



'A Review of the Conceptual Framework for Financial Reporting' (DP/2103/1)

FRC Response

January 2014

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Introduction

IN1 The FRC is pleased to comment on the IASB's Discussion Paper 'A Review of the Conceptual Framework for Financial Reporting'. The Discussion Paper provides a detailed and thoughtful overview of many complex issues, and contains a number of proposals with which we agree.

IN2 In particular, we welcome:

- The IASB's commitment to revisit the Conceptual Framework, to bring it up-to-date and add guidance in areas that are not adequately addressed.
- The equal emphasis placed on the statement of profit or loss and OCI and the statement of financial position, and the recognition of the statement of cash flows as a primary financial statement.
- The IASB's preliminary view that a single measurement basis may not provide the most relevant information, and that the selection of a measurement basis should depend upon how an asset or liability contributes to future cash flows.
- The retention of a total (or sub-total) for profit or loss as a primary source of information about the return an entity has made on its economic resources in a period.
- The retention of the current definition of equity—the residual interest in the assets of the entity after deducting all its liabilities.
- The inclusion of principles on presentation and disclosure as the first step of the IASB's disclosure initiative.

IN3 There are, however a number of areas where further development is necessary. Examples of these include:

- clarification of the definition of liabilities to situations where the requirement to transfer economic benefits can be avoided by the entity's future actions;

- the discussion of measurement concepts;
- the objective of the statement of profit or loss; and
- the unit of account.

We should be pleased to work with the IASB on these issues.

IN4 We are pleased that the IASB is willing to consider changes to the Chapters on objectives and qualitative characteristics (which were revised in 2010) where this is shown to be necessary by the development of other parts of the Conceptual Framework. We strongly believe that these Chapters should emphasise the importance of accountability (or 'stewardship'), reliability and prudence. These Chapters should also acknowledge that financial statements are more useful if they enable an assessment of the result of the entity's business model. These and other fundamental concepts—substance and going concern—are discussed in Section 2 below. Subsequent sections of this response demonstrate the significance of these ideas.

1 General approach

1.1 We strongly support the IASB's decision to recommence work on its Conceptual Framework. The Conceptual Framework is the cornerstone of high quality financial reporting, and we agree that the existing Conceptual Framework is out of date and incomplete. A revised Conceptual Framework should assist the IASB in the development of new accounting standards that are consistent and reflect current thinking. It will also, importantly, improve dialogue and understanding between the IASB and its stakeholders.

1.2 We agree with the IASB's decision to undertake work on the Conceptual Framework and standards concurrently. Work in one area will usefully complement work in the other. However, the Conceptual Framework should be developed with a single-minded determination to produce the best Conceptual Framework possible that will provide the foundation for high quality accounting standards. Principles should not be discarded or diluted merely because they are inconsistent with standards: still less should the Conceptual Framework be 'reverse engineered' to provide a rationalisation for existing standards. On the contrary, the Conceptual Framework should be aspirational and so provide a basis for improvements in financial reporting.

1.3 We also support the IASB's intention to complete its revision of the Conceptual Framework expeditiously. However, we are concerned that undue haste may not allow an adequate consideration of the complex and difficult issues that need to be addressed. It is also important that the IASB's stakeholders have ample opportunity to consider and debate proposals so that they may contribute to their improvement. Full debate and consultation will also assist in promoting support for the new Conceptual Framework.

1.4 We suggest that the IASB keeps the timetable for the revisions to the Conceptual Framework under review, and should be willing to amend it if it becomes clear that a high quality Conceptual Framework cannot be finalised by next year. Alternatively, the IASB might conclude that it should publish a revised Conceptual Framework, but also commence further work on areas where further improvements seem desirable and attainable. If that approach were adopted, it is important that the revised Conceptual Framework is as complete as possible, as, despite the best efforts of all concerned, it may continue to be current for a long time: the history of

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standard-setting provides numerous examples of 'temporary expedients' that have endured long after they were adopted.

1.5 We welcome the statement in paragraph 1.22 of the Discussion Paper that any decision to amend an existing standard would be subject to the IASB's normal process for admission to its agenda and consultation. In our view, a standard that is consistently interpreted and producing useful information should not be revised merely to remove an inconsistency with the (new) Conceptual Framework.

2 Fundamental concepts

2.1 The Discussion Paper explains that the IASB will not fundamentally reconsider the content of Chapters 1 and 3 of the Conceptual Framework that were published in 2010, but that it will make changes if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. It discusses a number of specific topics about which concerns have been expressed:

- accountability (or 'stewardship');
- reliability and its replacement with faithful representation; and
- the removal of any reference to the concept of 'prudence'.

We very strongly share these concerns.

2.2 We also consider that the Conceptual Framework should refer to the importance of facilitating an assessment of the business model and explain the relevance of the going concern assumption.

2.3 We welcome the Discussion Paper's proposal that the Conceptual Framework should acknowledge the importance of reporting the substance of transactions. A similar discussion was contained in the Conceptual Framework's discussion of qualitative characteristics until the 2010 revisions. In our view, it would most logically be restored to the discussion of qualitative characteristics and placed in Chapter 3.

2.4 The purpose of the Conceptual Framework is to guide the development of accounting standards by setting out clearly and unambiguously concepts that are generally agreed to be important influences on financial reporting. This provides a more consistent and robust foundation than the intuitions of standard-setters, which may be based on inconsistent implicit frameworks. To fulfil this purpose the Conceptual Framework needs to be complete: important ideas, such as prudence, cannot be omitted simply because they are generally agreed: apparent agreement may mask significant underlying differences. Explicitly addressing agreed concepts in the Conceptual Framework enables their interpretation to be clarified and reduces the possibility of undesirable interpretations gaining credence. It is clear, for example, that the pre-2010 Conceptual Framework helped dispel misconceptions

about the proper role of prudence. More recently, our work on going concern (the Sharman Inquiry) showed that there wide differences of view as to the meaning and implication of the going concern concept.

