JOINT OUTREACH EVENT

IASB EXPOSURE 2015 DRAFTS 3 AND 8

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING AND

PRACTICE STATEMENT ON MATERIALITY

ROME

30 NOVEMBER 2015

This feedback statement has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by either the EFRAG Board or the EFRAG Technical Expert Group. It has been reviewed by the IASB staff and has been jointly approved for publication by representatives of EFRAG and the OIC, who attended the joint outreach event.

Joint Outreach Event

This feedback statement has been prepared for the convenience of European constituents to summarise a joint outreach event held by EFRAG and the OIC, in cooperation with the IASB, on 30 November 2015.

The joint outreach event was chaired by Alberto Giussani, OIC Executive Board Member.

The joint outreach event was one of a series organised across Europe following the publication of the IASB Exposure Draft ED/2015/3 *Conceptual Framework for Financial Reporting* (the 'Exposure Draft') and the draft IFRS Practice Statement Application of Materiality to Financial Statements (the 'draft Practice Statement'). The purpose of the outreach event was to:

- stimulate the debate on the Conceptual Framework and on the draft Practice Statement in Europe;
- obtain input from European constituents and understand their main concerns and wishes, in particular from those that may not intend to submit a comment letter to the OIC, the IASB or EFRAG;
- receive input for the OIC's comment letter to EFRAG and the IASB; and
- learn whether the preliminary comments as set out in EFRAG's document for public consultation and in its draft comment letter on the draft Practice Statement were shared by European constituents.

Stephen Cooper (IASB Board Member) presented the Exposure Draft on selected issues and Filippo Poli (EFRAG Research Director) summarised EFRAG's initial views. An open debate took place with participants.

The participants had different backgrounds, and included users, preparers, auditors, regulators and academics.

Issues covered

Participants discussed the following issues regarding the Exposure Draft:

- Objective of general purpose financial reporting and qualitative characteristics of useful financial information, including stewardship and prudence;

- Elements of financial statements, recognition and derecognition; and
- Presentation and Disclosure (Other Comprehensive Income and recycling).

Presenters and participants at the event also discussed about the draft Practice Statement.

Comments received

Objective of general purpose financial reporting and qualitative characteristics of useful financial information, including stewardship and prudence

The IASB Board Member explained that the Conceptual Framework is intended as a practical tool for the IASB in standard setting, but it also helps preparers developing consistent accounting policies and others understanding and interpreting IFRS.

The drafting of the CF should be useful for entities to develop accounting policies where required by IFRS

One participant with an academic and legal background noted that the CF is normally labelled as the guide for future standard-setting activities. However, current IFRS require entities to consider guidance in the CF to develop their own accounting policies when IFRS do not regulate certain transactions. Accordingly, this participant believed that IASB should be careful in drafting the CF to avoid interfering with the way entities apply its principles to develop accounting policies. Another participant with similar background recommended that the IASB makes a clear distinction between those sections that apply only to the Standard setter, and those that should be applied by preparers.

Management's stewardship

The Exposure Draft gives greater prominence to assessing management's stewardship of the entity's resources in the description of the objective of financial reporting.

One participant with auditing background noted that, in previous years, the IASB had decided to remove the word stewardship given that there were perceived issues in translating it. The current ED reintroduced the term.

The IASB Board Member acknowledged the existence of this issue and noted that the ED includes more extensive explanations on the definition of stewardship and other terms (e.g. accountability) so that it would be easier to translate the term.

Mixed views arose on the introduction of stewardship within the objectives of financial reporting

The OIC Executive Board Member noted that stewardship should not be considered a separate objective of financial reporting because the same information is relevant to make investment decision and assess stewardship.

The EFRAG Research Director noted however that, while there are significant overlaps, some empirical research had shown that users give different prominence to different information in financial statements when making investment decisions or assessing the performance of management.

One participant with academic and legal background believed that the IASB could use disclosures to provide relevant information about stewardship rather than having it as a separate objective, which would create conflicts.

The Exposure Draft proposes to reintroduce 'substance over form' within the concept of 'faithful representation'.

Another participant with an academic and legal background concurred that CF should only contain overarching principles to prepare financial statements; among these the principle of the substance over form should be given greater prominence.

