ICAEW REPRESENTATION 154/15

Conceptual Framework for Financial Reporting

ICAEW welcomes the opportunity to comment on the exposure draft *Conceptual Framework for Financial Reporting* published by the International Accounting Standards Board (IASB) on 28 May 2015, a copy of which is available from this link.

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MAJOR POINTS

Support for the initiative, but some concerns

1. We welcome the exposure draft (ED), which we believe makes significant progress towards a high quality, comprehensive conceptual framework for International Financial Reporting Standards (IFRS). There are nonetheless several key points on which we think the ED's proposals remain unconvincing, and others where the ED deliberately defers resolving difficult issues. We comment on all these points below.

2. The concerns we express below are in general driven by a number of factors:

   - There are various points at which it would be better if the ED were clearer about whether it is aimed at delineating what the IASB should do when setting standards, which is what we think the conceptual framework should predominantly be aimed at, or at providing guidance for preparers. Clarifying this would help to disentangle some of the arguments about contentious issues.

   - We think the conceptual framework should be a living document, updated and amended as business practices change and as thinking about financial reporting develops. When the IASB issues standards that depart from the framework, it should explain why it has done so and in due course, when the framework is next revised, bring the framework into line with the new thinking embodied in the most recent standards. Obviously, this process of bringing the framework into line with the IASB's current thinking as embodied in its most recent standards should have been undertaken as part of the current review of the framework. We are not satisfied, though, that the proposals in the ED always match the IASB's current thinking as reflected in its recent standards, which raises questions about the proposed framework's credibility.

   - We think that a dangerous precedent would be set, with no real justification given for it, if the proposal to adopt two measurement bases for the same item were adopted. It is a basic tenet of accounting that the different statements articulate with one another in terms of the basis of measurement, and doing away with that without a proper justification would in our view be dangerous and likely to lead to significant complexity.

   - Some parts of the ED remain underdeveloped and are not as clearly articulated as they ought to be. We accept that specific decisions need to be made at a standards level, but this is not a reason for leaving these areas quite so undeveloped and it does not justify a lack of clarity.

True and fair view

3. The concept of 'fair presentation' appears in IAS 1, *Presentation of Financial Statements*, and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, but not in the ED. It seems to us to be a fundamental concept in financial reporting; it would be helpful if the framework were to discuss it and its relationship to faithful representation. It would also be helpful to confirm that fair presentation is considered by the IASB to mean the same as 'true and fair view', a concept that occurs in the laws of many jurisdictions that have adopted IFRS.

Prudence

4. We would welcome the reinstatement of prudence in the framework, but we do not agree with the ED as to how it should be done. The *Basis for Conclusions* distinguishes between 'cautious prudence' and 'asymmetric prudence'. The ED includes cautious prudence, which it says supports neutrality, but it excludes asymmetric prudence. Cautious prudence seems to us to be a matter for preparers, whereas asymmetric prudence is a matter for the IASB in setting standards.

5. Asymmetric prudence is as a matter of fact applied by the IASB in setting standards and it forms an important element of financial reporting as we know it. Without explicit recognition of asymmetric prudence, the conceptual framework will be missing a key concept in standard setting, in the absence of which it would be difficult to justify significant elements in current IFRS. We therefore believe that asymmetric prudence should be included in the framework,

with some high-level principles setting out how it will be constrained. To be clear, however, we do not believe or suggest that incorporating this approach to asymmetric prudence in the framework would or should stop the use of fair value measurement in appropriate circumstances or the recognition of fair value gains in financial statements.

Liabilities

6. Like the discussion paper (DP), the ED takes the usual approach in conceptual framework documents of building up from a foundation of definitions of assets and liabilities, treating income as a residual that emerges from changes in net assets. Although we do not disagree with this, in our view, the income statement is as important as the balance sheet, more so in the eyes of many, and the effect on the income statement will often need to be taken into account in deciding on questions of recognition and measurement.
7. We do not agree with the ED's definition of a liability, which in general we think is too narrow, although there may be instances (which we discuss in our detailed comments) when it might be too broad. If the proposed definition is strictly interpreted, items that would now be generally regarded as liabilities, and which we believe should continue to be recognised as liabilities, would not be recognised.
8. We believe that it may be necessary to define liabilities as comprising three categories:
   - legally enforceable obligations;
   - constructive obligations; and
   - certain other planned future outflows arising from past events.

   The third category would be intended to cover liabilities related to expenses such as levies, bonuses and some pension costs that are incurred in earning the income of the accounting period, but that do not necessarily give rise to what can be regarded as a 'present obligation', in the ordinary sense of these words, at the balance sheet date. The point at which an entity has 'no practical ability' to avoid a transfer will not necessarily coincide with the accounting period that ought to reflect the benefits received. Unless such expenses are recognised as they accrue, the income statement will give less useful information, both for assessing performance during the period and for forecasting future performance.