2.5 Moreover, for understandable reasons, the Conceptual Framework is often quoted selectively when it is referred to in the development of standards. Key concepts, such as stewardship, therefore must be prominent in the Conceptual Framework: it is not satisfactory if they are 'a bit hard to find'.

2.6 Much of financial reporting relies on a common understanding of basic ideas. There is no standard, for example, that requires the recognition of trade creditors, or explains the treatment of accruals and prepayments. There is a very real risk that these ideas will be neglected in the education of accountants, and even those that are accustomed to powerful concepts, such as that of going concern, may conclude that they are no longer applicable unless they are addressed in the Conceptual Framework.

2.7 The concepts that we are advocating should feature in the Conceptual Framework may be found in most elementary textbooks of accounting. (The business model concept may appear to be the exception to this, but we consider that it merely makes explicit an idea that has long been established.) In some recent projects (for example, the proposed revisions to IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' and the project on Revenue Recognition) the IASB's initial proposals for accounting standards were revised as respondents considered they were too 'academic' or 'technical'. A Conceptual Framework that explicitly includes these ideas would, in our view, assist the IASB in developing high-quality proposals for standards that will more readily gain acceptance and improve financial reporting.

2.8 It may be that the IASB intends to promote a change in thinking, or continue with changes introduced by its predecessors. We certainly do not object to change in principle. However, the onus is on those who urge change to make a powerful case for it and to provide evidence that shows that it will better meet the needs of users of financial statements. And if its changes prove unwise, the IASB should be willing to reconsider them.

2.9 Chapters 1 and 3 were developed jointly with the FASB and reflect some compromises that the current members of the IASB are free to correct, taking account of more recent thinking. We share the IASB's ambition to see work on the

Conceptual Framework progress expeditiously, and understand the decision not to subject Chapters 1 and 3 to a fundamental rethink. We agree that revisiting much of the material in those Chapters would be time consuming and unlikely to lead to fresh insights. However, the issues that are of concern to us may be addressed through relatively small, but significant, changes.

2.10 Although the discussion from paragraph 2.14 below addresses each concept separately, it should be appreciated that there are strong links between them. For example, an accountability objective requires an emphasis on the credibility of financial statements: reliability and prudence enhance that credibility. Prudence and reliability are related in that whether recognising a gain is prudent often depends on reliability. Accountability is enhanced by an alignment of financial reporting with the entity's business model.

2.11 The Conceptual Framework acknowledges (in paragraph OB6) that general purpose financial reports cannot provide all the information that is needed by investors and other users, who will also need to refer to other sources. But financial statements are published regularly, conform to accounting standards (as well as, in many cases, other regulations) and are audited.¹ This places financial statements in a unique position: much of the information that they provide is not completely new but they add considerable value by confirming and providing greater detail about what is already known by the market. Accountability, prudence and reliability reinforce the distinctive advantages of financial statements.

2.12 In the following discussion we indicate how the concepts whose addition or clarification we urge would affect the rest of the Conceptual Framework and standards developed from it. However, the Conceptual Framework cannot be expected to lead ineluctably to conclusions on specific accounting approaches: rather it provides a set of ideas that guide the development of standards. Standard-setting inevitably involves the exercise of judgement in balancing different, and sometimes conflicting, qualities. A specific concept taken in isolation may highlight an advantage of a particular accounting treatment, but will rarely be determinative.

¹ See Cascino *et al* 'The use of information by capital providers', recently published by the Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) and the European Financial Reporting Advisory Group (EFRAG).

2.13 Many of the ideas discussed in this section have also been addressed in the series of Bulletins that we have produced in collaboration with EFRAG and other national standard-setters under the title 'Getting a Better Framework'. These may be useful to the IASB in its further consideration of these issues.

Accountability (or 'stewardship')

2.14 Although there seems little important difference between the ideas of 'accountability' and 'stewardship' we generally use the former term.

2.15 In our view, the provision of information that provides accountability is a primary objective of financial reporting. It should be reflected in the Conceptual Framework as a separate objective, equal in prominence to that of providing information that is useful for making decisions about the provision of resources to the entity.

2.16 The current Conceptual Framework adopts an objective of decision-usefulness, which it suggests essentially involves facilitating an assessment of future net cash inflows to the entity. It also suggests that information on accountability either is an ancillary part or by-product of that objective. The information that responds to accountability is that on how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources (paragraph OB4). The importance of this is clear from the Discussion Paper's careful inclusion of this wording when summarising the objective of financial reporting. Moreover, the Basis for Conclusions in the 2010 Conceptual Framework states, 'The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management's stewardship is more important than the other.'

2.17 Shareholders entrust the management of an entity's affairs to management. Financial statements provide shareholders with an opportunity to assess the effectiveness of management, and, just as importantly, provide management with a means of reporting the results achieved under their direction. This facilitates dialogue about all aspects of a company's affairs including, for example, its competitive position, the success of its strategy and the opportunities for adopting alternative strategies. Financial statements provide a key point of reference in that dialogue, because of the features discussed in paragraph 2.11 above.

2.18 Potentially this requires that financial statements provide a much fuller set of information than that required for decisions such as whether to buy, sell or hold the shares. An accountability perspective emphasises the need for completeness, transparency and reliability and a focus on long-term considerations rather than the immediate future. It also underlines the importance of reporting past transactions and events—which is the essential subject matter of financial statements. Furthermore it emphasises the importance of 'confirmatory value': users need to be able to check the extent to which past predictions have been fulfilled.

2.19 It is, of course, not possible to distinguish transactions and events that are within or outside management's control. (Indeed we agree that ultimately management are responsible for all aspects of the entity's activities.) But an objective of accountability does not necessarily require such a distinction to be made. Financial statements can facilitate an assessment of accountability by, for example, clearly distinguishing the results of the business model (operating profit) from other income and expenses and by highlighting unusual items. An insight into management's effectiveness can also be gained by comparing the financial statements with those of other entities.