Prudence

The Exposure Draft reintroduces the notion of prudence in the Conceptual Framework to support neutrality and the use of caution when making judgments in conditions of uncertainty, so that assets and income are not overstated and liabilities and expenses are not understated. However, it also states that assets and income should not be knowingly understated, or liabilities and expenses overstated. Also, the IASB rejected the notion of asymmetric prudence because it would lead to different thresholds for the recognition of gains (or assets) than losses (or liabilities) and the selection of cost-based measurements over fair value.

EFRAG's initial view is that the Conceptual Framework should acknowledge that higher thresholds for the recognition of assets than for liabilities (asymmetric prudence) sometimes results in the most useful information.

Mixed views arose on the re-introduction of prudence within the objectives of financial reporting

The OIC Executive Board Member noted that information must not be neutral to be useful for investors as it should cater specifically for users' needs instead of balancing needs of all the other interested parties. Furthermore, he agreed that the term prudence could create confusion in understanding its meaning and interactions with other general objectives of financial statements.

One participant from the banking industry noted that current regulation in Italy forbids distributing unrealised profits. This should be considered while looking at prudence to support the asymmetry in recognition and measurement of assets and liabilities. This participant noted that while the recognition of unrealised gains could be appropriate in consolidated financial statements to achieve faithful representation and relevance, this should be avoided in separate financial statements that are the legal basis to distribute dividends, to avoid conflicts with existing laws.

The OIC Executive Board Member noted that normally local regulations limit distribution of dividends when financial statements include some unrealised profits; however, the issue is broader because entities allowed to distribute realised profits could do it by funding the settlement of dividend liabilities using external funds, thus hindering future capacity to produce future free cash flows. In its view, where prudence was to be reintroduced, the IASB should also consider these circumstances.

One participant with an academic and legal background noted that the Accounting Directive provides rules that support the capital integrity and maintenance, accordingly in considering current proposals in the ED a specific analysis should be made to ascertain that no conflict with European regulations exists.

The IASB Board Member noted that the IASB develops general principles for more than 100 jurisdictions. While the IASB tries, whenever possible, to consider local issues, it cannot be expected to solve all of them, and conflicts with local legislation should normally be dealt with by the legislator.

The IASB Board Member noted that the IASB would have to address the issue related to identifying in the CF situations where prudence should be advocated or not among the core objectives of financial statements where all other objectives always played a role in developing IFRS. In his view, it could be easier for the IASB to deal with prudence at the level of each standard instead of identifying limited circumstances where prudence should be prominent and overcome, for example, neutrality. He made the example of contingent assets and liabilities. He queried EFRAG to highlight these circumstances in its final comment letter.

Elements of financial statements, recognition and derecognition

The Exposure Draft proposes simplifying the definitions of assets and liabilities and base those definitions on the existence of rights and obligations, with equity still identified as a residual.

Concerns were raised about the deletion of the reference to the expectation of future cash flows within the definition of assets

The OIC Executive Board Member believed that the reference to the expectation of future cash flows from the use of the asset is needed; it was noted that the current guidance in IFRS (e.g. IAS 36 *Impairment of Assets* for the estimate of the value in use) refers to the cash flows that an asset is capable to produce directly or indirectly through the use or control of the asset. Regarding the proposed definition of liability, he also noted that more liabilities could be recognised, and questioned whether the IASB really intended to achieve this outcome.

The EFRAG Research Director said that EFRAG broadly supported the new definitions, and added that EFRAG had published a questionnaire to test how constituents would apply them, and if they could result in unintended consequences.

The OIC Executive Board Member noted that in their past consultations, constituents had not raised any concern about the fact that recognition was subject to likelihood of future cash flows. He doubted that recognising an asset with a low probability of producing future cash flows resulted in relevant information. Participants at the event concurred that it does not.

One participant with academic and legal background noted that maintaining the probability threshold increases discipline and scrutiny in accounting for elements, while its removal raises a number of concerns, especially in the context of separate financial statements that have a different role.

Changes in current definitions should be made only where they make them more aligned to the underlying conceptual ground

The OIC Technical Director noted that the IASB proposes to recognise liabilities when the entity has no practical ability to avoid them. He thought that this was more an attempt at addressing issues raised in relation to the IFRIC interpretation on Levies, rather than a conceptual approach.

