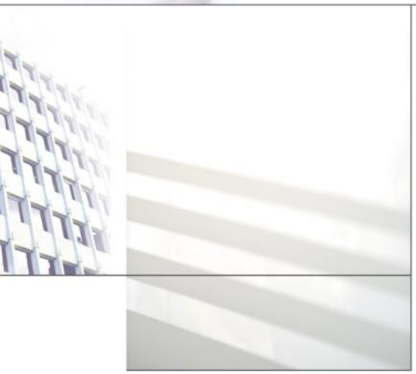

EFRAG

European Financial Reporting Advisory Group

# EFRAG’s preliminary position on the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*

Draft comment letter 26 September 2013

# *EFRAG's overall assessment (1/3)*

| | **EFRAG preliminary position** |
|---|---|
| *The project and the approach* | EFRAG welcomes that the IASB has initiated a project on improving its Conceptual Framework. EFRAG also appreciates the work the IASB has done in analysing areas that have proven problematic in the past and we support the practical approach taken in the project which is focusing on these difficult areas. EFRAG also agrees with explicitly limiting the scope of the project to financial statements. |
| *Chapters 1 and 3* | EFRAG disagrees with the IASB approach only to make changes to the existing chapters of the Conceptual Framework if the work on the issues discussed in the DP highlights areas that need clarification or amending. EFRAG does not support how the existing chapters are dealing with stewardship, reliability and prudence. |
| *Stewardship* | EFRAG thinks that providing information that is useful for assessing stewardship is equally essential as providing information that is useful for assessing future net cash flows. The significance attached to assessing stewardship is important as, contrary to what is reflected in the existing Conceptual Framework, the same information may not be the most useful for considering stewardship and evaluating prospects for future cash flows. |

# EFRAG's overall assessment (2/3)

| | EFRAG preliminary position |
|---|---|
| *Reliability* | 'Reliability' should replace 'faithful representation' as a fundamental qualitative characteristic. The Conceptual Framework describes 'faithful representation' as something that can be achieved by disclosures whereas it was acknowledged before the 2010 amendment, when 'reliability' was replaced by 'faithful representation', that there could be a trade-off in recognised amounts between relevance and reliability. Furthermore, EFRAG thinks that verifiability should form part of reliability instead of just being considered an enhancing, albeit unnecessary, qualitative characteristic. |
| *Prudence* | Prudence should be reintroduced and explained in the Conceptual Framework. Prudence is clearly reflected both in Standards in force today and those being developed. EFRAG therefore believes that it is essential to articulate the concept of prudence clearly in the Conceptual Framework in order to ensure that it is applied consistently across both current and future Standards. |
| *The business model* | EFRAG agrees with the DP that financial statements can be made more relevant if the IASB considers how an entity conducts its business activities. |
| *Measurement* | EFRAG agrees with the DP that measurement should reflect how an entity is generating its cash flows. |

# EFRAG's overall assessment (3/3)

| | EFRAG preliminary position |
|---|---|
| *OCI and recycling* | EFRAG agrees with the approach suggested in the DP (Approach 2B) that does not artificially limit the IASB's possibilities for defining the primary performance to be reflected in profit or loss. |
| *Definitions of assets and liabilities* | EFRAG broadly agrees with the proposed definitions of assets and liabilities (subject to testing) and the additional proposed guidance where an obligation is present when it has arisen from past events and is practically unconditional (View 2 of the DP). However, it considers that constructive obligations are defined too narrowly in the proposal. |
| *Recognition* | EFRAG is of the view that uncertainty has a distinct impact on relevance and reliability, and that certain conditions of uncertainty may lead to non-recognition. |
| *Liabilities versus equity* | EFRAG agrees with the definition of equity but does not support the proposals in the DP in relation to 'wealth transfers' to reflect changes in rights and obligations that may be settled by transfer of an entity's equity instruments. |
| *Conflicts with existing standards* | EFRAG is of the view that the IASB could decide on new or revised Standards that conflict with an aspect of the revised Conceptual Framework and that the IASB in these cases should explain the reasons for the departure. In addition to what is proposed in the DP, EFRAG considers that conflicts with existing Standards should be identified. |