2.20 Some of the information that is required to meet an accountability objective is similar to that required by a decision-useful objective (although judgements on materiality may differ in some areas). However, even if the view is taken that the set of information is the same, it would be necessary to specify accountability as a separate objective. As the current Conceptual Framework acknowledges, it is not practicable for financial statements to provide all the information that may be required. Thus standard-setting involves selecting which information should be reported. If accountability is merely ancillary to a decision-useful objective, there is a risk that information primarily relevant to decision-usefulness would invariably be selected rather than that which contributes most to accountability.

2.21 Cases where accountability would have implications for the Conceptual Framework are noted in paragraphs 4.7, 4.32, 4.38, 7.11, 8.2 and 8.6 of this response. Further discussion of the implications of accountability is set out in the 'Getting a Better Framework' Bulletin 'Accountability and the Objective of Financial Reporting'.

Reliability and faithful representation

2.22 We urge the IASB to reconsider the replacement of the qualitative characteristic of 'reliability' with 'faithful representation'. As noted in connection with accountability above, financial statements are a key part of the dialogue that maintains trust between shareholders and management. To fulfil that requirement the financial statements must be credible: they must contain reliable information.

2.23 The Discussion Paper states that the main reason for the change from reliability to faithful representation was 'a lack of understanding of the term reliability'. We, however, are not convinced that 'reliability' is more ambiguous than many of the terms used in the Conceptual Framework. Rather we suspect that misunderstandings arose as some focussed on reliability to the exclusion of all other considerations. We do not suggest that this is appropriate: there are cases where information should be reported although it has only a low level of reliability. The Conceptual Framework should, however, challenge the standard-setter to attain the best possible balance between the qualitative characteristics. In particular, there is often a tension between relevance and reliability: the most relevant information may not be capable of being portrayed reliably, and the most reliable information may not be very relevant.

2.24 The current Conceptual Framework's approach to this is problematic: the concept of 'faithful representation' is not an adequate replacement for reliability. One of the reasons for this is that the concept and its description are too general. As described in the current Conceptual Framework, a faithful representation is given provided adequate disclosure is made, including the nature of the asset or liability, the measurement basis used and the uncertainties that significantly affect that amount. Given that description, any measurement basis of any asset or liability would be consistent with the idea of 'faithful representation' (with suitable disclosures). Thus 'faithful representation', as described, fails to exclude the provision of any information and therefore cannot guide the development of accounting standards.

2.25 Moreover, the Conceptual Framework goes on to suggest (in paragraph QC18) that the most relevant information should be identified and reported if it is available and can be faithfully represented. Given that anything can be faithfully represented, this condition will always be met. Thus, far from providing the creative tension that should require the IASB to find the best balance between relevance and

reliability, the Conceptual Framework effectively requires that relevance prevails in all cases.

2.26 One of the qualities of reliable information is that the use of subjective estimates is minimised. Although such information may not be the most relevant, it enables users to form their own estimates, which may be superior. For example, suppose an entity needs to report on a new investment. Arguably the most relevant information for a user who wishes to assess the future returns from the investment is the present value of the returns: however this will probably rely on many estimates and assumptions: even if extensive disclosures are provided it may be difficult to quantify their effect and assess the quality of any estimate. In contrast, if the investment is reported at cost (which in this particular case can be determined reliably), users are enabled to make their own estimates and will fully appreciate their limitations. This, of course, does not demonstrate that cost is always to be preferred: that will be a judgement depending on the particular circumstances. But it does, we think, make the point that in some cases it may be preferable to report information that is more reliable and less relevant, especially as financial statements complement and provide confirmatory value of information for other sources, as referred to in paragraph 2.11 above.

2.27 Cases where reliability would have implications for the Conceptual Framework are noted in paragraphs 4.1, 4.28, 4.30, 6.3, 6.7 and 6.13 of this response. Further discussion of reliability is contained in the 'Getting a Better Framework' Bulletin 'Reliability of Financial Information'.

Prudence

2.28 We urge the IASB to include in the Conceptual Framework a specific discussion of the concept of prudence (or conservatism), which is an important influence on the development of financial reporting and reinforces the credibility of financial statements.

2.29 The Discussion Paper notes the description of prudence in the pre-2010 Conceptual Framework was one that 'few would disagree with' and that it is reflected

in many of the standard-setting decisions of the IASB.² We agree with both these observations.

2.30 In our view, the Conceptual Framework should state that the role of prudence is in the development of accounting policies, particularly in ensuring that all losses and liabilities are reflected promptly and that gains are not recognised except where there is adequate evidence. Once it has been determined that an item should be recognised and an appropriate measurement basis selected, prudence has no role. The estimated amount should not deliberately depart from the selected basis.

2.31 There is considerable academic research³ that shows that prudence—more timely recognition of losses than of gains—is valuable. One of the reasons for this is that 'good news' is rarely concealed for long and the market is often aware of it. 'Good news' that is reported before it is reasonably assured may be disregarded by users because of its lack of reliability, and if it is not confirmed by subsequent events the credibility of financial reporting is undermined.

2.32 However, the market needs reassurance that all 'bad news' is reflected in financial statements. Even if bad news is already public, a prudent account of it provides confirmatory value. Furthermore, requirements to report losses in financial statements can be expected to encourage earlier release of the news.

2.33 Prudence—considered as the development of accounting policies that ensure that losses are recognised on a timely basis and that gains are not recognised unless there is adequate evidence—is consistent with many features of current accounting:

- Assets are written down when impaired to reflect bad news but not written up for good news.

² The influence of prudence/conservatism on IFRS is discussed in Richard Barker & Anne McGeachin (2013) Why is there inconsistency in accounting for liabilities under IFRS? An analysis of recognition, measurement, estimation and conservatism, *Accounting and Business Research* Vol 43, No 6 pp 580–604. See also Alfred Wagenhofer, *The Role of Revenue Recognition in Performance reporting*, paper presented at the ICAEW's Information for Better Markets Conference, December 2013.

