Response to IASB Exposure Draft ED/2015/3: Conceptual Framework for Financial Reporting

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INTRODUCTION

ICAS welcomes the opportunity to comment on the IASB's Exposure Draft ED/2015/3 – Conceptual Framework for Financial Reporting.

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK's and the world's great companies.

Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Accounting Standards Committee has considered the Exposure Draft and I am pleased to forward their comments.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Technical Policy and Secretary to the Accounting Standards Committee.

General comments

As noted in our response to the 2013 discussion paper, ICAS strongly supports the IASB's work to review and update the Conceptual Framework. We welcome the fact that the IASB has sought to address concerns raised by ICAS and other commentators in response to the discussion paper, and in many respects we find the Exposure Draft a significant improvement on that document. In particular, we welcome the improved discussion of stewardship and prudence, measurement and recognition.

In our response to the discussion paper, we noted that we see the purpose of the conceptual framework as being to assist the IASB in updating existing standards and developing new standards, and preparers in developing accounting policies for transactions and events that are not within the scope of specific IFRSs. The framework should also portray a vision of what financial reporting should be. Ideally therefore, it should be useful both as a practical guide and as an aspirational document. We believe that the current draft of the framework is more successful as a practical guide, whilst there are further improvements that could be made which would result in a more visionary document. Specifically:

- Stewardship should be stated as an objective in its own right. We believe that this would result in the financial statements giving a more complete view of financial performance and position, and would reflect the ways in which financial statements are actually used. A stewardship objective also facilitates the incorporation of the business model concept in financial reporting, which we believe is vital in ensuring the relevance of the financial statements in the future.
- A more fundamental discussion of how to define financial performance, profit and other comprehensive income is necessary. Along with stewardship and the business model, performance is one of the key elements which will enable financial reporting to link more effectively with other elements of corporate reporting.

Our responses to the questions in the invitation to comment are set out below.

Question 1—Proposed changes to Chapters 1 and 2
Do you support the proposals:
(a) to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources;
(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state that prudence is important in achieving neutrality;
(c) to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;
(d) to clarify that measurement uncertainty is one factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant; and
(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?
Why or why not?

Response:

Stewardship

We strongly support the IASB's proposal to give more prominence to the importance of providing information needed to assess management's stewardship of the entity's resources, and welcome the fact that the Board has sought to respond to the concerns of many commentators on this issue. However, we believe the framework ought to go further by establishing stewardship as an objective in its own right, rather than framing it as a sub-set of the decision-usefulness objective. In some cases, different, or additional information may be required to meet these two objectives, therefore it may not be sufficient that stewardship is treated as part of decision-usefulness. In addition, when assessing stewardship, there is evidence that there are fewer alternative sources of information available to users, therefore the role of the financial statements is arguably more important than in a decision-usefulness objective.[1]

Prudence

We are supportive of the re-introduction of the concept of prudence in the framework, which we have supported in our responses to previous consultations on the conceptual framework.

We note that prudence is a difficult issue given the numerous different interpretations of its meaning, therefore it is important for the conceptual framework to state what prudence does not mean – we still find that the pre-2010 framework did this more effectively than the current version. We note also that the Basis for Conclusions includes some useful material on asymmetric prudence and we would like to see some of this reflected in the main framework. The concept of asymmetric prudence is important as a guide to IASB in setting new standards.

We are unconvinced by the treatment of prudence as an aspect of neutrality, when according to BC 2.2, the very reason that prudence was removed in 2010 was that it was considered that it might be used to override neutrality.

Substance over form

We welcome the re-introduction of an explicit reference to substance over form in the Conceptual Framework, within the qualitative characteristics of useful financial information.

[1] See Cascino et al (2015 – forthcoming), 'Professional Investors and the Decision-Usefulness of Financial Reporting' ICAS & EFRAG

Measurement uncertainty

We do not agree with the discussion of measurement uncertainty being positioned as an aspect of relevance – this does not make sense to us, as information could be highly uncertain but still relevant. We see measurement uncertainty as an element of reliability/faithful representation, thereby emphasising the trade-off between the two fundamental qualitative characteristics of relevance and faithful representation. The positioning within relevance makes this trade-off less clear, and risks the interpretation that relevance is more important than faithful representation.

Relevance and faithful representation

Whilst we commend the IASB for re-introducing the important concepts of prudence and substance over form as elements of faithful representation, we continue to believe that the term lacks a key aspect of reliability i.e. reliable information 'can be depended on by users to faithfully represent what it purports to represent'. We believe that it is important that this aspect is re-introduced in the main body of the framework, even if the term 'faithful representation' is retained.