# Introduction (Question 1)

| | EFRAG preliminary position |
|---|---|
| *Purpose and status of the Conceptual Framework* | EFRAG generally agrees with the proposal on the purpose and status of the Conceptual Framework, but does not understand why parts of the Conceptual Framework should be for the IASB's use only. EFRAG agrees with the proposal that the IASB could introduce requirements in Standards that could conflict with the Conceptual Framework. |
| *Implications of revising the Conceptual Framework* | EFRAG believes that future conflicts as well as existing conflicts should be identified and explained. Unsupportable conflicts would be natural candidates for projects to be considered as part of the IASB's agenda consultations.<br><br>The IASB will also need to provide clarification as to what the procedure would be when the IFRS Interpretations Committee or others should interpret that requirements that are based on other principles than those of the reviewed Conceptual Framework |

# *Elements of financial statements (Questions 2 - 4) (1/2)*

| | **EFRAG preliminary position** |
|---|---|
| *Definitions of assets and liabilities* | EFRAG believes that the proposed definitions may be easier to understand than the current ones. EFRAG also agrees with the DP that the definitions of assets and liabilities should not include probability thresholds. (EFRAG's comments in relation to probability thresholds for recognition of assets and liabilities are provided below in relation to the questions on recognition). |
| *Definitions of income and expenses* | EFRAG therefore supports that income and expenses are defined on the basis of changes in assets and liabilities as that provides greater clarity for the development of accounting standards without resulting in the statement(s) of profit or loss and other comprehensive income being secondary to the statement of financial position. |
| *Definitions related to equity* | EFRAG believes it would be useful to define contributions to equity, distributions of equity and transfers between classes of equity. |

# *Elements of financial statements (Questions 2 - 4) (2/2)*

| | **EFRAG preliminary position** |
|---|---|
| *Definitions related to the statement of cash flows* | EFRAG does not see any particular benefits in defining cash receipts and cash payments. Instead the IASB should consider what the statement of cash flows should communicate. |
| *Questions to constituents* | EFRAG is currently split on whether the definition of an economic resource should be amended to specify that the right, or other source of value, should be capable of producing economic benefits *to the entity*. EFRAG therefore asks constituents for their views on this issue. |

# *Additional guidance to support the asset and liability definitions (Questions 5 - 7)*

| | **EFRAG preliminary position** |
|---|---|
| *The definitions of liabilities* | EFRAG agrees with the DP that the IASB should retain the existing definition of a liability which encompasses both legal and constructive obligations. |
| *Constructive obligations* | EFRAG thinks that constructive obligations should be defined broader than what is proposed in the DP. We do not agree with the DP that a constructive obligation only exists when an entity has a duty or responsibility to another party or parties that will benefit from the entity fulfilling its duty or responsibility. |
| *'Present' obligation* | The DP discusses when an obligation is 'present'. EFRAG thinks that a present obligation must have arisen from past events and be practically unconditional. |
| *Other guidance* | EFRAG supports the additional guidance provided in the DP on the meaning of 'economic resource'; the meaning of 'control'; the meaning of 'transfer an economic resource'; reporting the substance of contractual rights and contractual obligations; and executory contracts. However, it notes that the definition of control may be different from how some currently interpret the term. In addition EFRAG considers that the Conceptual Framework should provide additional guidance on when economic compulsion should be considered when distinguishing between equity and liability. |