³ See, for example, S.P. Kothari, Karthik Ramanna, and Douglas J. Skinner (2010) Implications for GAAP from an analysis of positive research in accounting, *Journal of Accounting and Economics* 50 pp. 246–286, and the discussion by Richard Lambert at pp287–295 of the same issue.

- Provision is made for onerous executory contracts, but gains on contracts that are expected to be profitable are not recognised.
- Inventory is stated at cost, even when a future sale is highly probable; and even if an order has been received.

2.34 The pre-2010 Conceptual Framework stated, with admirable clarity, that 'prudence does not allow...the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses'. Thus the objection noted in the Discussion Paper (paragraph 9.18) that such deliberate misstatements would lead to a misstatement of financial performance in later periods does not apply.

2.35 The other objection noted in the Discussion Paper is that prudence is inconsistent with neutrality. The current Conceptual Framework characterises neutrality as the absence of bias, and states that 'A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users'. We do not agree that the notion of prudence, correctly understood, is incompatible with neutrality.

2.36 The value of financial statements lies in providing information, the credibility and understandability of which is enhanced by observing conventions and practices—most of which are now codified in accounting standards. The conventional nature of financial statements needs to be understood: no-one should believe that they capture the economic value of the entity or its true economic profit.

2.37 Financial statements may, for example, record liabilities for legal cases that may be lost but not assets for cases that may be won. They may also record losses on onerous contracts but not the profits that will be made on favourable contracts. Although these may be departures from 'economic reality', they are not attempts to mislead or influence users' reaction to the information, but rather the result of applying well founded conventions. Thus the financial statements are neutral, not biased. They are simply prepared in accordance with accounting principles and accounting standards.

2.38 Cases where prudence would have implications for the Conceptual Framework are noted in paragraphs 4.1, 4.28, 4.34, 4.39 and 6.13 of this response. Further discussion of the implications of prudence is set out in the 'Getting a Better Framework' Bulletin 'Prudence'.

The business model

2.39 In our view, the Conceptual Framework should acknowledge that financial statements should provide information that assists in an assessment of the entity's business model. Financial statements should not simply provide an inventory of assets and liabilities and information on changes in them, but should portray how the entity uses its assets and liabilities in order to create value. A shareholder has a stake in the success (or failure) of a business, rather than simply a portion of the entity's assets and liabilities.

2.40 Much of financial reporting already reflects a business model; for example by distinguishing inventory from property, plant and equipment; and revenue from other receipts. Thus introducing the notion of a business model would be consistent with rather than a radical departure from current practice.

2.41 As mentioned above, providing information to assist such an assessment is clearly required by an accountability objective. It is also relevant under a decision-useful objective as the predictive value of income and expenses that relate to an entity's business model is significantly different from that of other income and expenses.

2.42 We suggest that it would be appropriate for the Conceptual Framework to provide a general description of the business model, rather than a specific definition. This should emphasise that the business model focuses on the means by which an entity creates value. It should be noted that the business model for most (probably the majority) of entities involves the obtaining of inputs through exchange transactions, and using those inputs, usually after some kind of process to provide goods and services to customers from which revenue is obtained. Reporting the results of such a business model clearly requires information on the cost of inputs and their transformation and on the revenues obtained from them. Other business models involve the acquisition of assets in order to benefit from gains resulting from their increase in value: in such a case reporting assets at current value may be helpful.

2.43 The Discussion Paper notes some instances where its proposals have regard to the way in which the entity conducts its business activities. However, a general reference to the relevance of information that reflects the business model is required

to ensure that it is considered in the development of new standards, or other parts of the Conceptual Framework.

2.44 In our view, a close relationship between the business model and financial reporting can significantly enhance comparability by promoting consistency of treatment by entities within a sector. This will greatly assist investors whose analysis is often focussed on detecting differences between entities within the same sector.

2.45 Furthermore, we do not believe that providing a discussion of the business model concept in the Conceptual Framework would necessarily lead to a serious loss of comparability. Its main influence is likely to be in the development of standards. It might be reflected by appropriate definitions of terms and by prescribing the circumstances in which particular accounting treatments would be used, rather than simply by permitting an unconstrained choice of treatment. Consistent with our view that the Conceptual Framework should provide a set of ideas that need to be considered together in the development of standards, the Conceptual Framework should not suggest that the business model should override all other considerations.

2.46 Cases where the business model would influence the Conceptual Framework are noted in paragraphs 6.10, 6.12–6.14, 6.17, 7.5, 7.19, 8.3, 8.7 and 8.8 of this response. Further discussion of the business model is in the 'Getting a Better Framework' Bulletin 'The Role of the Business Model in Financial Reporting'.

Going concern

2.47 The Discussion Paper identifies a few situations where the going concern assumption is relevant, and asks respondents to identify any further cases. This suggests that, apart from a passing mention in specific paragraphs, reference to the going concern might be deleted from the Conceptual Framework. We would be concerned by such a change.

2.48 The going concern assumption has long been identified as one of the fundamental accounting concepts, and can be traced back at least as far as the writings of Lawrence Dicksee in the early years of last century. Removal of the going concern concept from the Conceptual Framework would undermine its importance and could suggest that it is no longer relevant to financial reporting. It would also create the risk of divergent interpretations of the term and its implications gaining credence.

2.49 It is therefore important that the Conceptual Framework continues to reflect the concept of going concern. The most appropriate location for a discussion of the concept would be in the discussion of relevance as, in virtually all cases where general purpose financial statements are prepared, information prepared on a going concern basis is most relevant. This is the case even if continuation of the business is dependent on securing new finance, although it may be necessary to disclose material uncertainties about an entity's ability to continue as a going concern. The explanation of the concept in paragraph 4.1 of the current Conceptual Framework is, in our view, broadly appropriate.

3 Purpose and status of the Conceptual Framework (Discussion Paper Section 1)

Question 1

Paragraphs 1.25–1.33 set out the proposed purpose and status of the Conceptual Framework. The IASB's preliminary views are that:

- (a) the primary purpose of the revised Conceptual Framework is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and*
- (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the Conceptual Framework. If this happens the IASB would describe the departure from the Conceptual Framework, and the reasons for that departure, in the Basis for Conclusions on that Standard.*

Do you agree with these preliminary views? Why or why not?