Measurement

9. We believe that the description of measurement bases in the ED needs more thought, including consideration of how the bases in the ED fit with the IASB's own measurement requirements in recent standards such as IFRS 9, *Financial Instruments*, and IFRS 15, *Revenue from Contracts with Customers*.
10. We do not think that the ED has identified all relevant measurement bases or categorised them in the most helpful way. We can see some merit in dividing measurement bases into two broad categories. However, dividing them between 'historical cost' and 'current value' does not seem to be the best approach as, in the ED, it results in current cost – widely known as one of the measurement bases used in a form of current value accounting ('deprival value') – being discussed under the heading of historical cost. A better division would be between entry values and exit values. We note that the IASB has already used such terminology in IFRS 13, *Fair Value Measurement*.
11. We believe that it would be helpful for the framework to deal with complex measurement bases, which are common in financial reporting, but not discussed as such in the ED. So-called 'historical cost' under IFRS includes such complex bases as 'lower of cost and net realisable value' and 'lower of cost and recoverable amount'. The latter is itself a complex basis. So some measurements on the 'historical cost' basis actually use a current exit value, such as fair value or net realisable value or value in use.
12. We disagree with the ED's approach to the use of two measurement bases for the same item at the same time. This seems to be just a convenient mechanism for simultaneously applying different views about the appropriate measurement basis for a particular item, in order to reconcile those who take opposing views as to the primacy or importance of the statement of

financial position or the income statement. In our view it is important to keep the articulation between the statement of financial position and the income statement, and this implies that any item in the accounts should be measured on just one basis.

13. Income and expenses arising from the chosen measurement basis may, nonetheless, be analysed into their component parts in the income statement and other comprehensive income (OCI) where this provides useful information. And this analysis might be driven by different measurement bases, although other factors may drive disaggregation, as they do, for example, with defined benefit pension accounting. This analysis can be stipulated as appropriate in the relevant standards, but we think it dangerous to suggest that a routine disconnection between the statement of financial position and the statement of profit or loss is acceptable.

Profit or loss, OCI and recycling

14. For many years, we have been in favour of a single income statement, as we can see no convincing principle for distinguishing elements of OCI from other income and expenses. However, we note that the IASB proposes to preserve the concept of OCI, with considerable support from constituents. Our replies on this issue should be taken in this context. As we indicated in our response to the DP, we do not think that it is necessary to provide a definition of profit or loss, but we do believe that the framework should at least explain the objective of profit or loss. While the ED attempts to describe the purpose of profit or loss, we believe the description could be improved by stating explicitly that profit or loss measures financial performance for the period.
15. The ED makes useful progress in tackling the question of what should be included in OCI, but we continue to believe that a more principled approach to this issue is required. If the description of the objective of profit or loss, clarified as we suggest above, were applied in deciding what should go to OCI, it would not, in our view, lead to the proposals in the ED.
16. We believe that OCI should be restricted to items that neither help to measure the current year's performance nor help to estimate future performance. These are, of course, vague concepts, as are any other concepts proposed in this area. However, we think that the list might typically include only:
    - gains on the revaluation of property, plant and equipment (PPE);
    - gains on the sale of PPE, except where they are in substance corrections of accumulated depreciation;
    - foreign currency translation adjustments on foreign subsidiaries;
    - actuarial gains and losses on a defined benefit pension scheme; and
    - fair value gains and losses on effective hedges.

    However, we believe that more work is needed on this subject.
17. We do not agree that there should be a rebuttable presumption that all income and expenses recognised in OCI should subsequently be recycled to profit or loss. Of the items that we believe should be recognised in OCI, in our view only fair value gains and losses on effective hedges should be recycled to profit or loss. This is because they would be recycled at the point that they become relevant to measuring performance for the period. There is no time at which the other items we have identified would be relevant to measuring performance for the period or to predicting future performance.

Capital maintenance

18. In our opinion, the chapter on capital maintenance is out-of-date and misleading. If there are no plans to update it properly and link it to the rest of the framework, we propose that it should be deleted.

RESPONSES TO SPECIFIC QUESTIONS

Chapters 1 and 2: The objective of general purpose financial reporting and the qualitative characteristics of useful financial information

Q1: 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?

Stewardship

19. We agree with the way in which the ED gives more prominence to the role of stewardship, which is an improvement on the existing (2010) framework. We would not want the framework to go further because this would run the risk of trying to serve two different objectives, which in certain circumstances might be in conflict.

Prudence

20. As indicated above, we would welcome the reinstatement of prudence in the framework, but do not agree with the ED as to how it should be done. The *Basis for Conclusions* distinguishes between 'cautious prudence' and 'asymmetric prudence'. The ED includes cautious prudence, which it says supports neutrality, but it excludes asymmetric prudence. Cautious prudence seems to us to be a matter for preparers, not standard setters, and we believe that this should be made clear in the framework. While we agree that preparers should be neutral and that they should exercise caution, we think that it is confusing to describe cautious prudence as an aspect of neutrality. Indeed, there is no need to use the word 'prudence' in this context, and it could be reserved for its more obvious meaning, which we discuss next.

21. By contrast, whether or not to apply asymmetric prudence should be an issue for the IASB in setting standards and is not an issue for preparers in making judgements when they prepare financial statements. As a matter of fact, such prudence is applied by the IASB in setting standards and it forms an important element of financial reporting as we know it. The pervasive use of the 'recoverable historical cost' basis for measurement is an example of asymmetric prudence. We believe that the IASB and most of its stakeholders are content to see this basis continue in use, as are we. There would be political advantages for the IASB if it were to acknowledge, in the framework, the suitability of this form of prudence for the measurement of some assets.