# Recognition and derecognition (Questions 8 and 9) (1/2)

| | EFRAG preliminary position |
|---|---|
| *Questions to constituents* | EFRAG agrees with the DP that relevance and faithful representation should be considered when deciding on recognition of assets and liabilities. EFRAG has not reached a consensus on whether the Conceptual Framework should include probability thresholds in relation to recognition following a three-step approach:<br><br>Step 1: First, it should be considered whether the main component of the asset or liability represents an outcome risk or is linked to an item that represents an outcome risk. If it is, then no probability threshold related to uncertainty should apply.<br><br>Step 2: If the main component of the asset or liability is not an outcome risk, then it should be assessed how reliable/verifiable the probabilities related to various outcomes can be determined. If the probabilities related to various outcomes can be determined with a high degree of reliability/verifiability, then assets and liabilities should only be recognised if it is more likely than not that an expected inflow or outflow will happen.<br><br>Step 3: If the probabilities related to various outcomes cannot be determined with a high degree of reliability/verifiability, then liabilities should be recognised unless the probability of an outflow is remote and an asset should be recognised when the probability of an inflow is virtually certain.<br><br>Do you support the suggested approach, the DP or any other approach? |

# *Recognition and derecognition (Questions 8 and 9) (2/2)*

| | EFRAG preliminary position |
|---|---|
| *Derecognition* | EFRAG supports that proposals included in the DP, but think guidance should be provided on the difference between a modification of an asset or liability and derecognition of an asset or liability and recognition of another. |

# Definition of equity and distinction between liabilities and equity instruments (Question 10) (1/3)

| | EFRAG preliminary position |
|---|---|
| *Definition of equity* | EFRAG supports retaining a split between equity and liability claims and equity being the residual claim on the entity that is not directly measured. However, EFRAG does not believe it is consistent with some of proposals in the DP in relation to primary and secondary equity claims. |
| *Equity being a claim on the entity that is not a liability* | EFRAG believes that it is necessary to determine whether equity should be defined from a proprietary perspective (equity instruments are those held by owners, irrespective of their characteristics) or entity perspective (equity is distinguished based on the characteristics of instruments, and owners are the holders of such instruments).<br><br>EFRAG supports distinguishing equity based on the characteristics of the instruments but at the same time acknowledges the issues this has caused with respect to some basic ownership instruments in Europe (e.g. puttable shares and interests in partnerships).<br><br>EFRAG has made a number of suggestions to ensure that if equity is defined from an entity perspective, the financial statements remain relevant for holders of basic ownership instruments that are liabilities. |
| *Most residual instrument is equity* | EFRAG does not agree with the DP that when no instrument meets the definition of equity, the most residual instrument should be considered equity. Doing so would be in conflict with considering equity from an entity perspective and difficulties may arise in identifying what instrument is 'most residual'. |

# Definition of equity and distinction between liabilities and equity instruments (Question 10) (2/3)

| | EFRAG preliminary position |
|---|---|
| *Obligations to issue equity instruments are not liabilities.* | The DP informally describes two categories of equity:<br>(a) Primary equity claims; and<br>(b) Secondary equity claims.<br>Primary equity claims are equity claims that contain a right to share in distributions in equity, either during the life of an entity or on liquidation but without containing any obligation to transfer either an economic resource (which would make it a liability) or an equity claim (which would make it a secondary equity claim).<br>Secondary equity claims are contractual arrangements that result in the entity being obliged to deliver, or have a contractual right to receive, other equity instruments (which could be either primary or secondary equity claims).<br>EFRAG accepts that secondary equity claims be classified as equity, partly because it can provide important information on cash leverage, and partly because of the problems associated with classifying secondary equity claims where equity instruments would be received as assets (the right would be an asset, but when own equity instruments were received from the counterparty, this would be a reduction in equity and net assets). |

# Definition of equity and distinction between liabilities and equity instruments (Question 10) (3/3)

| | EFRAG preliminary position |
|---|---|
| *'Wealth transfers'* | EFRAG agrees that the various primary equity claims on an entity should be portrayed based on claims on recognised net assets (similar to NCI currently) and believes this is a logical consequence of defining equity as the residual.<br><br>EFRAG does not support the proposals with respect to secondary equity claims or the use of a notion of a wealth transfer to describe changes in equity claims. EFRAG thinks that secondary equity claims (being contractual obligations to deliver, or rights to receive, primary equity claims) should be measured as if they were assets and liabilities, with changes recognised in comprehensive income.<br><br>These secondary equity claims could relate to an entity's trading, borrowing and investing activities and EFRAG thinks that it would be inappropriate for them to be described as transactions with owners instead of being reflected in comprehensive income |

