

EFRAG

European Financial Reporting Advisory Group ■



Getting a Better Framework

OUR STRATEGY



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This paper is issued by the European Financial Reporting Advisory Group (EFRAG), 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).



Getting a Better Framework

- 1 The IASB is restarting work on its Conceptual Framework. Its ambition is to complete the work by 2015. This is the most important development in financial reporting since the restructuring of the IASB and the adoption of IFRS for use in Europe.
- 2 A new Framework is not merely an academic exercise: both the IASB and its constituents will expect it to be closely adhered to in the development of new standards and in the revision of current accounting standards. It will also need to be considered when dealing with issues that are not addressed in accounting standards. Its influence will last at least for the next decade and probably for much longer. The IASB's stakeholders around the world will make substantive and well-argued submissions. It is important that European views are among those heard in the debate.
- 3 The Framework will deal with important issues. Some examples, which are presented in more detail below, are:
 - Should stewardship (or accountability) be considered when developing accounting standards? (Paragraph 10)
 - Is there adequate emphasis on the importance of prudence and reliability? (Paragraphs 11-13)
 - Will it be required to recognise all assets and liabilities? Are some—such as liabilities under lawsuits that will probably not succeed, and certain intangibles—better dealt with by disclosure than by numbers in the main financial statements? (Paragraph 19)
 - Will the Framework lead to appropriate selection of measurement bases, or will it specify an 'ideal' measurement basis such as fair value? Should the business model play a role in that area of accounting? (Paragraphs 20-21)
 - How should performance be defined? What income and expense should be excluded from profit and dealt with in other comprehensive income? Should items originally reported in other comprehensive income be 'recycled' to the profit and loss account in later periods? (Paragraphs 24-27)
- 4 EFRAG and the national standard-setters of France, Germany, Italy and the United Kingdom have agreed to work in partnership on this subject. This will help us reach a wider audience for our debates and make effective use of our resources. The aim of the partnership is to promote discussion, and to ensure that European views are influential in the debate so that the final framework may reflect an underlying accounting model that European stakeholders believe is conducive to robust and effective accounting standards. Whilst we expect that we will agree on many issues, each partner organisation retains the responsibility for reaching their own position.

- 5 The objectives of this paper are:
 - to illustrate some of the major issues that will arise in the process of developing the new Framework.
 - to explain our strategy for engaging with the IASB in its development of the new Framework.
 - to encourage others within Europe to engage in the development of the new Framework.
- 6 We welcome the development of a new Framework. The IASB has been struggling for too long to complete major projects with the existing Framework, the inadequacies of which are generally recognised. As a result, some past proposals have been based on creative interpretations of the existing Framework: in other cases proposals have been based on concepts that are unclear and have not been generally agreed. Proposed revisions of the standard on provisions (IAS 37) provide an example of the former, and the reporting of income and expenses within ‘other comprehensive income’ (with or without recycling) is a case of the latter. A new Framework should ensure that new standards are based on clear principles that the IASB’s stakeholders understand and support.
- 7 As we support the IASB’s new work, we think it important to engage with the IASB in a constructive spirit. This requires that we set out well founded arguments for our positions, and show respect for contrary views.




WHERE ARE WE NOW?

- 8 The IASB discussed restarting its Conceptual Framework project during its meeting in September, when it was unanimously agreed that:
 - (a) The project should focus on elements of financial statements (including recognition and derecognition), measurement, reporting entity, presentation and disclosure.
 - (b) The aim should be to work towards a single Discussion Paper covering all of these areas and then a single Exposure Draft, rather than separate documents for each area.
 - (c) The IASB will conduct this project as an IASB project, not as a joint project with any other standard-setter.
 - (d) The IASB should complete the project by September 2015.

The IASB plans that its first consultation will be a Discussion Paper which will be issued in the middle of 2013.

- 9 In September 2010 the IASB published two new chapters of the Conceptual Framework. They deal with 'The objective of general purpose financial reporting' and 'Qualitative characteristics of useful financial information'. In developing these chapters, the IASB had to deal with some controversial issues.
- 10 One of these is the role of stewardship or 'accountability'. Many respondents, including some from Europe, suggested that the objective of financial statements should not be cast wholly in terms of providing decision-useful information for investors and others, but that providing information on management's stewardship should be specified as an additional, complementary objective. The 2010 Chapter, whilst avoiding the term 'stewardship', refers to users' needs for '*information about...how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources*'. This is presented as part of the objective of decision-usefulness and not as a separate objective.
- 11 Another issue that provoked some controversy is the role accorded to prudence and reliability. The new Chapter on Qualitative Characteristics does not include either term. The Basis for Conclusions explains that prudence has been omitted because it is incompatible with neutrality, and reliability because it is ambiguous: it might mean verifiable, free from material error, faithful representation (perhaps combined with neutrality) or precision.

