German Banking Industry Committee

Die Deutsche Kreditwirtschaft

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Our ref: EE/CK
Ref. DK: IASB
Ref. DSGV: 8006

24. November 2015

Comments by the German Banking Industry Committee regarding Exposure Draft ED/2015/3 Conceptual Framework for Financial Reporting

Dear Mr Hoogervorst,

We are pleased to be given this opportunity to comment on the aforestated IASB Exposure Draft.

Just like the IASB, we see the Conceptual Framework as an important basis for the future preparation and presentation of financial statements and for developing new and revising existing standards.

With a view to some of the proposals put forward by the IASB, however, we do see need for revision and clarification which we will address in the following. In doing so, we have focused on what we consider to be the key aspects of the Conceptual Framework.

We generally consider the reintroduction of "prudence" to be acceptable in order to avoid arbitrary overstatement of assets and income or understatement of liabilities and expenses.

With a view to the revision of the definition of "liabilities" or "present obligation", it is not clear what is meant by "economic consequences significantly more adverse than the transfer itself". We believe that a new definition of "liability" should first undergo comprehensive examination with a view to its effects before being included in the Conceptual Framework.

We would like to once again emphasize the importance of the respective business model of a company with a view to its control and measurement of assets/liabilities and due to this the importance of anchoring the business-model concept in the Conceptual Framework.

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The following pages contain our detailed comments on the individual questions regarding the Exposure Draft.

Yours sincerely,
on behalf of the German Banking Industry Committee
German Savings Banks Association

by proxy | by proxy

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Details comments

Question 1—Proposed changes to Chapters 1 and 2: amendments to the existing CF
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;

The inclusion of "stewardship" and the IASB's explanation for this are understandable. The IASB defines "stewardship" as a sub-goal of decision usefulness. We believe, however, that it cannot be fully ruled out that these two goals may compete with each other and that the goals could ultimately diverge. It could hence be useful for the IASB to discuss in detail in the final Framework how these two goals interact.

Investors with a long-term perspective are especially interested in the accountability function as an independent function of financial reporting. The Conceptual Framework should hence clearly express this function.

(b) to reintroduce an explicit reference to the notion of prudence (described as caution when making judgments under conditions of uncertainty) and to state that prudence is important in achieving neutrality;

The IASB proposes the reintroduction of prudence in order to avoid deliberate overstatement of assets and income or understatement of liabilities and expenses ("cautious prudence"). We believe that this reflects the status quo to date, even though there is currently no explicit reference to "prudence" in the Conceptual Framework. With this in mind, we consider the reintroduction of prudence to be the right approach, also with a view to political discussions. In line with the notion of "cautious prudence", it should be ensured in cases of judgements under conditions of uncertainty that assets and income are not overstated and liabilities and expenses are not understated in the balance sheet. We agree with the IASB that the notion of asymmetric prudence, i.e. whereby losses are generally to be recognised at an earlier point in time, must be rejected. This would be in contradiction with the principle of neutrality.

(c) to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;

Even if the economic substance should be considered with a view to faithful representation, the legal form should not be omitted. We therefore propose that the wording be revised in order to prevent any misinterpretation. The wording proposed in the ED could be misunderstood to mean that the economic substance of a business transaction can be determined irrespective of the contractually agreed wording. We strongly believe that the economic substance cannot be considered independently of the legal aspects of an item in the financial statement.

In this context, we would like to note that para. 4.54 of the ED could be inconsistent with IFRS 9. The latter states that non-contractual components of a transaction should be considered as if they were contractual components. IFRS 9 B4.1.13 (Instrument E), on the other hand, states that a legislative power, which is not explicitly a contractual component, may not be taken into account if such payment flows are solely payments of interest and principal. We believe that it makes sense to discuss/examine in more detail interaction between "substance over form" and the accounting rules for reporting financial instruments.

(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

No comment.

(e) to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?

We agree.

Question 2—Description and boundary of a reporting entity: new chapter
Do you agree with:
(a) the proposed description of a reporting entity in paragraphs 3.11–3.12; and

No comment.

(b) the discussion of the boundary of a reporting entity in paragraphs 3.13–3.25?

We do not believe that consolidated financial statements provide generally more useful information than unconsolidated financial statements. Decisive for relevance is the respective purpose for which the financial statements were drawn up.

Question 3—Definitions of elements: new chapter
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;

We generally welcome any clarification or more precise definitions. However, we cannot finally assess whether or not the changed definition would lead to an improvement compared to the status quo. It is questionable whether the changed definition would lead to a broader definition of assets since the "potential to produce economic benefits" is not the same as the current expectation ("expected").

(b) a liability;

See answer to question 4.

(c) equity;

We agree with the (unchanged) definition of equity. In light of the research project to distinguish between equity and liabilities, however, it is not clear why the IASB is proposing in the Conceptual Framework changes in the definition of liabilities because, according to the IASB, these may have to be adjusted again after the research project has been concluded. Furthermore, decisions to define "liability" now anchored in the Conceptual Framework could either forestall or pre-determine discussions in the research project.
Changes here should not take place until after the announced research project has been concluded.

(d) income; and
(e) expenses?

No comment.

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

The IASB defines a present obligation as "...no practical ability to avoid the transfer" and the obligation has arisen from past events. The scope of the obligation is determined by previously conducted activities or by a flow of benefits already received. We believe, however, that these statements by the IASB still need to be clarified.