Response to question 1

3.1 We broadly agree with the preliminary views set out in the question. However, we think that the relationship between a new or revised standard and the Conceptual Framework should be explained in the Basis for Conclusions of all standards, and not only where the new standard conflicts with the Conceptual Framework. In many cases this explanation could be concise, but it would nonetheless demonstrate that the IASB is adhering to its Conceptual Framework and provide useful insight into how the IASB interprets the Conceptual Framework. Such an explanation may be particularly relevant when an otherwise superior alternative has been rejected in the light of cost/benefit considerations.

3.2 We also agree that parties other than the IASB may find the Conceptual Framework useful for the purposes set out in paragraph 1.28 of the Discussion Paper—that is, to understand and interpret standards and develop accounting policies for circumstances not addressed by a standard or interpretation. In this

connection we would observe that, in the event that the IASB restricts the use of the Conceptual Framework by preparers in developing accounting policies for circumstances not addressed by a standard or interpretation, that restriction is more appropriately reflected in IFRS than in the Conceptual Framework. As stated in paragraph 4.5 below, we do not agree that preparers should be prevented from using the guidance in the Conceptual Framework in determining whether an asset or liability should be recognised.

4 Elements of financial statements, recognition and derecognition (Discussion Paper Sections 2–4)

General comments

4.1 One of the key contributions of the Conceptual Framework is to ensure that assets and liabilities, and changes in them, are recognised only when doing so improves the usefulness of financial statements. The definitions of assets and liabilities and the recognition criteria must ensure that the information is as complete as can be expected, but also provide a robust safeguard against the recognition of assets and liabilities that merely contribute to clutter. We would question, for example, whether all the intangible assets of an acquired business should be recognised, particularly, where measurement is difficult, or if liabilities should be recognised for all claims that are highly unlikely to result in a payment. Questioning the reporting of such items is, of course, consistent with our views on reliability and prudence.

4.2 An undue proliferation of the items reported reduces the understandability of financial statements and may obscure important messages. It also significantly increases the burden on preparers. Vagueness in the definitions and recognition criteria also creates uncertainty as to whether particular items are required to be recognised.

4.3 We are therefore concerned that some of the terms used in the proposed definition of assets and liabilities, for example 'source of value' and 'capable of', are vague and that the definitions may therefore be interpreted broadly. If they are to be retained it is essential that the definitions and recognition criteria set out in the Conceptual Framework (taken together with supporting explanation) are clear and robust. The vagueness of these terms means that the control part of the definitions and the recognition criteria are especially important. In turn, the recognition criteria rely heavily on the notion of relevance: this will only be operational if supplemented by guidance along the lines suggested in paragraph 4.26 of the Discussion Paper.

4.4 In our view it is important that the Exposure Draft explains the implications of the proposed definitions and criteria for a number of possible assets and liabilities to demonstrate the probable effect at the standards level.

4.5 The Discussion Paper suggests that all assets and liabilities should be recognised 'unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or liability'. It therefore appears that an entity, when referring to the Conceptual Framework for guidance on a matter not covered by a standard, would be required to recognise all items within the definitions of assets and liabilities no matter how irrelevant or costly the information conveyed would be. We do not agree that this is appropriate, and are particularly concerned that it may lead to inappropriate recognition given the broad definitions that are proposed.

Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. The IASB proposes the following definitions:

- (a) an asset is a present economic resource controlled by the entity as a result of past events.*
- (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.*
- (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.*

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

Response to question 2

4.6 In our view, the proposed definitions are an improvement on those on the existing Conceptual Framework. However, as noted in paragraphs 4.1–4.5 above, they are rather vague and may therefore be interpreted broadly. It is therefore important that the Conceptual Framework provides guidance on the intended meaning in order to ensure consistent application. In particular:

- (i) 'Other sources of value' is potentially very wide-ranging, as evidenced by the examples listed in paragraph 3.5(c) of the Discussion Paper. We question whether all of these examples should fall within the definition of an asset. Probably they do not because the entity has no*

control, in which case the Conceptual Framework should make this clear. It seems likely that the notion of 'control' will play a larger role than is the case with the existing definition.

- (ii) It would also be helpful to clarify the notion of 'capable of' or replace it with a more definite term. We note that the ambiguity of the term 'capable of' has been one identified by the IASB's constituents as one of the reasons that it can be difficult to determine whether an acquisition is of a business or of assets.

4.7 We agree that a reference to 'past events' should be retained. Although we understand that it may be considered unnecessary, we think it helpful as it is consistent with the historical, largely transactions-based nature of accounting, and responds to an accountability objective.

4.8 It would also be helpful to clarify that the term 'rights' is not limited to contractual rights, but also includes, for example rights arising under statute.

Question 3

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB's preliminary views are that:

- (a) *the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.*
- (b) *the Conceptual Framework should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.*
- (c) *the recognition criteria should not retain the existing reference to probability.*

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

Response to question 3

4.9 Potential assets and liabilities where there is only a low probability of an inflow or outflow present a significant challenge. As noted above, reporting some such assets and liabilities may not provide useful information, and obscure more important information. It may also impose significant cost on preparers. We agree, however, that some potential assets and liabilities that have only a low probability of a future inflow and outflow—for example some derivatives—should be reported.

4.10 A possible approach would be to include a reference to the probability of a future inflow or outflow in the definitions and/or recognition criteria, and then to allow for certain exceptions. However, this might seem conceptually inconsistent, and it would be necessary to ensure the exceptions were logical and unambiguous.

4.11 We therefore are inclined to agree with the IASB's preliminary views that definitions of assets and liabilities, and the recognition criteria should not contain a specific reference to probability. However, this is premised on the assumption that the Conceptual Framework will explain that an asset or liability may not be recognised where there is only a low probability of an inflow or outflow. As stated in paragraph 4.4 above, it is important that the Exposure Draft explains the implications of the proposed definitions and criteria for a number of possible assets and liabilities to demonstrate the probable effect at the standards level.