# Measurement (Questions 11 - 15) (1/3)

| | **EFRAG preliminary position** |
|---|---|
| *Objective of measurement* | EFRAG agrees with the proposed objective of measurement and the supportive guidance, but wonders in what way this objective in substance differs from the general objective of financial reporting, the objective of recognition or the objective of presentation. |
| *Focus on both SFP&SCI* | EFRAG supports the view that when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI. |
| *Business model* | EFRAG believes that the business model should also play an important role in selecting the appropriate measurement basis. Considering the business model (i.e. how the asset contributes to future cash flows and for a particular liability how the entity will settle or otherwise fulfil that liability) for measurement purposes would help users to better understand the financial performance of an asset (or a group of assets) in comparison with the expected outcome. |
| *Linkage with presentation* | In order to create a common understanding as to what the IASB aims to accomplish, EFRAG recommends that the measurement section should state clearly the linkage with the presentation section. |

# Measurement (Questions 11 - 15) (2/3)

| | EFRAG preliminary position |
|---|---|
| *Minimum number of different measurements* | In EFRAG's opinion, the IASB's preliminary view that the number of different measurements used should be the smallest number necessary seems to suggest that the IASB would like to predetermine the number of measurement bases to be used. EFRAG believes that limiting the number of measurement bases could conflict with the objective of financial reporting. In addition, EFRAG does not expect that excluding this limitation from the *Conceptual Framework* would cause a proliferation of measurement bases. |
| *Classification of assets into four categories* | EFRAG believes that classifying assets into four categories (using, charging for rights to use, selling, holding) is reasonable. However, EFRAG believes that the Conceptual Framework should not be conclusive about what situations fall under the respective categories. |
| *Using assets* | EFRAG generally agrees with the view that cost-based measures would provide relevant information for assets that the entity is using. However, EFRAG disagrees with arguments that a current measure would provide better information for assessing how efficiently and effectively an entity's management and governing board have used the entity's resources. That would effectively mean representation of opportunity costs that management and governing board were missing. |

# Measurement (Questions 11 - 15) (3/3)

| | **EFRAG preliminary position** |
|---|---|
| *Liabilities with stated terms but highly uncertain amounts.* | EFRAG believes that circumstances in which current market prices are difficult to determine first call into question whether the measurement objective should be to represent current market prices. |
| *Liabilities with stated terms that are settled by performing services or paying others to perform services* | EFRAG believes that an appropriate measurement basis for a liability that is expected to be settled by the performance of services or, payments to others for performing services, would differ depending on whether (i) an entity performs the services or (ii) an entity pays others to perform services. If an entity performs the services, a cost-based measure starting with the proceeds received (in some cases with interest accretion) is likely to be appropriate for such obligations. However, the current market price of the services may be more relevant information if the entity will pay others to perform the services. |
| *Derivatives* | EFRAG agrees that current market prices are likely to be the most relevant measure for assessing prospects for future cash flows of derivative instruments. On the other hand, EFRAG notes that there is no substantial difference between a simple interest swap and a loan and deposit with netting and therefore there should be no justification for any measurement differences. |