22. However, we also observe other examples of asymmetric prudence in IFRS. In an old standard (IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*), there is asymmetry between contingent liabilities and contingent assets. To take a further example that the IASB has considered recently, IFRS 15 applies a constraint to variable consideration, restricting measurement of the associated asset to an amount that it is highly probable will not be subject to significant reversal when the uncertainty is resolved. This constrained amount will often be much lower than fair value. It appears to us that this is an example of the IASB selecting a

measurement basis that is asymmetrically prudent. To be clear, however, we do not believe or suggest that incorporating this approach to asymmetrical prudence in the framework would or should stop the use of fair value measurement in appropriate circumstances or the recognition of fair value gains in financial statements.

23. We encourage the IASB to consider whether it now believes that these, and any other, examples of asymmetric prudence (beyond using the recoverable cost basis) are appropriate. If it does, then we believe that the framework should contain a principle justifying them. If, instead, the IASB believes that these examples are inconsistent with its current thinking or were necessary for some reason such as *force majeure* or cost/benefit considerations, then the *Basis for Conclusions* could explain this (in its 'BCE' section).

24. Without explicit recognition of asymmetric prudence, the conceptual framework will be missing a key concept in standard setting. We believe that it should be included in the framework, with some high-level principles setting out how it will be applied, either limited to the historical cost basis or as something wider. If the framework does not acknowledge this issue and clarify the IASB's understanding of the proper limits of asymmetric prudence, two problems will or may arise:

    - the IASB will continue to write standards that appear to have no justification under the framework; and
    - the IASB may use inconsistent amounts of asymmetric prudence in different standards or people may expect or want it to be used when it is inappropriate. This would also increase the potential for misplaced criticism of the framework and standards.

Substance over form

25. We agree with the proposed reintroduction of substance over form in the conceptual framework. In our view, though, the description in the ED needs to be expanded. It might say, for example: 'The economic substance of a transaction or state of affairs reflects the rights and obligations associated with it, which will sometimes differ from those usually associated with its legal form.' Economic substance rests on the supporting legal arrangements and legal form cannot be ignored. The UK standard FRS 5, *Reporting the Substance of Transactions*, dealt well with the problem, and there may be wording in it (such as paragraphs 14 and 16-19) on which the IASB could draw.

Measurement uncertainty

26. Paragraphs 2.12 and 2.13 on measurement uncertainty do not seem to us to be well-drafted. They appear to be aimed primarily at preparers, but make a point that is more relevant to the IASB in setting standards. They also appear to be suggesting that information is less relevant where there is measurement uncertainty, whereas in many circumstances the presence of significant uncertainties can of course make information even more pertinent. We do not therefore support these paragraphs as they stand.

Fundamental qualitative characteristics

27. In responding to previous consultations on the conceptual framework we have queried the division of qualitative characteristics into 'fundamental' and 'enhancing'. We remain unconvinced that this is a useful distinction.

28. We note that the quality of 'transparency' is not mentioned in the ED. In practice, it is often referred to in the context of good financial reporting. At the IASB's first research conference, in Oxford in 2014, a paper showed that preparers frequently refer to transparency in the context of policy changes under IAS 8.[1] We think that transparency could usefully be discussed as part of faithful representation.

[1] C. W. Nobes and C. Stadler, 'The qualitative characteristics of financial information and managers' accounting decisions: evidence from IFRS policy changes', *Accounting and Business Research* (2015).

Other comments

29. We also have other comments on Chapters 1 and 2, particularly in relation to 'fair presentation' and 'true and fair view', which we set out in response to Question 18.

Chapter 3: Financial statements and the reporting entity

Q2: 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?

Description of a reporting entity

30. The definition of a reporting entity is not particularly useful, and it is indeed somewhat circular in that it refers to 'general purpose financial statements' whose definition in turn refers to reporting entities, but otherwise we have no objection to it.

Boundary of a reporting entity

31. The IASB's 2010 ED on the reporting entity (prepared jointly with the US Financial Accounting Standards Board) contained useful material on joint control and significant influence, explaining that they are not in fact forms of control. This has not been carried through to the current ED, and we think that it should be put into the framework.

32. We also have other comments on this chapter, which we raise in response to Question 18.

Chapter 4: The elements of financial statements

Q3: 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?

Asset and economic resource

33. We agree with the definitions of an asset and an economic resource. However, we have a couple of points on the discussion of these terms in the ED, which we raise in response to Question 5.

Liability

34. We do not agree with the definition of a liability, which in general we think is too narrow. If the proposed definition is strictly interpreted, items that are now, rightly in our view, regarded as liabilities would not be recognised. We believe that it may be necessary to define liabilities as comprising three categories:

- legally enforceable obligations;
- constructive obligations; and
- certain other planned future outflows arising from past events.