4.12 We agree that existence uncertainty should be resolved in the development of standards. However, acknowledging the distinction in the Conceptual Framework may be helpful as it acknowledges the variety of the practical limitations that constrain financial reporting, and may clarify thinking in considering how particular circumstances might be reflected in accounting standards.

Question 4

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52.

Do you have any comments on these items? Would it be helpful for the Conceptual Framework to identify them as elements of financial statements?

Response to question 4

4.13 The terms 'income' and 'expense' have established meanings and connotations that are not always appropriate for the wide compass of items that fall within these elements in the Conceptual Framework. It would therefore be more helpful and reduce misunderstanding if the Conceptual Framework were to employ more general terms, such as 'gains' and 'losses' for the elements that correspond to changes in assets and liabilities. 'Gains' and 'losses' clearly include all income and expenses but also, for example, the loss arising from natural disasters or misappropriation of assets, or the profit on sale of a major asset, which may not be thought of as 'income' and 'expenses'. Adopting such an approach would enable the terms 'income' and 'expenses' to be used for more specific purposes either elsewhere in the Conceptual Framework or, perhaps more probably, in accounting standards.

4.14 The Conceptual Framework should require that the primary financial statements should contain only elements as defined. As stated in paragraph 8.9 below, we do not consider that the Conceptual Framework should merely permit recycling where the criteria for it are met. It follows that, if recycling is to be required for certain items, the definition of income and expenses (or of gains and losses) therefore needs to be amended to include recycling adjustments.

4.15 The definition of income in the current Conceptual Framework is incorrect, as it defines income (which is a credit) as an increase in assets (which is a debit)⁴. This should be reconsidered.

4.16 As is explained in our response to question 10 below we do not support the recognition of transfers of wealth between classes of equity, and therefore these should not be defined as elements.

⁴ See Richard Barker (2010) On the Definitions of Income, Expenses and Profit in IFRS, Accounting in Europe, 7:2, 147–158.

Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

Response to question 5

4.17 We agree with the IASB's preliminary view that liabilities should include constructive as well as enforceable obligations. Restricting the definition of liabilities to enforceable obligations would incur the risk of reporting based on legal niceties rather than business and economic realities. It is therefore important that the definition of liabilities should be wider than obligations that are enforceable.

4.18 For example, in the UK directors are required to have regard inter alia to the need to foster the company's business relationships and to maintain high standards of business conduct. It would be anomalous to deny that a liability exists where directors consider this requires them to honour an undertaking—for example to compensate customers for a product failure—that is not enforceable by the beneficiary.

4.19 The Discussion Paper sets out possible further guidance on 'constructive obligations' in paragraph 3.50. Whilst guidance of this nature would be helpful, aspects of the guidance may merit reconsideration. In particular:

- (i) It is envisaged that the guidance would emphasise that the duty or responsibility must be owed to another party who would benefit, and can reasonably rely on, the entity to fulfil its duty or responsibility. It is not clear that this is right. The contrary view is suggested by paragraph 3.34 of the Discussion Paper, which says: 'If a liability exists for one party, an asset always exists for another party or parties, except perhaps for some obligations to clean up damage to the environment.'

- (ii) The phrase 'reasonably rely' in sub-paragraph (c) could usefully be clarified. It may mean that the other party can 'rationally be confident that' or can 'rationally consider itself entitled to assume that'. The latter meaning would seem to be more appropriate as the objective should be to identify obligations rather than expectations.
- (iii) The same sub-paragraph suggests that the reasonable reliance should be based on the entity's 'past actions'. This might be taken to refer to the entity's past practice of dealing with similar situations, but it does not seem right that the entity's past history should be regarded as determinative at the Conceptual Framework level (although it might be a practicable basis to use at the standards level). If 'past actions' is intended to refer, for example, to undertakings given by the entity, it would be helpful if this were clarified.

Question 6

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the Conceptual Framework are put forward:

- (a) *View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.*
- (b) *View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.*
- (c) *View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.*

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

Response to question 6

4.20 We concur with the IASB's preliminary view that View 1 should be rejected. It is an important principle that the definition of liabilities should include all obligations that an entity has no practical ability to avoid, but further clarity on 'practical ability' is necessary: if it is interpreted narrowly, then there may be little substantive difference between View 2 and View 1. We are attracted to the underlying logic of View 3—namely that if an entity has received services under an exchange transaction then it has an obligation to pay for them: however, as many of the examples concern government-imposed levies it is difficult to be sure what the exchange is, and to what period it relates.

4.21 Clearly this is an area where further analysis is required. We suggest that it may be helpful to expand the number of examples, and also to provide a richer context for consideration. It may be more helpful to consider aspects beside the narrow question of whether a liability for the levy (or other item) exists. It may be, for example, that in some cases an entity has a liability either to pay the levy or to take action to avoid it. Or it may be necessary to consider whether assets are impaired. We would be very willing to undertake further consideration of these issues, if that would be helpful to the IASB.

Question 7

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

Response to question 7

Reporting the substance of transactions

4.22 As mentioned in Section 2 above, we welcome the proposal to reintroduce to the Conceptual Framework material on reporting the substance of rights and

obligations, without which the Conceptual Framework would be seriously incomplete. In our view, the proposals in paragraph 3.102 of the Discussion Paper capture the essence of what this material should be.

4.23 The Conceptual Framework should make clear that considerations of substance over form applies generally to the identification of assets and liabilities. Although the interpretation of contracts is one of the areas where the issue of substance over form is often relevant, we do not consider it should be restricted to an assessment of contractual obligations. It is an overriding principle that the substance of transactions and arrangements should be reported. We therefore consider that this topic is best addressed in the discussion of qualitative characteristics, in Chapter 3.