Question 2—Description and boundary of a reporting entity
Do you agree with:
(a) the proposed description of a reporting entity in paragraphs 3.11–3.12; and
(b) the discussion of the boundary of a reporting entity in paragraphs 3.13–3.25?
Why or why not?

Response:
We agree with the proposed description of a reporting entity, and the discussion of the boundary of a reporting entity.

Question 3—Definitions of elements
Do you agree with the proposed definitions of elements (excluding issues relating to the distinction between liabilities and equity):
(a) an asset, and the related definition of an economic resource;
(b) a liability;
(c) equity;
(d) income; and
(e) expenses?
Why or why not? If you disagree with the proposed definitions, what alternative definitions do you suggest and why?

Response:
We generally agree with the proposed definitions of elements of the financial statements. The definition of an economic resource is an improvement on the discussion paper version, in that it no longer refers to 'other source of value' which we felt made the definition too broad. We note that the phrase 'is capable of' has been changed to 'has the potential to', which may be interpreted in a wider sense.

We suggest the following wording change in paragraph 4.27 – 'an entity's obligation to transfer an economic resource need only have the potential to require the entity to transfer an economic resource to another party.'

We disagree with the removal of a definition of revenue as an element of financial statements, as this is unhelpful in establishing concepts of financial performance and profit.

Question 4—Present obligation
Do you agree with the proposed description of a present obligation and the proposed guidance to support that description? Why or why not?

Response:
We agree with the proposed description of a present obligation, which is line with view 2 which we supported in the discussion paper.

Question 5—Other guidance on the elements
Do you have any comments on the proposed guidance?
Do you believe that additional guidance is needed? If so, please specify what that guidance should include.

Response:
We have no other comments.

Question 6—Recognition criteria
Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?

Response:
We generally support the proposed approach to recognition – we welcome the fact that the IASB has dropped the discussion paper proposal that only the IASB can determine that particular assets or liabilities should not be recognised. We agree that the criteria for recognition should be based on the qualitative characteristics of relevance and faithful representation (reliability), but we believe that the material on measurement uncertainty should be included within the section on faithful representation.

Question 7—Derecognition
Do you agree with the proposed discussion of derecognition? Why or why not? If you do not agree, what changes do you suggest and why?

Response:
We agree with the proposed discussion of derecognition which we believe is an improvement on the Discussion Paper. It is appropriate that the Conceptual Framework discusses alternative approaches to derecognition and leaves the decision as to which one to use to be determined in individual standards.

Question 8—Measurement bases
Has the IASB:
(a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?
(b) properly described the information provided by each of the measurement bases, and their advantages and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

Response:
We generally agree with the material on measurement bases, and find this section an improvement on the discussion paper. We agree with the measurement bases defined being historic cost and current value, and support the deletion of other cash-flow-based measurements as a separate measurement base. We welcome the fact that in the description of fair value at paragraph 6.23, the reference to 'investors, creditors and other lenders' in the assessment of future cash flows has been deleted.

Question 9—Factors to consider when selecting a measurement basis
Has the IASB correctly identified the factors to consider when selecting a measurement basis? If not, what factors would you consider and why?

Response:
In the description of the factors to consider when selecting a measurement basis, the IASB has largely relied upon the overarching qualitative characteristics which is appropriate – the trade-off between relevance and reliability/faithful representation is the key consideration in selecting a measurement base. However, we believe the guidance could be strengthened and made more helpful by explaining the role that an entity's business model plays in assessing these factors.

Question 10—More than one relevant measurement basis
Do you agree with the approach discussed in paragraphs 6.74–6.77 and BC6.68? Why or why not?

Response:
We believe that in some cases using a different measurement base in the statement of profit or loss and in the statement of financial position could provide the most useful information, and reflect best the way that an entity manages the particular asset or liability.

Question 11—Objective and scope of financial statements and communication
Do you have any comments on the discussion of the objective and scope of financial statements, and on the use of presentation and disclosure as communication tools?

Response:
We agree with the discussion of the objective and scope of financial statements, and we agree that it is useful to discuss presentation and disclosure as communication tools. In our response to the discussion paper, we disagreed with the definition of presentation as a sub-set of disclosure – the ED now does not explain the difference between presentation and disclosure, which should be addressed before the framework is finalised.

Whilst we strongly support the use of presentation and disclosure objectives, the discussion of these at paragraphs 7.16 to 7.18 is very high level – on the completion of the principles of disclosure project (we believe this is a priority area for the IASB), the Board should consider if there is further material that should be included in the conceptual framework.