# *Presentation and disclosure (Questions 16 - 18)*

| | **EFRAG preliminary position** |
|---|---|
| *Primary financial statements and the notes* | EFRAG generally agrees with the DP about the scope and content of guidance that should be included in the Conceptual Framework on: the presentation in the primary financial statements and disclosure in the notes to the financial statements. However, EFRAG believes that the Conceptual Framework should include further guidance on the notes. In this regards the discussion paper *Towards a Disclosure Framework for the Notes* issued by EFRAG, ANC and FRC including the related feedback statement, presenting the comments of constituents, could be useful. |
| *Materiality* | EFRAG agrees with the DP that additional material on the application of materiality could be provided by amending Standards or by providing educational material. The most useful may be a combination. In the discussion paper *Towards a Disclosure Framework for the Notes*, EFRAG, the ANC and the FRC have developed some indicators for materiality for types of information. EFRAG considers that these indicators, could be a useful basis for developing some concrete guidance on the issue. |
| *Communica-tion principles* | EFRAG agrees with the DP that communication principles should be part of the Conceptual Framework and generally agrees with the principles suggested in the DP. |

# Presentation in the statement of comprehensive income – P&L and OCI (Questions 19 - 21)

| | EFRAG preliminary position |
|---|---|
| *Total or subtotal for profit or loss* | EFRAG agrees that the Conceptual Framework should require profit or loss to be presented. EFRAG also considers that profit or loss is the primary measure of an entity's performance. |
| *Recycling* | EFRAG thinks that all items presented in OCI should qualify for recycling to profit or loss unless recycling would not provide relevant information in profit or loss. If there were to be no recycling, the Conceptual Framework would not need to specify whether an entity should present profit or loss. EFRAG laso believes that recycling of remeasurements that are expected to reverse fully or significantly change over the holding period of the asset or liability would generally not result in relevant information in the profit or loss. |
| *Approaches for presenting items in OCI* | EFRAG supports the broader Approach 2B and believes an entity's business model should play a role in defining primary performance and thus which items of income and expense should go to profit or loss and which into OCI. Therefore, the Conceptual Framework should not artificially limit the IASB's possibilities for defining the primary performance, reflected in profit or loss. |

# Other issues (Questions 22 - 26) (1/2)

| | EFRAG preliminary position |
|---|---|
| *Chapters 1 and 3 of the existing Conceptual Framework* | EFRAG thinks that the first chapters of the Conceptual Framework should be revised. EFRAG believes that it should appear from the first chapters that the objective of assessing stewardship is as important as the objective of assessing the prospects for future cash flows and that the two objectives could conflict. Reliability should be reintroduced as a concept and prudence should be built into IFRS. |
| *The use of the business model concept in financial reporting* | EFRAG believes that the business model notion should be referred to in IASB's financial reporting requirements on a systematic basis and thus be part of the IASB's Conceptual Framework. |
| *Unit of account* | EFRAG generally agrees with the DP that the unit of account should be considered at a standards level, but thinks that the IASB should commit itself more explicitly to consider the unit of account in relation to each Standard. |

# Other issues (Questions 22 - 26) (2/2)

| | EFRAG preliminary position |
|---|---|
| *Going Concern* | EFRAG agrees with the DP that the going concern assumption is relevant: (a) When distinguishing between debt and equity as payments that would arise only on liquidations do not meet the definition of a present obligation; (b) When measuring assets and liabilities, as an entity's ability to continue as a going concern may affect how it will use an asset and settle a liability; and (c) When preparing disclosures. However, EFRAG thinks that the link between the going concern assumption and concepts such as 'practically unconditional' and 'no realistic alternative' should be explained. |
| *Capital maintenance* | EFRAG agrees with the DP that the IASB should defer its work on capital maintenance until it considers how to account for inflation. |

# Additional comments

| | EFRAG preliminary position |
|---|---|
| *Reporting entity* | EFRAG thinks it is unfortunate that the IASB has decided not to discuss the reporting entity issue in relation to the DP. EFRAG thinks that several issues could have benefitted from additional discussion before moving to the next phase of the review of the Conceptual Framework. In particular EFRAG believes that the perspective from which financial statements are presented is critical and should be discussed in the Conceptual Framework |
| *Reporting period* | EFRAG considers that some guidance on what the reporting period represents should be provided – but not necessarily in the Conceptual Framework. |