4.24 The example of economic compulsion given in paragraph 3.108 is confusing, as it seems to suggest that an option may be substantive and yet be ignored in the assessment of the accounting treatment. If it is to be retained in the Conceptual Framework it should be clarified.

Executory contracts

4.25 We agree that it is appropriate for the Conceptual Framework to address the principles that apply to the accounting for executory contracts. We have the following comments on the discussion given in paragraphs 3.109–3.112 of the Discussion Paper.

4.26 It is explained in paragraph 3.110(c) of the Discussion Paper that executory contracts may not be recognised because either:

- (i) they give rise to a right-and-obligation to exchange (typically measured at zero), rather than distinct rights to receive and obligations to transfer; or
- (ii) the assets and liabilities are offset.

4.27 However, it is simply stated that which of these applies 'may depend on the circumstances'. It would be helpful to set out the principles that determine the position that applies. There is also no discussion of whether (and why) offset is appropriate for contracts in class (ii). Paragraphs 3.12 and 3.13 of the Discussion Paper discuss a similar contrast between having a single net asset or liability and

offsetting but this is also incomplete, as identification of separate rights and obligations is part of the unit of account issue, which the Discussion Paper suggests the Conceptual Framework will not address. That discussion also simply notes that distinct assets and liabilities are sometimes offset, but does not explore the circumstances in which offset should be applied.⁵ Offsetting is also addressed in the Discussion Paper at paragraphs 7.29–7.30, but that discussion merely refers the general concepts of faithful representation and cost-benefit.

4.28 The argument that an executory contract is not recognised (unless onerous) is essentially that 'the rights of one party have the same value as the obligations of the other party'. This seems to be plausible from the perspective of the purchaser as on performance it will recognise the asset received in place of cash or a liability and equity will be unchanged—the value of the asset is equal to that of the consideration given. However, it does not work for the seller, because it typically it will report income on performance, as the value of the cash received (or receivable) will be greater than the inventory that is derecognised. A better justification may be that recognition of an executory contract by a seller would require an allocation between the profit that is made on obtaining and performing the contract: that split would be arbitrary and of doubtful usefulness. Deferring recognition of the profit on a contract until performance is consistent with the concepts of prudence, relevance and reliability.

4.29 We note the comment made in paragraph 3.112 of the Discussion Paper that 'strictly speaking, trade date accounting is inconsistent with the concepts discussed in this Discussion Paper'. We are not sure we agree that this is a direct consequence of the Discussion Paper's proposals, and note that any change to accounting practice on this would follow from a standards-level project that would be subject to the IASB's agenda setting criteria and due process requirements.

⁵ The UK accounting standard 'FRS 5 Reporting the Substance of Transactions' formerly prohibited offsetting except for monetary balances where the entity had the ability to insist on net settlement, and that ability was assured beyond reasonable doubt. This required that the debit balance matured no later than the credit balance and that the ability to insist on net settlement would survive the insolvency of the other party.

Question 8

Paragraphs 4.1–4.27 discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or*
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.*

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Response to question 8

4.30 We agree that assets and liabilities should not be recognised if doing so does not provide relevant information, or information that is not sufficiently relevant to justify the cost of doing so. However, in our view it is essential that the Conceptual Framework should also set out guidance, along the general lines set out in paragraph 4.26 of the Discussion Paper, to provide indicators of when recognition might not result in relevant information. We note that these include the key ideas of lack of reliability of measurement and low probability of inflow or outflow of economic benefits, which are contained in the existing Conceptual Framework.

4.31 We note that applying this approach would require an assessment of a number of factors. This is appropriate as the variety of circumstances that are encountered in standard-setting are so varied that application of any rigid rule is unlikely to provide the best solution in every case.

4.32 In developing this guidance, the IASB should consider whether additional factors should be added. In particular:

- There may be little or no additional relevance in recognising an asset or liability that is inseparable—that is, it cannot be sold except together with the business of which it forms a part.
- It may be relevant to report assets that have been purchased even though similar assets that have been internally generated are not, in order for financial statements to assist in assessing management's stewardship. This might most often arise for intangibles such as computer software. The Discussion Paper notes (at paragraph 2.30) that some consider that the purchase of an asset provides evidence of the existence of an asset: we would add that the purchase also provides evidence of its value.

4.33 It would also be helpful for the Conceptual Framework to note that decisions on whether to recognise an asset or liability should also evaluate the benefits of reporting by alternative means. For example, it may be more informative to disclose the range of possible outcomes for a highly uncertain liability than to recognise the liability—which would require assigning a specific amount to it, and may give rise to misunderstanding when that amount differs from the amount ultimately paid.

4.34 The proposals in the Discussion Paper do not distinguish between the recognition of losses and gains. In discussing prudence in Section 2 above, we explained why timely recognition of losses is more important than that of gains. The Conceptual Framework should highlight that early recognition of losses is more relevant than that of gains.

4.35 We discuss the inadequacies of the concept of 'faithful representation' as set out in the current Conceptual Framework in Section 2 above. This supports the view reported in paragraph 4.20 of the Discussion Paper that 'there are no circumstances when recognising an asset or a liability would provide information that is relevant but yet would not result in a faithful representation of that asset or liability and of changes in that asset or liability'. Accordingly adding a separate criterion that refers to faithful representation would be redundant. It may be, however, that a more careful description of the concept of 'faithful representation' would make it more useful and justify its use in the criteria for recognition.

4.36 As stated in paragraph 4.5 above, in our view entities should be able to conclude, when considering a transaction or event that is not the subject of a

standard, than an asset or liability should not be recognised because it fails to meet the recognition criteria. Use of the recognition criteria should not be reserved to the IASB.

Question 9

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;*
- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or*
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.*

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Response to question 9

4.37 We welcome the identification of the two challenges that arise on derecognition (i) reporting the assets and liabilities remaining after the transaction and (ii) faithfully reflecting the changes in assets and liabilities as a result of the transaction.

