, although widely accepted as a concept, there are differing views as to what prudence means in practice. In EFRAG's view prudence represents a degree of caution which generally recognises downside risks and not upside potential inherent in uncertain future events.
- 237 As such a prudence filter within the Conceptual Framework should operate in setting Standards for recognition or measurement – it does not relate to disclosure as the uncertainties/risks can be described at least qualitatively if not quantitatively. For example, when the inflows related to an asset are contingent on an uncertain future event, the filter could prevent this (contingent) asset from being recognised at all on the statement of financial position. However, information about the potential asset could and should be provided in the notes to the financial statements.
- 238 Prudence is clearly reflected both in Standards in force today and those being developed. For example, the new Standard on revenue recognition requires a customer contract to exist in order to recognise revenue and hence the uplift in inventory above cost; similarly, even with a customer contract, recognition of variable consideration is limited to the amount which is reasonably assured (rather than, for example, the expected amount). In contrast a potential reduction in inventory below cost is recognised as soon as it is expected. Whilst for financial instruments the measurement criteria are generally more even handed, even then, for example, the treatment of day one profits uses the concept of prudence. EFRAG therefore believes that it is essential to include a clearly articulated concept of prudence in the Conceptual Framework in order to ensure that it is applied consistently across the Standards (both current and future).
- 239 In EFRAG's view, the concept of prudence should be explained after neutrality has been explained (similar to the pre-2010 Conceptual Framework) to highlight that prudence should not be applied in standard setting in a manner that would not result in neutral information.
- 240 EFRAG's view on prudence is further explained in the Bulletin *Prudence*⁹.

Additional issues to consider in Chapters 1 and 3

- 241 In addition to the comments on stewardship, reliability and prudence, EFRAG has a few other comments on Chapters 1 and 3 in the Conceptual Framework.
- 242 From a literature review of capital providers' use of financial statements¹⁰, it appears that capital providers have diverse needs. We think that this should be acknowledged in the Conceptual Framework. Similarly, we think that the Conceptual Framework should state that when assessing what information to be included in the financial statements, the specific benefits of requiring information to be presented in the financial statements should be assessed. This includes the features that set the financial statements apart from other information sources with inherent weaknesses such as lack of reliability and verifiability.

⁸ The Bulletin *Reliability of financial information* was issued by EFRAG, ANC, ASCG, OIC and FRC.

⁹ The Bulletin *Prudence* was issued by EFRAG, ANC, ASCG, OIC and FRC.

¹⁰ The literature review was published by EFRAG and ICAS in December 2013 and carried out by Stefano Cascino, Mark Clatworthy, Beatriz Garcia Osmá, Joachim Gassen, Shahed Imam and Thomas Jeanjean.

- 243 The DP considers whether the Conceptual Framework should include more guidance on identifying the substance of contractual rights and contractual obligations. While EFRAG agrees with this, we believe that reporting the substance relates to financial statements in general and should not just be considered additional guidance to support the asset and liability definitions. EFRAG therefore suggests that the discussion of reporting substance should be included in Chapter 3 of the Conceptual Framework.

The use of the business model concept in financial reporting

Question 23

The business model concept is discussed in paragraphs 9.23–9.34. This DP 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?

EFRAG’s response

EFRAG believes that the business model notion should be referred to in IASB’s financial reporting requirements on a systematic basis and thus be part of the IASB’s Conceptual Framework.

- 244 The role of the business model for financial statements has been subject to extensive research conducted through EFRAG’s proactive project undertaken jointly with the French ANC and the UK FRC. The final results of this project, the Research Paper *The Role of the Business Model in Financial Statements*, was issued in December 2013.
- 245 In addition to the Research Paper, EFRAG and the standard setters from France, Germany, Italy and the United Kingdom issued a Bulletin *The Role of the Business Model in Financial Reporting* in June 2013 as part of a series of papers to promote discussion on topics related to the IFRS Conceptual Framework debate.
- 246 Both the Research Paper and the Bulletin discuss the following issues:
- (a) The use of the business model in IFRS;
 - (b) An assumed meaning of the term;
 - (c) The conceptual discussion on the business model;
 - (d) A discussion on the distinction between the business model and management intent; and
 - (e) Implications of the business model for IFRS.
- 247 A summary of this discussion is provided below.