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- 12 In place of reliability, the new chapter emphasises ‘faithful representation’. Information is said to have faithful representation when it *‘faithfully represents the phenomena that it purports to represent’*. The Basis for Conclusions states that faithful representation *‘encompasses the main characteristics that the previous frameworks included as aspects of reliability’*. The new Framework also identifies verifiability as an ‘enhancing qualitative characteristic’.
 - 13 Speaking recently in Brussels, Hans Hoogervorst noted that aspects of the Framework remain controversial. In particular, whilst the previous Framework’s treatment of prudence was ‘spot on’, its removal was defensible in view of the need to converge with the FASB and to underline the importance of neutrality: the information in financial statements should not be slanted to favour a particular decision. He nonetheless emphasised that the basic tenets of the concept of prudence remain intact and visible throughout International Financial Reporting Standards. It remains open to question, however, whether the Framework should specifically refer to prudence and what precisely prudence means.
 - 14 Restarting work on the Conceptual Framework might be seen as an opportunity to urge the IASB to reopen the issues dealt with in the 2010 Chapters. It may be recalled that whilst the new Chapters were developed jointly with the FASB, the IASB’s future work will be carried out as an IASB project, not jointly with any other standard-setter. It appears, however, that the IASB intends to make only consequential amendments to the 2010 Chapters perhaps because of the ambitious timetable. Under the previous phased approach it was planned to review the entire Framework after the individual phases were completed. It is now planned that all remaining parts will be the subject of a single project: this may create inconsistencies unless some issues addressed in the 2010 Chapters are reconsidered.
 - 15 Whilst we understand the issue of timing, we are of the view that future considerations should not be overly constrained by the 2010 Chapters. These chapters should be clarified or amended if they do not provide sound foundations for satisfactory conclusions on issues arising in new work. The final Framework needs to be consistent and complete.



THE NEXT FEW YEARS

- 16 As noted above, the IASB has indicated that the project will focus on: elements of financial statements (including recognition and derecognition); measurement; reporting entity; and presentation and disclosure. The following paragraphs highlight some of the important issues that will arise in these areas. There are others.

Elements and recognition

- 17 The existing Framework defines assets and liabilities. Its definitions of equity, income and expenses are dependent on those of assets and liabilities.
- 18 In its past work, the IASB devoted considerable time to a reconsideration of the definition of assets and liabilities, but the impact of the changes that were considered was not clear. It is obviously important that the new definitions of assets and liabilities are robust. They should also lead to a workable and robust concept of equity, which has long been a troublesome feature of IFRS. In addition, the definitions of income and expenses need to provide a satisfactory basis for the reporting of performance.
- 19 Recognition criteria also seem to be necessary. Some items clearly are assets and liabilities, but recognising them in financial statements arguably does not improve their relevance or usefulness. Examples include liabilities under lawsuits that will probably not prevail, and some of the intangible assets recognised under IFRS 3 'Business Combinations'. Clearly there is a link to disclosure, as the treatment in the financial statements or notes thereto of unrecognised items will need to be addressed.

Measurement

- 20 The IASB's most recent work on measurement has focussed on an approach that would identify the merits and limitations of different types of measurement, and therefore suggest the circumstances in which specific measurement bases are likely to be appropriate. This approach, which is similar to that under consideration by the International Public Sector Accounting Standards Board, seems more promising than attempting to identify an 'ideal' measurement approach that would have to be applied in all circumstances¹.

¹ EFRAG's Comment Letter on the staff paper 'Measurement Framework for Financial Reporting by Profit-Oriented Entities' published by the CICA suggests that a measurement framework should provide help in choosing the best measurement basis rather than to identify a single ideal measurement basis.


- 21 The Framework may need to embrace a variety of measurement bases, and in particular allow for standards to select a basis that is appropriate in the circumstances of the entity, rather than requiring a particular basis to be used in all circumstances. Advocacy of ‘entity-specific’ measurements must, however, meet the challenge of either embracing a role for management intent or showing that such measures do not rely merely on management intent. This is an issue that is being addressed in the project ‘The Role of the Business Model in Financial Reporting’ which is being conducted jointly by the ANC, the FRC and EFRAG.