The third category would be intended to cover liabilities related to expenses such as levies, bonuses and some pension costs that are incurred in earning the income of the accounting period, but that do not necessarily give rise to what can be regarded as a 'present obligation' (see Question 4 below), in the ordinary sense of these words, at the balance sheet date. The point at which an entity has 'no practical ability' to avoid a transfer will not necessarily coincide with the accounting period that ought to reflect the consumption of the benefits received.

35. We therefore believe that, unless an approach along the lines we suggest is adopted, there is a risk that either:

- in order to comply with the ED's definition of 'liability', significant expenses would not be recognised in the relevant accounting period, with the result that the income statement would give less useful information, both for assessing performance during the period and for forecasting future performance; or
- in order to recognise expenses in the relevant accounting period, significant liabilities that do not comply with the DP's definition would be recognised.

Clearly, the exact wording of the third category will need careful consideration by the IASB so as to limit its scope to that intended.

36. There may also be circumstances, though, in which the definition in the ED is too broad and, because an item meets the definition of a liability, expenses relating to a later period are recognised in the current period. We discuss this point under Question 4 below.

37. For some items in the third category of obligation that we suggest above it may be difficult to identify a benefit received – in the case of levies, for example. This seems to us to be a lacuna in the conceptual framework, which in general assumes a commercial basis for transactions, ie, that payments are made for benefits received. This is not always the case, and it would be helpful for the framework to discuss items such as levies and taxes that come into the category of non-reciprocal transactions, but which are important features of business activity.

38. The *Basis for Conclusions* (BC4.92) indicates that it is expected that executory contracts measured at historical cost will not usually give rise to a liability. It would be useful to broaden the concept of executory contracts to cover other executory arrangements, so that it would include non-reciprocal transactions such as the payment of levies and taxes. This would help to deal with the problem that we identify below (Question 4) that there is a risk that levies relating to future periods would have to be treated as liabilities before the period to which they relate. Such arrangements might reasonably be viewed as executory.

Equity

39. We agree with the definition of equity, but at paragraph 4.44 the statement that equity claims are 'claims against the entity that do not meet the definition of a liability' should presumably be 'recognised claims against the entity that are not **recognised** as liabilities' as it is what is in the accounts that matters.

Income and expenses

40. We do not agree with the definitions of 'income' and 'expenses'. As stated in our response to the DP, both definitions have the wrong focus. Income is an increase in equity (not an increase in assets or decrease in liabilities) and expenses are a decrease in equity (not a decrease in assets or an increase in liabilities).

41. The definitions also need to be able to cope with remeasurements and changes in estimates. For example, if an impairment expense is subsequently reversed, this is in practice treated as a negative expense, but under paragraph 4.48 it should be income. Conversely, if variable revenue is initially estimated, but the estimate is subsequently revised downwards, this is in practice treated as negative income, but under paragraph 4.49 it should be an expense.

42. Under IFRS 2, *Share-based Payment*, equity-settled share-based remuneration is reported as an expense. However, it appears at first sight not to fit the ED's definition, because there is no increase in a liability. Indeed, because the services received are momentarily assets under

paragraph 4.9 (see Question 5 below), the receipt of the services appears to meet the definition of income. It would then be possible to see the **consumption** of the services as an expense (caused by the reduction in the momentary asset). This suggests that there is a problem with the definitions.

43. We are also concerned that, unless our view on liabilities (set out above) is accepted, these definitions would give insufficient weight to the income statement. For example, as we discuss in relation to liabilities, it is important to reflect expenses as they are incurred (ie, when benefits are received and consumed), even if they do not give rise to liabilities as defined in the ED at the moment they are incurred.

Q4: 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?

44. As we have stated above, we do not agree with the definition of 'liability', which in general we consider to be too narrow, although in some circumstances it may be too wide. The definition of 'present obligation' might offer an opportunity to mitigate some of that narrowness, and the discussion of constructive obligations (paragraph 4.34) does so to some extent, but not enough in our view. The key words are that 'the entity has no practical ability to avoid the transfer'. We believe that this is narrower than is appropriate in order to provide useful information and is indeed incompatible with current practice, eg, in applying IFRS 2 and IAS 19, *Employee Benefits*, in cases where accrued benefits are unvested but expected to be paid.

45. Commercial arrangements sometimes allow scope for an entity to avoid paying for benefits that it has already received and consumed, but only by triggering undesirable economic consequences. For example, an entity might be able to avoid paying a bonus to a particular employee by terminating her employment, but may fully intend to pay the bonus because the employee's services are worth retaining. In such circumstances, we think that users of financial statements are better served if the expense associated with the benefit is reflected in the period in which the benefit is consumed (ie, when the services are received), rather than in a later period when the entity can no longer avoid the outflow. As noted in our response to Question 3, there may be occasions – eg, in relation to levies – when it is difficult to identify a benefit received, and the conceptual framework needs to address such situations more generally as well as in relation to liabilities specifically.