Question 12—Description of the statement of profit or loss
Do you support the proposed description of the statement of profit or loss? Why or why not?
If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.

Response:
We support the proposed description of the statement of profit or loss, but we think that the framework should provide further guidance on what is meant by 'the return that an entity has made on its economic resources'. We believe that this would provide greater clarity on what should be included within profit or loss and would provide the basis for a definition of profit, which is a necessary element of the Conceptual Framework. Additionally, we believe it is of fundamental importance that the framework defines financial performance which would therefore establish principles for the use of OCI and the issue of recycling. We see the lack of definitions of profit and financial performance as a major area of weakness in this Exposure Draft.

Question 13—Reporting items of income or expenses in other comprehensive income
Do you agree with the proposals on the use of other comprehensive income? Do you think that they provide useful guidance to the IASB for future decisions about the use of other comprehensive income? Why or why not?
If you disagree, what alternative do you suggest and why?

Response:
We believe it is important that profit retains its prominence over other comprehensive income, and therefore items should be reported in other comprehensive income where this provides more relevant information. The use of OCI cannot be fully determined without further work being undertaken on the definitions of profit and financial performance.

Question 14—Recycling
Do you agree that the Conceptual Framework should include the rebuttable presumption described above? Why or why not?
If you disagree, what do you propose instead and why?

Response:
As we stated in our response to the discussion paper, we do not think that all items of income and expense presented in OCI should be recycled into profit or loss – items should not be recycled if they would not provide relevant information in profit or loss. Generally, we are not in favour of sections of the framework being reserved for use by the IASB only – paragraph BC7.44 states that only the IASB is able to rebut the presumption that items of income or expenditure should be reported in the

statement of profit or loss. This is indicative of the fact that further work is required to establish robust principles around reporting performance and profit.

Another important consideration in the debate on recycling is the presentation of recycled items within profit or loss. We believe that the presentation should enable an understanding of the reason for recycling, and where the items have been recycled to.

<u>Question 15—Effects of the proposed changes to the Conceptual Framework</u>
Do you agree with the analysis in paragraphs BCE.1–BCE.31? Should the IASB consider any other effects of the proposals in the Exposure Draft?

<u>Response:</u>
We agree with the analysis of the effects of proposed changes to the framework. It is important that on completion of the revised framework, the IASB undertakes to review existing standards for inconsistencies with the framework, and determine how to address these.

<u>Question 16—Business activities</u>
Do you agree with the proposed approach to business activities? Why or why not?

<u>Response:</u>
As we noted in our response to the 2013 discussion paper, we believe that the business model is an important concept in financial reporting, which should be dealt with in the conceptual framework. Reflecting the business model is key for the following reasons:

- it can improve the relevance of information by demonstrating the differences between entities operating different business models, therefore results in more useful information
- it assists the achievement of the stewardship objective by enabling an assessment of how management has performed
- it is important to recognise that financial reporting is part of a wider corporate reporting package. Demonstrating that the business model is reflected in the financial statements will help ensure that their key role within the corporate reporting sphere is maintained going forward.

<u>Question 17—Long-term investment</u>
Do you agree with the IASB's conclusions on long-term investment? Why or why not?

<u>Response:</u>
We agree with the IASB's conclusions on long-term investment. Whilst ICAS supports the promotion of a longer term perspective, in order to create an environment for sustainable business investment and development, we agree it is appropriate that the issue is not specifically referred to within the Conceptual Framework. Financial reports should be transparent and neutral, and therefore should not be biased towards one particular business or investment model. We agree that long-term investment should not be referred to as a specific business model, since the Framework does not explicitly identify different business models.

We also agree that the information needs of long-term investors should not need to be specifically referred to in the framework. However, we believe the stewardship objective is key in ensuring that these information needs are met, along with those of other users of the accounts. Long-term investors are more likely to require information that will help them assess the performance of management, therefore as noted previously, we still think that stewardship should be given greater prominence in the framework.

<u>Question 18—Other comments</u>
Do you have comments on any other aspect of the Exposure Draft? Please indicate the specific paragraphs or group of paragraphs to which your comments relate (if applicable).
As previously noted, the IASB is not requesting comments on all parts of Chapters 1 and 2, on how to distinguish liabilities from equity claims (see Chapter 4) or on Chapter 8.

Response:
Whilst we note that the IASB is not requesting comments on how to distinguish liabilities from equity claims, we are concerned that an area of such importance should be addressed as a matter of urgency.

Chapter 8 on capital maintenance is now outdated, and should be deleted rather than carried forward unchanged.