The reporting entity

- 22 The part of the Framework that deals with the reporting entity addresses the boundaries of the economic activities that are dealt with in financial statements. An Exposure Draft published in March 2010 (which has not been finalised) requires the presentation of consolidated financial statements where one entity controls another. The notion of control is used not only in the context of consolidation but also in the context of the definition of assets. Given its importance in accounting, the question arises whether the Framework should provide a definition of ‘control’ that is used consistently wherever the concept is relied on.
- 23 In Europe, the 4th EC Directive on company law requires the preparation of accounts for the individual legal entity. Member states may permit or require such accounts to be prepared in accordance with EU-adopted IFRS. If the Framework does not provide a role for individual financial statements, future IFRSs may not be suitable for them, and so if IFRS were to be used for such statements, they would need to be supplemented, perhaps in an *ad hoc* manner. The OIC, jointly with EFRAG, and the standard-setters of the Netherlands and Spain, are currently conducting a project that considers what changes (if any) to IFRS are necessary in respect of separate financial statements.

Presentation

- 24 The topic of presentation gives rise to a number of issues. In particular it needs to be considered whether financial performance is to be defined, and how it is to be presented in the financial statements.
- 25 One major issue to be addressed in this connection is the need for and the role of ‘other comprehensive income’. It is important that it is unambiguously specified so that the significance of both profit or loss and other comprehensive income is clear.

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- 26 There is a link between presentation and measurement, particularly in cases where a current measurement of an asset or liability is relevant, but it is questionable whether and how changes in that current value should be reported.
- 27 A related issue is whether income and expenses reported in ‘other comprehensive income’ should be ‘recycled’ to profit and loss in a later period. If so, the principles that should determine when recycling is appropriate need to be agreed.

Disclosure

- 28 We would hope that the part of the project that looks at disclosure will provide principles that help ensure that all relevant information that can reasonably be expected is disclosed, whilst avoiding the excessive clutter that is often seen in today’s financial statements. We would hope that the Discussion Paper ‘Towards a Disclosure Framework for the Notes’ which was recently published by EFRAG, the FRC and the ANC, and the paper ‘Thinking about disclosures in a broader context’ which was published by the FRC with the support of the ANC and the ASCG will be helpful in this connection.

Financial reporting or financial statements?

- 29 The 2010 Chapters retitled the Framework, which is now ‘The Conceptual Framework for Financial Reporting 2010’: in contrast the old Framework’s title referred to ‘financial statements’. It may be useful to explore the implications of this change.



OUR STRATEGY, AND HOW TO GET INVOLVED

- 30 As mentioned above, we intend to engage with the IASB in a constructive spirit.
- 31 It is expected that the IASB will welcome positive suggestions and may ask others to assist by contributing views on issues as work develops. We shall welcome any such invitations and ensure that our responses are thoughtful and well argued. We recognise that this will make a significant demand on our resources: given the importance of the Framework we accept this.
- 32 We do not intend, however, to confine our work to issues identified by the IASB. We shall develop proposals for consideration by the IASB on other issues that we consider important.
- 33 We intend to publish Bulletins, available through the websites of organisations in the partnership, which will discuss the issues that arise in the course of the project, explain their importance and seek constituents' feedback. This will provide an update on the work of the partnership and of the IASB. We expect Bulletins will be relatively short, and confine themselves to the key messages. Concise, well-argued papers are likely to be both more influential and accessible than extensive treatises.
- 34 Bulletins will provide a discussion of issues in order to stimulate debate. The comments received on the Bulletins will be considered in developing our views. We shall also ensure that all comments are drawn to the attention of the IASB.
- 35 Experience shows the value of outreach events at which views can be exchanged and debated in person. We shall organise such events as the project progresses.
- 36 EFRAG and its partners will run its due process in the most open and proactive manner possible. We have heard from European constituents, and have shared with them, the need for the conceptual framework to be revised and agreed, so as to clarify the accounting model that will form the basis for future IFRS. For this reason, we encourage every European stakeholder to engage in the debate to the extent of their means.
- 37 EFRAG and its partners will also develop and issue regular updates on the development of the conceptual framework in the form of a specific newsletter, to keep European constituents informed of how the debate with the IASB and other stakeholders worldwide progresses and the extent to which views from around the world converge with those of Europe.