It is not clear, for instance, what is meant by "economic consequences significantly more adverse than the transfer itself" so that it is not completely clear when a liability exists (e.g. in the case of legal disputes or the matter of a bank levy). The proposals in the ED can be read as a clear expansion of debts that can be carried in the balance sheet. It could therefore make sense to keep to the wording that includes the term "expected". "A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

The implications of the new paragraph 4.34 ("Obligations can also arise from an entity's customary practices") are also unclear and seem to refer to constructive obligations. Based on the wording and the systematology, however, these details apply to all liabilities (and hence also to financial liabilities).

Banks customarily issue equity instruments that come with a right of termination for the issuer. If these equity instruments are regularly prematurely paid back, are these instruments then liabilities because the repayment is the "entity's customary practice"?

Co-operative entities issue co-operative shares as equity. The co-operative member has the opportunity to apply to the bank to pay back his share. According to their statutes, German co-operative banks have an "unconditional right to refuse redemption", however, they do in practice pay back the equity shares following request by the member. Are co-operative shares then liabilities within the meaning of the ED because repayment is the "entity's customary practice"? Or does the "legal right" in this case correspond to "practical ability"?

Within the Conceptual Framework the statements regarding the "practical ability to avoid the transfer" do not lead to a sensible result; the term might be appropriate in an accounting standard for provisions and contingent liabilities. A standard could contain more precise descriptions about when the legal situation should be overruled by the "practical ability".

Therefore, the details regarding "practical ability to avoid the transfer" are, in our opinion, **not suitable as a superseding definition of all liabilities**. We are in favour of maintaining the current definition of liabilities until after the planned research project has been concluded.

We hence believe that it makes sense for the IASB to first test the definition of "liability" on the basis of various issues/cases with a view to its impacts and examine whether an improvement can be achieved compared to the current definition. It may also make sense to keep the term "expected". "A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

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

No comment.

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

The probability of an inflow or outflow of economic benefits should be maintained as a recognition criterion. The probability approach is a practical means of already filtering during recognition assets and debts with low probability which are difficult to identify and measure.

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

The ED states that as a rule derecognition is carried out when a company loses control of an asset. In our opinion, this reflects the existing rules for assets in too brief a form because the transfer of all risks and rewards must be examined in advance.

Question 8—Measurement bases
Has the IASB:
(a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?

(b) properly described the information provided by each of the measurement bases, and their advantages and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?

In principle, both measurement bases are correctly described, however, the Conceptual Framework should note that there are also other bases (or intermediate stages of the measurement bases described).

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

At this point it should be added that the respective business model of an entity influences the measurement basis to be selected. We also refer here to the EFRAG discussion paper on "The role of the business model in financial statements" as well our comments on this issue last year.

A properly articulated business model will be helpful in communicating management's understanding of the business to the market. As in entities, the same types of assets and liabilities may be used within different activities and a business model will help in identifying the relevant measurement basis and in applying the proper accounting. Therefore, stakeholders will be able to better understand the different economic contributions that the same types of assets and liabilities may have in an entity's activities.

The business model approach is already being developed within financial reporting, e. g. by the new classification and measurement provisions of IFRS 9 'Financial Instruments'. However, given the wide range of aspects of value creation that the business model affects, a common understanding of the business model concept is needed. Therefore, it is appropriate that this concept also be addressed by the Conceptual Framework. Addressing the business model on a conceptual level would help to take into consideration circumstances that are specific to particular industries that might not be reflected adequately without such business model considerations.

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

We believe that the principle of considering the business model in the measurement in some cases may suggest using different measurement bases in the balance sheet and in the statement of profit and loss. It should hence not be seen to be an exception to consider it relevant to use different measurement bases for one and the same case.

Irrespective of the foregoing, we would like to note that the word "sometimes" is used repeatedly in this section of the ED. It is not clear whether exceptions are being defined here or what the IASB generally wishes to say.

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

The Conceptual Framework should show more clearly which information belongs in the financial statements and the notes to the financial statements and which information belongs in the other reports, such as the management report. The aim of the Conceptual Framework should be to avoid any overburdening of the financial report, for instance, with elements related to risk reporting.

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

- *Are differences between the two elements of comprehensive income clearly articulated?*
- *What criteria would be helpful for the recognition of amounts in OCI?*

We agree with the current description. However, we would like to generally note that there is still no real concept to distinguish between profit and loss and OCI or to define "performance". The proposals put forward by EFRAG in its bulletin could provide a basis for further considerations (see also our comments regarding the business model in conjunction with questions 9, 10 and 16).

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

See answer to question 12.

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

We support the possibility of recycling.

Question 15—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?

No comment.

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

We refer here to our comments on the 2014 Discussion Paper and our response to question 9. The notion of 'business model' is already (explicitly or implicitly) employed in certain financial reporting contexts, and illustrates its relevance. In summary, using a business model approach is an effective way for entities to present financial information to investors in a way that is appropriate to that entity's operating environment. Consequently, we are in favour of recognising this notion within the Conceptual Framework, and on a standard-by-standard-basis as appropriate. Recognising the business model in a standard setting should lead to the creation of financial information that is more relevant to how the entity operates in its economic environment and provides a more faithful representation of an entity's financial position and performance.

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

No comment.

Question 18—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.

No comment.