An assumed meaning of the term

- 248 Both the Research Paper and the Bulletin use an assumed meaning of the term. The assumed meaning focuses on the value creation process of an entity, i.e. how the entity generates cash flows. In case of non-financial institutions, it represents the end-to-end value creation process or processes of an entity within the business and geographical markets it operates.

The conceptual discussion on the business model

- 249 To assess whether the business model could, or even should, play a role in financial reporting, the Research Paper and the Bulletin discuss whether such a role is essential for, or enhances the response to, the key qualitative characteristics in the IASB Conceptual Framework.
- 250 Based on this assessment, the tentative view expressed in the Bulletin is that the business model should play a role in financial reporting, including the financial statements. Not doing so would result in less relevant information, would not lead to a faithful representation of economic reality, would harm comparability, and would make the financial statements less understandable. For this reason, the role of the business model should be explicitly incorporated in the IASB literature.

A discussion on the distinction between business model and management intent

- 251 The Research Paper and the Bulletin provide a discussion on the similarities and differences between the business model and management intent, an issue which has been debated extensively in the academic literature.
- 252 An important similarity between the business model and management intent is that they are both entity-specific, i.e., the financial statements reflecting both the business model and management intent present what actually happened and how the entity performed. In other words, the financial statements provide information that is useful for an assessment of management's accountability, or stewardship. The resulting information therefore meets the relevance criterion. Both the business model and management intent are also verifiable, if they are documented with the necessary level of detail. Some take these similarities one step further and argue that the business model is the same as management intent or that the two notions are connected, at least, for purposes of financial reporting.
- 253 The tentative view expressed in the Bulletin is that there is a distinction between the business model and management intent. Both notions provide relevant information, but business models tend to focus on the larger picture, are generally more stable, and usually require much less documentation to make them verifiable.

Implications of the business model for Conceptual Framework

- 254 EFRAG believes that financial reporting should portray the business model in order to faithfully represent the economic reality of the reporting entity, since it focuses on the actual, past and current transactions and events. Therefore, once the business model is identified and observed, the accounting treatment related to a business model should be derived from the business model.
- 255 EFRAG, ANC, ASCG, OIC and FRC do not believe that the current status quo, i.e. the business model being referred to in financial reporting requirements only on an ad hoc basis, explicitly or implicitly, at Standards level should be maintained. As a consequence, they support the development of a proper rationale for the use of the business model notion as part of the Conceptual Framework, with appropriate guidance for standard setting purposes.
- 256 Such guidance would help identify whether and when the business model notion should be explicitly incorporated on individual Standards level. The Conceptual Framework should also require that the business model be based on observable and verifiable evidence.
- 257 If the business model approach is applied, its meaning would need to be described in the Conceptual Framework and in individual accounting Standards that explicitly incorporate the term. Although we acknowledge that the assumed meaning provided in paragraph 248 could probably be further developed, in our opinion a very general definition/identification of the business model notion similar to the one presented above would suffice for the Conceptual Framework. Nevertheless, if the business model notion

would be explicitly incorporated in individual Standards, then the notion would need to be defined/identified in more detail to be operational.

- 258 Furthermore, Standards should reflect faithfully an entity's business model or models. If that is not the case, EFRAG believes that financial reporting requirements have not been developed appropriately.
- 259 Additionally, the Conceptual Framework should highlight and illustrate how the business model can play a role in (i) recognition, (ii) measurement, (iii) presentation and (iv) disclosures. Some suggestions are presented hereafter.

Playing a role in recognition

- 260 If the business model plays a role in recognition, an item could be an asset for some entities and not recognised by others. An example can be found in IAS 39, paragraph 5, which states that the Standard should be applied to "contracts to buy or sell a non-financial items that can be settled net in cash ... with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements." This means that a contract to receive an amount of coal is a non-recognised executory contract for an energy producer, but a recognised financial instrument for a commodities trader.