46. There may also be instances, though, where the definition of present obligation is too broad. Paragraph 4.36 states that an 'An entity has a present obligation as a result of a past event only if it has already received the economic benefits, or conducted the activities, that establish the extent of its obligation.' In practice, it may be difficult to establish whether a relevant past event has taken place, with the result that recognition is unintentionally broadened and entities are effectively required to recognise a liability whenever they have no practical ability to avoid a transfer. For example, impending legislation in the EU is expected to impose levies on banks over a period of, say, 10 years. We are concerned that the full 10 years' worth of levies would meet the definition of a liability from the moment that the scheme becomes mandatory, which would in our view allocate the charge among the periods to which it relates in a misleading way. We have suggested above, in response to Question 3, that it would be helpful to extend the concept of executory contracts to other arrangements such as levies, which might provide a conceptual basis for a solution to this problem.

Q5: 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.

47. We are not convinced by the statement at paragraph 4.9 that 'Goods or services … that are received and immediately consumed are momentarily rights to obtain economic benefits …' We believe that, in some circumstances, entities may receive and consume benefits without ever having had the power to insist that the benefits are provided. For example, an entity may

pay to obtain access to potential customers in the hope that they will make purchases, but it has no power to require that they do.

48. We do not agree with the discussion of ‘economic resource’ at paragraph 4.10. Roads etc are economic resources. The reason they are not assets of an entity is that they are not controlled by it, and the discussion of this point therefore belongs under the heading of ‘Control’ rather than ‘Rights’.

Chapter 5: Recognition and derecognition

Q6: 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?

49. We broadly support the ED’s approach to recognition, but have two concerns. Paragraph 4.62(a) misses one of the key reasons to adopt a portfolio approach, which is greater measurement precision. For example, whether a provision for returns should be made may be effectively impossible to calculate if an item is considered in isolation, but may well be statistically feasible for a population of items.

50. We are not sure that the approach described in paragraph 4.62(b) is compatible with the proposed exemption for small asset leases in the current proposals for lease accounting. Would paragraph 4.62(b) imply that small asset leases should be brought within the scope of the new standard where they are material in total? We think that the unit of measurement issue should be addressed more comprehensively, perhaps again differentiating between when standard setters should deal with it in standards as opposed to when preparers of financial statements should consider it.

Q7: 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?

51. We broadly support the ED’s approach to derecognition, but we think that it would be useful to include some discussion of the implications of substance over form for this subject. The ED’s approach would in effect leave decisions on derecognition to individual standards, and the problem of how the substance of a bundle of related transactions should be interpreted is one that the IASB will face in deciding derecognition issues in standards.

52. Paragraphs 5.30-5.32 discuss situations in which, although an asset or a component of an asset has been transferred, derecognition might be inappropriate. Not derecognising in such cases would on the face of it result in the continuing recognition of assets (or components of assets) that no longer meet the definition of assets. But if the substance of the transaction is considered, it may be easier to justify continuing recognition. For example, if a single transaction combines a sale of an item with an agreement to repurchase it, as discussed at paragraph 5.30(b), then its legal form will consist of those two elements. However, if the substance is considered in terms of changes to rights and obligations, then it may instead be analysed either as a transfer of a right of use for a period of time or as the provision of security for a borrowing.

Chapter 6: Measurement

Q8: 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?

53. We believe that the description of measurement bases in the ED needs more thought, including consideration of how the bases in the ED fit with the IASB's own measurement requirements in recent standards such as IFRS 9 and IFRS 15.

54. We do not think that the ED has identified all relevant measurement bases or categorised them in the most helpful way. It would be difficult to establish an exhaustive list of the different measurement bases used in IFRS as sometimes the approach to measurement for a particular item does not fit any of the traditional bases. It is not clear, for example, how the basis of measurement for an amount of variable consideration set out at paragraph 56 of IFRS 15 should be described.

55. We can see some merit in dividing measurement bases into two broad categories. However, dividing them between 'historical cost' and 'current value' does not seem to be the best approach as, in the ED, it results in current cost – widely known as one of the measurement bases used in a form of current value accounting ('deprival value') – being discussed under the heading of historical cost. A better division would be between entry values and exit values; historical cost and current cost would then fall into the entry value category (as is recognised at paragraph 6.18 of the ED) and fair value, value in use and fulfilment value into the exit value category. This approach would also remove the problem in the ED that it is compelled to discuss the 'cost' of a liability, which seems to be inapt given that liabilities have the reverse of a cost, ie, proceeds. Alternatively, the two headings could be 'historical values' and 'current values'. However, we can see the advantages of discussing historical cost and current cost together.

56. We believe that it would be helpful for the framework to deal with complex measurement bases, which are common in financial reporting, but not discussed as such in the ED. So-called 'historical cost' under IFRS includes such complex bases as 'lower of cost and net realisable value' and 'lower of cost and recoverable amount'. So that in practice what is regarded as a historical cost measurement is often a current exit value, such as fair value or net realisable value or value in use. Deprival value is also a complex measurement basis, being the lower of replacement cost and recoverable amount, which is the higher of net selling price and value in use. A partial version of this is the measurement basis for impaired assets under IAS 36, *Impairment of Assets*.