Presentation and Disclosure (Other Comprehensive Income and recycling)

The Exposure Draft classifies the measurement bases into two categories: current value and historical cost. The Exposure Draft also states that the statement of profit or loss is the primary source of information about an entity's financial performance for the period. As a result, the Exposure Draft includes a rebuttable presumption that all income and expenses should be included in the statement of profit or loss, and where dual measurement results in financial information that is more relevant, the difference should be accounted for in OCI.

EFRAG published a bulletin where it tried to provide more guidance on when OCI should be used. It stated that the business model of the entity should affect the selection of the appropriate measurement basis, with the main focus on reporting performance. When the appropriate measurement to depict the financial position is different, then OCI would be needed.

The IASB's pragmatic approach to address the lack of conceptual ground on the use of the OCI was supported as it avoids complexity

The OIC Technical Director noted that EFRAG's proposals had some merits but were too complex to include at the Conceptual Framework level, while the IASB's approach was pragmatic. In his view, it would have been better to try to define what OCI is or what realised income is.

The IASB Board Member appreciated EFRAG's analysis on business models but disagreed with their accounting consequences. Regarding the long term investment business model, he noted that for complex financial instruments, identifying a cost-based measurement to report performance in profit or loss would be arbitrary. One way to achieve it was bifurcating the instrument, but the IASB had removed it in IFRS 9 due to its complexity. In this respect, he noted that EFRAG had requested to reintroduce bifurcation in recognition and measurement of financial assets.

Draft Practice Statement on materiality

The IASB published the draft Practice Statement, a non-authoritative form of guidance, to assist management in making decisions about materiality and complement the current guidance in IFRS.

EFRAG published its draft comment letter on the draft Practice Statement where it expressed its support for the issue of additional guidance; however it recommended to draft it in a more concise and practical way and focus on areas where judgement is deemed difficult.

Participants supported the issue of the Practice Statement even if they believed that improvements in the drafting are needed to address a number of practical issues

The OIC Executive Board Member noted that because the draft Practice Statement had been published recently, only very initial tentative positions had been formed on it, namely:

- it was queried whether different levels of materiality exists, whether it applies to recognition, measurement or disclosures;
- Illustrative examples could result in rule-based guidance;
- Compatibility with local regulation on fraud in financial statements should be assessed;
- Guidance on stewardship seems to scope out some areas from the application of materiality (e.g. related parties disclosures).

The OIC General Secretary asked if the IASB expected that the practice statement would affect the behaviour of regulators that often require providing every disclosure regardless of their materiality. The IASB Board Member noted that materiality is not only a quantitative notion, but it is also qualitative. He added that it is out of the IASB's remit to discipline the application of materiality in requirements from regulators, even when they refer to information in financial statements. The IASB is however considering the issue of placement of information within its Principles of Disclosures project that will result in a discussion paper to be exposed in 2016.

The EFRAG Research Director asked whether the IASB had liaised with ESMA to discuss the Practice Statement. The IASB Board Member confirmed that they had consulted a number of regulators.

One participant with an insurance background requested whether materiality applies in setting or choosing accounting policies in order to avoid complexity in applying IFRS, he considered for example the case of applying IFRS 9 and the forthcoming IFRS 4. This participant noted that in big conglomerates sometimes applying certain requirements is complex while resulting in accounting effects that are trivial if considered within the context of the financial statements taken as a whole.

The OIC Executive Board Member noted that in his view this issue is more related to the desired level of precision in making estimates that are reliable.

The IASB Board Member reported an example he had come across recently on measuring the fair value of an employee stock option whose strike price was 1 CU and the share price was 75 CU. In that case, the entity had performed complex assessment to estimate the time value of money component and provided a conspicuous amount of disclosures about its volatility; whilst each time value of money and its volatility played any role on measuring the value of the option given that it was entirely based on the intrinsic value of the instrument. Accordingly, he concluded that when a measuring basis does not result in meaningful outcomes, an entity could usually select a different basis for measurement that meets the objective of financial reporting by advocating materiality.

The OIC Executive Board Member noted that one example is when measuring certain assets and liabilities at amortised cost, it does not result in substantial difference compared to measuring them at cost and therefore it is not applied.