Playing a role in measurement

- 261 Measurement (and the related accounting policy choice) is an obvious place where the business model should play a role, because current IFRS require, or permit, different measurement requirements depending on how an asset or a liability, or a group of assets or liabilities, contribute to the entity's cash flow generation. Please see paragraph 138 above in Section 6 *Measurement* which addresses the measurement of inventory.
- 262 Furthermore, EFRAG also believe that the business model provides an essential basis for understanding how assets and liabilities are used within a certain entity and thus how the assets contribute to future cash flows and how liabilities will be settled or fulfilled. The DP notes (paragraphs 6.75–6.96) that the way an asset will ultimately contribute to cash flows will often not be certain and that for most assets there are choices that may change. The business model thus actually limits management discretion (management intent) in selecting the appropriate measurement basis.

Playing a role in presentation

- 263 Presenting assets, liabilities, income and expenses in such a way that investors can understand how they contribute to the entity's cash flow generation can in itself be a way of representing the entity's business model. Segregating assets and liabilities which play a different economic role in the entity, for example helping provide optimum daily cash management versus creating liquidity for acquisitions and capital expenditures, would provide users with both a better basis for looking at financial results and forming expectations of future financial results.
- 264 To a certain extent, this was the approach presented in the IASB-FASB joint project *Financial Statements Presentation*, which proposed that separation should not only be made into operating, investing and financing activities, based on the nature of the assets and liabilities, but also on the economic role they played in the activities of the entity. These underlying principles were widely welcomed (although constituents active in the financial services industry commented that such distinction was not always easy to make), and such a presentation was supportive of more meaningful sub-totals and performance indicators, such as operating profit.

Playing a role in disclosures

- 265 Business models could also play a role in the determination of priorities in information provided. In order to help users to clearly identify the most important elements of

information, it could be assumed that the most important and relevant information should be given priority in the primary financial statements. The business model notion would help in identifying this most important information. Complementary (secondary) information would be presented somewhere else, for example in the notes to the financial statements. In particular, if there are two ways of measuring the same item or transaction, the one that is more closely related to the representation of the effects of the application of the business model in terms of cash flow generation should be placed in the primary financial statements and the complementary one in the note disclosures.

- 266 For more analysis on the above issues, please refer to the Research Paper *The Role of the Business Model in Financial Statements*, which EFRAG and the standard setters from France and the United Kingdom issued in December 2013.

Unit of account

Question 24

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?

EFRAG’s response

EFRAG believes that the IASB should commit itself more explicitly to consider the unit of account in relation to each Standard.

- 267 EFRAG thinks that the Conceptual Framework should include a section on how to determine the unit of account. The unit of account affects several measurement and recognition issues. It could therefore be relevant to include some guidance on aggregation, segregation and whether economic resources should be considered a bundle of rights (as noted in the DP).
- 268 EFRAG thinks that when the unit of account is determined on a standards level, the assessment should focus on the figures (the aggregate of events and transactions) ultimately reported in the financial statements taking the entity’s business model into account. For example, if an entity has sold one product in the accounting period and has provided a product warranty, the most likely outcome of this obligation may be zero (when the entity has experience that its products are free from errors). However, if the entity has sold thousands of similar products, the most useful information about the likely outcome of the warranty obligation may be to consider the bundle of warranties as the unit of account when reporting the most likely outcome. Similarly, if the entity’s business model is to buy and sell equity instruments in bundles rather than individually, it may be more relevant to consider these bundles as the unit of account rather than measuring each equity instrument individually and then add these together (see also the comments to the business model above).
- 269 For some industries the unit of account may not be a physical item or a contractual right. For example, the unit of account for financial institutions may be the different risk components. In other cases EFRAG believes that the unit of account could consist of both assets and liabilities (e.g. in relation to insurance) if this results in the most relevant information.
- 270 Although EFRAG agrees with the DP that the unit of account should be considered in relation to each Standard, we think that the Conceptual Framework should commit the IASB more explicitly to consider the unit of account when developing new or revised

guidance. In other words, the Basis for Conclusions to the new or revised guidance should identify the unit of account that has been selected and the reasons for its selection.

Going Concern

Question 25

Going concern is discussed in paragraphs 9.42–9.44 of the. 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?