57. The concept of 'cost of release' for liabilities is not discussed in the ED because, according to the *Basis for Conclusions* (paragraph BC6.30(b)), release from a liability is 'relatively unusual'. We do not think that release from liabilities is unusual. It occurs, for example, in litigation settlements, when contract terms are modified, and when members leave pension schemes. It is therefore common enough to deserve discussion in the conceptual framework. (Paragraphs 6.34 to 6.46, which discuss fulfilment value, are the relevant section of the ED.)

58. The unit of account, referred to at Question 6 above in relation to recognition, is also relevant to measurement issues. Items are or may be grouped for measurement purposes under, for example, IAS 36 (cash-generating units), and IFRS 9 (portfolio hedges of interest rate risk and measurement of expected losses on a 'collective' basis or using a group of financial instruments). The discussion in the framework needs to give some indication of when it would or would not be appropriate to use such an approach. This is a key issue for both standard setters and preparers.

59. It would be useful if the framework could include some discussion of fungible items and how they should be measured so as to avoid 'cherry picking' items to give a desired result. We envisage that this would include a discussion of FIFO (first in, first out) and other methods of measuring inventories.

60. Paragraph 6.8(c) of the ED may give the impression that any amount recognised for an onerous liability is added to an existing liability, when in fact it may need to be recognised as a separate item.

61. It is not clear why paragraph 6.25 (recognition of income from the risk premium element of a liability) is in the ED, especially as its concluding sentence seems to have uncertain

implications. Is the suggestion that, as users may find the practice described counterintuitive, it should not be adopted or that it should be adopted and users need to get used to it?

62. Referring to paragraph 6.29(b), we are unable to think of circumstances in which income and expenses measured at fair value (not an extensive group) could usefully be analysed so as to provide information about 'the efficiency with which the entity has used the asset'. With the exception of biological items, assets held at fair value are not usually held for use, and changes in fair value of assets not held for use follow a random walk; they do not show efficiency of use. This point in the ED may therefore be redundant.

63. We disagree with the statement at paragraph 6.59 that 'timeliness has no specific implications for measurement'. Its implications vary from instance to instance, but some measurement techniques take longer than others, reducing the timeliness of the information they provide and of the accounts as a whole.

64. Paragraph 6.69 states that 'If an entity receives an asset from a holder of an existing or new equity claim, it would normally be appropriate … to measure the asset initially at a current value'. We do not think that this is correct. If 'momentary assets' (see Question 5 above) are included, share-based payments are probably the commonest example of such transactions, but it is doubtful whether such services really are assets. For assets as they are more usually understood, the most frequent transactions in this category are probably intra-group transfers, which are commonly recorded at book value (a historical amount), rather than at a current value.

65. We also note that the tone of paragraph 6.69 differs from that of the rest of the chapter as it seems to be giving a solution and not setting out considerations that the IASB would take into account in preparing standards.

Q9: 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?

66. We have nothing to add to our response to Question 8.

Q10: 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?

67. We disagree with the approach set out in the ED. In our view it is important to retain the articulation between the statement of financial position and the income statement as a basic principle of accounting. This implies that any item in the accounts should be measured on just one basis. Income and expenses arising from the chosen measurement basis may, nonetheless, be analysed into component parts in the income statement and OCI where this provides useful information. Such an analysis might use different measurement bases for identifying component parts, but other criteria may also be relevant. Requirements to provide an analysis of income should be stipulated as appropriate in the relevant standards.

Chapter 7: Presentation and disclosure

Q11: 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?

68. Considering the importance of disclosure in IFRS financial reporting, the subject does not seem to be given due weight in the ED. The lack of material in the ED may be because the IASB proposes to discuss the subject more fully in a separate disclosure framework. We suggest that either disclosure should be given a fuller discussion in the conceptual framework, including some high-level principles to indicate when disclosures will be required, or the conceptual framework should state that the subject is/will be discussed more fully in a separate disclosure framework. At the moment, there is a risk that disclosure requirements in standards

can be compensation for those who lose the argument on recognition or measurement questions, rather than based on underlying principles.

69. Paragraph 7.3(a) states that information in the notes includes information about unrecognised elements and the risk arising from them. This is true in some cases (when specified by standards), but not in others, and it would be useful to distinguish between the two in the framework. For example, we would expect the notes to contain this sort of information for contingent liabilities, but not for internally generated intangibles.

70. Paragraph 7.13 discusses offsetting of assets and liabilities. It would be useful to extend the discussion to include some high-level guidance on items in the income statement and the statement of cash flows. For example, it may be appropriate to offset items that are inherently similar, but some positive and some negative, and inappropriate to offset items that are inherently dissimilar. The key consideration should be whether offsetting produces more useful information.

Q12: 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.

71. As we indicated in our response to the DP, we do not think that it is necessary to provide a definition of profit or loss. However, given that the IASB intends to distinguish profit or loss from OCI, we do believe that the framework should at least explain the objective of profit or loss. The ED does this at paragraph 7.20 and, in slightly different words, at paragraph 7.22. While we have no strong objection to the description provided there, we do not think that the ED's proposals on OCI or recycling, on which we comment below, fit the approach to profit or loss implied by the description.

72. In our view, the description at 7.20 could in any case be improved by incorporating some of the wording at paragraph 7.21 into the description, rather than – as at present – adding it as an afterthought. This would mean, we suggest, stating at 7.20 that profit or loss measures financial performance for the period. This is perhaps implicit in 7.20's statement that it 'depicts the return … during the period', but it is a somewhat obscure way of expressing the thought.

Q13: 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?

73. Assuming that a concept of OCI is to be required, then the ED makes useful progress in tackling the question of what should be included in it, although we continue to believe that a more principled approach to this issue is required. If the description of the objective of profit or loss given at paragraph 7.20 (clarified as we suggest above) were applied in deciding what should go to OCI, it would not, in our view, lead to the proposals in the ED.

74. We believe that OCI should be restricted to items that neither help to measure the current year's performance nor help to estimate future performance. These are, of course, vague concepts, as are any other concepts proposed in this area. However, we think that the list might typically include only:

- gains on the revaluation of PPE;
- gains on the sale of PPE, except where they are in substance corrections of accumulated depreciation;
- foreign currency translation adjustments on foreign subsidiaries;
- actuarial gains and losses on a defined benefit pension scheme; and

- fair value gains and losses on effective hedges.

This is, of course, similar to the list under current IFRS practice, except that it includes gains on the sale of certain types of PPE. This category might typically be land and buildings that have risen in value, partly because they are not consumed or not wholly consumed by the entity.

75. We believe that more work is needed on these concepts. For example, under current IFRS, depreciation, impairments, losses on revaluation and gains/losses on sale go to profit or loss, but revaluation gains go to OCI. It is not clear which principle in the present framework or in the ED would support this. We do not see why gains on the sale of PPE are ‘performance’ or help to estimate future performance. In developing a more soundly based approach to what should be included in profit or loss or OCI it may be useful to refer to an entity’s business model and to consider whether gains or losses help to show the success or failure of that model (in which case they probably belong in profit or loss) or are irrelevant to that judgement (in which case they probably belong in OCI).

76. Even if the approach we suggest is not adopted, we believe that the approach proposed at paragraph 7.24 as to what should be included in OCI is too restrictive. It would mean, for example, that foreign currency translation adjustments on foreign subsidiaries would be included in profit or loss rather than OCI, which would in our view make the profit for the year a less useful measure. This particular issue could be solved by adding the words ‘(including current exchange rates)’ after ‘current value’ in 7.24(a).

Q14: 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?

77. We do not agree that there should be a rebuttable presumption that all income and expenses recognised in OCI should subsequently be recycled to profit or loss. Of the items identified above that we believe should be recognised in OCI, in our view only fair value gains and losses on effective hedges should be recycled to profit or loss. This is because they would be recycled at the point that they become relevant to measuring performance for the period. There is no time at which the other items we have identified would be relevant to measuring performance for the period or to predicting future performance. For example, we do not see how it is helpful to a user’s assessment of current performance to include in profit or loss the accumulated foreign currency translation adjustments on a foreign subsidiary at the time it is sold when those gains and losses might have been accruing over decades.

78. We also note that users can be confused by the appearance of recycled items in profit or loss. For example, under IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, a loss on a disposal group that is about to be sold will be recognised in profit or loss. When, in the next period, the unit is actually sold, gains or losses relating to the unit, but arising in prior years on foreign currency translation or non-controlling interests, will be recycled to profit or loss. Users either find this information difficult to understand, as they thought that the loss on disposal had already been accounted for in the previous period, or they find it useless when they do understand it.

79. We believe that those who support more extensive recycling do so at least partly because they are concerned to have a cumulative figure of profit that includes all realised gains to date. We suggest that this could be achieved by transfers between reserves when items are realised, assuming that a robust definition of ‘realised’ can be internationally agreed, which we doubt. This would achieve the desired result without contaminating either the measure of current performance or the basis for forecasting future performance.

Other questions for respondents

Q15: Effects of the proposed changes to the Conceptual Framework

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?

80. We are not confident that the *Basis for Conclusions* has identified all potential inconsistencies between the ED and existing standards, and in this response we have raised a number of questions on issues where inconsistencies may arise.

Q16: Business activities

Do you agree with the proposed approach to business activities? Why or why not?

81. We agree with the ED's proposed approach to business activities. Business models already play a significant role in financial reporting. We support this and believe it should continue. We believe that the ED as drafted will allow this, without building into the framework an excessive role for business models.

Q17: Long-term investment

Do you agree with the IASB's conclusions on long-term investment? Why or why not?

82. We agree with the IASB's conclusions on long-term investment, and that there is no reason to think that long-term investors' information needs differ significantly from those of short-term investors if they are both making decisions based on underlying fundamentals of performance through financial analysis, rather than taking bets on market movements or rumours.

Q18: Other comments

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.

Chapter 1: The objective of general purpose financial reporting

83. We do not think that paragraph 1.2 provides a good description of the objective of general purpose financial reporting. It stretches the meaning of 'providing resources' to treat it as including buying and selling shares or debt in secondary markets. And it clearly does not include decisions about management appointments and remuneration. We suggest that the first sentence of paragraph 1.2 should stop after the words 'making decisions' and that the second sentence should be expanded to cover decisions about management appointments and remuneration.