EFRAG's response

EFRAG agrees with the situations identified. In addition, we think that these situations are so important that the going concern notion should be considered as a fundamental underlying assumption. We also think that the link between the going concern assumption and concepts such as 'practically unconditional' and 'no realistic alternative' should be explained.

- 271 EFRAG agrees with the situations identified in the DP where the going concern assumption is relevant. These situations are so important that the going concern notion should be considered as a fundamental underlying assumption and highlighted in the Conceptual Framework, as currently.
- 272 EFRAG notes that there are currently mixed views about whether the going concern assumption should play a role in assessing whether a liability exists. The issue has arisen when the liability depends on the entity's future actions. For example, in situations where the entity will have to pay a levy if it stays in business. In the section on additional guidance to support the asset and liability definitions, the DP, however, notes that the going concern assumption should not play a role for the assessment in those circumstances. The IASB notes that even though financial reporting generally presumes that an entity is in going concern, that fact does not mean that the entity is obliged to remain in business. EFRAG considers this guidance helpful, and thinks that it should be included in the Conceptual Framework.
- 273 However, EFRAG thinks that more guidance on going concern is needed. For example, if the IASB chooses an approach where liabilities are recognised for obligations that are practically unconditional. In these cases, guidance is needed on how practicality and the going concern assumption interact. Similarly, EFRAG thinks that the going concern assumption indirectly will affect when a constructive obligation should be recognised as 'no realistic alternative' also assumes that the entity will remain a going concern. Both 'practically unconditional' and 'no realistic alternative' are, however, more than just the going concern assumption.

Capital maintenance

Question 26

Capital maintenance is discussed in paragraphs 9.45–9.54 of the DP. 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.

EFRAG's response

EFRAG agrees that the IASB should defer its work on capital maintenance until it considers how to account for high inflation.

274 EFRAG notes that the issue of capital maintenance is more than how to account for high inflation. However, as accounting for high inflation is part of the issue of capital maintenance, EFRAG thinks that it may be beneficial to consider the issue of capital maintenance in connection with a new or revised Standard on accounting for high inflation. EFRAG does therefore not suggest any amendments to the Conceptual Framework on this issue as part of this review.

Additional issues

275 In addition to the issues considered in the DP, EFRAG would like to provide some additional comments related to the reporting entity and the reporting period.

Reporting entity

276 The IASB has decided not to discuss the reporting entity issue in relation to this DP. Instead the IASB will consider the comments received in response to its 2010 Exposure Draft on the reporting entity when preparing an Exposure Draft on the review of the Conceptual Framework for financial reporting. EFRAG considers this unfortunate. EFRAG thinks that several issues could have benefitted from additional discussion before moving to the next phase of the review of the Conceptual Framework. In particular EFRAG believes that the perspective from which financial statements are presented is critical and should be discussed in the Conceptual Framework. EFRAG notes that this issue was not included in the 2010 Exposure Draft on the reporting entity. However, clarifying the perspective is important in assessing how to resolve accounting policy issues and is central to considering how to satisfy the objective of financial reporting. EFRAG therefore thinks that it is necessary to carry out an in-depth analysis of the implications of adopting either perspective and to ensure they are properly debated. It would have been beneficial to initiate this work when developing the DP.

277 In addition, EFRAG thinks that the IASB should examine more comprehensively whether the application of a joint control approach for determining the boundaries of the group reporting entity provides decision-useful information.

Reporting period

278 EFRAG considers that some guidance on what the reporting period represents should be provided. EFRAG questions, for example, the logic of current requirements where:

- (a) Impairment of goodwill recognised in one interim period cannot be reversed although it would not have been recognised if only an annual report had been prepared.
- (b) A levy relating to an entire year that only meets the criteria for recognition in the last quarter of a financial year would only be reflected in the result of this last quarter. Accordingly, some could argue that the quarterly reports of the first periods of the financial year have provided a too optimistic reflection of the entity's performance.

279 EFRAG acknowledges that these issues may primarily relate to interim reporting, and could thus be considered in relation to IAS 34 *Interim Financial Reporting*. However, EFRAG wants to raise the issue in case the IASB considers it more appropriate to deal with the issue in relation to the Conceptual Framework.