84. The concept of 'fair presentation' appears in IAS 1, *Presentation of Financial Statements*, and IAS 8, but not in the ED. It seems to us to be a fundamental concept in financial reporting; it would be helpful if the framework were to discuss it and its relationship to faithful representation. It would also be helpful to confirm that fair presentation is considered by the IASB to mean the same as 'true and fair view', a concept that occurs in the law of many jurisdictions that have adopted IFRS. These points were included in the original, 1989 version of the framework (at paragraph 46), and we would welcome their re-appearance.

85. The last sentence of paragraph 1.13 is unconvincing as IFRS deals primarily with consolidated accounts, whereas understanding how future cash flows will be distributed among those with a claim against the reporting entity often depends on information in the entity accounts. It is a problem in this connection that IFRS does not really have a concept of entity accounts; IAS 27, *Separate Financial Statements*, does not address the issue.

Chapter 2: Qualitative characteristics of useful financial information

86. The discussion of 'understandability' at paragraphs 2.33-2.35 makes no mention of disclosure, yet a key purpose of disclosure is to make information more understandable. We think this discussion would be significantly improved if it referred to the role of disclosure.

87. The 2010 version of the conceptual framework deleted the words in the 1989 version saying that 'users are assumed to have a reasonable knowledge of … accounting'. We think that this change was unhelpful and that the reference to a reasonable knowledge of accounting should be reinstated. Financial reporting is full of information that may well be incomprehensible to, or easily misunderstood by, those who have no knowledge of accounting, and it would be misleading to pretend that such a reader could understand it all.

Chapter 3: Financial statements and the reporting entity

88. The IASB could usefully articulate the extent to which its standards should deal with separate financial statements, as opposed to leaving certain issues to market practice as they are not significant to the parties that are interested in the reporting entity at the consolidated level. This could also consider the position of minority interests. Also, the question of intra-group transactions is not addressed in the ED, but we believe that it would be useful for the conceptual framework to set out how the IASB will take such transactions – in particular, off-market, non-reciprocal intra-group transactions – into account in setting standards. The discussion of 'relevance' at paragraphs 6.53-6.56, for example, could also usefully refer to this topic. The key point is that the benefits of financial reporting information arising from intra-group transactions are usually limited as users normally rely on the group accounts.

Chapter 5: Recognition and derecognition

89. Paragraph 5.21(b) states that a measurement may not provide relevant information if it 'requires unusually difficult … allocations of cash flows that do not relate solely to the item being measured'. We do not see why the difficulty of a measurement would affect its relevance.

Chapter 8: Concepts of capital and capital maintenance

90. Chapter 8 does not deal properly with the question of capital maintenance, and in our view it should be deleted as it adds nothing useful to the conceptual framework. While capital maintenance is an important issue for all companies, this chapter appears to have been drafted in the context of IAS 29, *Financial Reporting in Hyperinflationary Economies*, which is the only IFRS standard to refer to physical capital maintenance and the current cost basis of measurement. This standard is of limited application.
91. Paragraphs 8.1 and 8.2 imply that companies generally have a choice between physical and financial capital maintenance concepts. This is not in fact the case as, except in IAS 29, IFRS assumes a financial capital maintenance concept.

MINOR DRAFTING POINTS

Chapter 3: Financial statements and the reporting entity

92. Paragraph 3.23 may be taken to suggest that unconsolidated financial statements are unlikely to provide useful information. We think it would be preferable to say that both can provide useful information, although in general consolidated financial statements will provide more useful information.

Chapter 4: The elements of financial statements

93. The penultimate box in the table at paragraph 4.4, 'Contributions from, and distributions to, holders of equity claims', should in our view be given the sub-heading 'Other' and added to the previous category, whose heading should be changed to 'Financial performance and other changes in resources and claims'.
94. It would be helpful to clarify at paragraph 4.22 whether exposure to significant variations in the amount of economic benefits is potentially evidence that the entity controls the resource or is merely a reason to look for such evidence. We think the latter.
95. The penultimate word of paragraph 4.41 should be 'is' not 'in'.
96. We think that the unexplained appearance of 'equity claims' (paragraph 4.44) immediately after the definition of equity could cause some confusion and we suggest that the meaning of the term should be explained at this point.

Chapter 5: Recognition and derecognition

97. In the diagram at paragraph 5.5, 'holders of' should be inserted before the final 'equity claims'.

98. It would be helpful to clarify at paragraph 5.29 whether exposure to positive or negative variations in the amount of economic benefits is potentially evidence that the entity controls the resource or is merely a reason to look for such evidence. We think the latter.

Chapter 6: Measurement

99. Paragraph 6.33 would be clearer if it began '**Even** if an entity is estimating the fair value of a specialised item'.

Chapter 7: Presentation and disclosure

100. It could be added at paragraph 7.7 that comparative information about preceding periods is particularly relevant when there have been restatements.

101. Paragraph 7.18 could usefully mention cross-referencing.

Chapter 8: Concepts of capital and capital maintenance

102. Paragraphs 8.4, 8.7 and 8.10 refer to 'capital maintenance adjustments', but these are not used in IFRS except under the most unusual circumstances of IAS 29.