4.38 The control approach can be said to promote comparability, as two entities that have identical assets will report them in the same way. However, 'stickiness' (a prohibition of derecognition unless stringent criteria are met) also promotes comparability—that between the financial position at the beginning and end of the reporting period. This may also provide the most transparent information on the entity's history which is useful for an assessment of accountability. This is not to

suggest that 'stickiness' should invariably prevail, but rather to emphasise the difficulty of the challenges that the Discussion Paper highlights.

4.39 Whether an asset or liability is derecognised should depend on the substance of the transaction. In particular, derecognition is not appropriate when a transaction has no economic substance. Furthermore, prudence requires that caution is exercised in the recognition of income on transactions where the substance is doubtful.

4.40 The risks-and-rewards approach set out in the Discussion Paper is not the same as that used in the former UK standard FRS 5 'Reporting the substance of transactions'. The FRS 5 approach, which we support, prohibits derecognition only when there is no significant change in the entity's exposure to risks and rewards, rather than when it retains most of the risks and rewards. In Example 4.1 in the Discussion Paper the receivables would not continue to be reported at the same amount, if (as assumed) the change in the exposure to credit risk is significant.

4.41 Such a risk-and-rewards approach is complementary to rather than opposed to, the 'control' approach to derecognition. Considering risks-and-rewards in assessing whether control has been retained will assist in identifying the substance of a transaction. It will, in particular avoid the conclusion that a transaction justifies derecognition merely on the grounds that legal ownership of an asset has been transferred. We note that the Basis for Conclusions to IFRS 10 'Consolidated Financial Statements' acknowledges that a consideration of risks and rewards is relevant to application of a control approach (paragraph BC32).

4.42 If a control approach contained a requirement to consider changes in risks and rewards it would seem likely that the sale of bond with a repurchase agreement (Example 4.2 in the Discussion Paper) would not lead to derecognition and would be consistent with the view that the transaction had virtually no effect on the amount, timing and uncertainty of the entity's cash flows, other than receiving cash and repaying it with interest.

5 Definition of equity and distinction between liabilities and equity instruments (Discussion Paper Section 5)

General comments

5.1 The Discussion Paper presents quite radical proposals on the accounting for equity. It would seem that implementation of many of the proposals would fall to be reflected in a future accounting standard, but there is insufficient detail to form a view as to the merits of such a standard. It would seem that the proposals have only relatively minor implications for the Conceptual Framework.

5.2 The Discussion Paper explains (in paragraph 1.20) that the Exposure Draft will contain material on the reporting entity. It provides a summary of the IASB's 2010 Exposure Draft and the comments received on it. One point made by many commentators was that there should be a discussion of the perspective from which financial statements are prepared: that is whether an entity or proprietary perspective should be used. We agree with this, and consider that the Exposure Draft should explain how its proposals relate to these perspectives.

Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB's preliminary view:

- (a) the Conceptual Framework should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.*
- (b) the Conceptual Framework should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:*
 - (i) obligations to issue equity instruments are not liabilities; and*
 - (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).*

- (c) *an entity should:*
- (i) *at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.*
 - (ii) *recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.*
- (d) *if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.*

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

Response to question 10

5.3 We agree that the current definition of equity—the residual interest in the assets of the entity after deducting all its liabilities—should be retained.

5.4 We do not believe that the proposed statement of changes in equity will provide useful information. In particular, we do not agree that classes of equity should be remeasured by reference to market value. The amount at which equity is stated in the financial statements does not purport to reflect the market value of the entity. For this reason, there is no logic in reducing the amount attributed to ordinary shareholders' funds, by the market value of other classes of equity (such as options). We therefore do not support further development of the Discussion Paper's proposals on this subject.

5.5 We do not consider it necessary for the Conceptual Framework to address the case of entities that have not issued any equity instruments. However, we agree that accounting standards might address the financial reporting of these entities.

6 Measurement (Discussion Paper Section 6)

General comments

6.1 The discussion of measurement in Section 6 of the Discussion Paper fails to provide the depth of analysis that is necessary if the Conceptual Framework is to provide useful guidance to the IASB for the development of accounting standards. Many of the points made are consistent with current practices (which are accepted with only cursory justification) rather than providing a foundation for the improvement of financial reporting.

6.2 The objective that is identified for measurement merely repeats the objective of financial statements and the qualitative characteristics. The discussion of specific measurement bases is superficial and incomplete. As a result it is questionable whether the proposed guidance for the Conceptual Framework will be adequate.

6.3 It appears that cash-flow based measurements are to be used wherever it is concluded that cost or current market prices are unavailable or unsuitable. They are therefore the default measure and so might, perhaps, be used fairly often. However, cash-flow based measurements are often highly dependent on subjective estimates and judgements and, as discussed in paragraph 2.26 of this response, this impairs reliability. It should therefore be acknowledged that such measures should be used only where their superior relevance outweighs this disadvantage.

6.4 As is clear from paragraphs 6.119–6.121 of the Discussion Paper, cash-flow based measurements do not respond to any specific objective: but the measurement objective should be derived from the Conceptual Framework, not invented for each individual standard.

6.5 Among the issues that might be addressed in the Conceptual Framework are:

- The relationship between entity-specific and market values, and the circumstances in which each might be used.
- The use of exit and entry values. Although the Discussion Paper notes in paragraph 6.50 that exit prices are relevant for assets that will be sold, and states that 'an entry price...might be relevant for assets

held for use', it does not discuss why entry prices may be more relevant.

- Related to this is the question of the circumstances (if any) in which transaction costs should be reflected in the carrying amount of an asset or liability.
- The consequences for measurement of changing prices. It is a serious mistake to assume that changing prices are only a major issue in highly inflationary economies. The cumulative effect of even moderate inflation is often significant. Furthermore, even in those economies where general inflation has recently been relatively low, the volatility of specific prices (for example, those for commodities) has been extreme—and a return of more serious general inflation cannot be discounted. We do not suggest that the Conceptual Framework should be a manifesto for the wholesale introduction of price-level adjusted accounting; but we do think that it should provide a rationale for the circumstances in which standards should require a measurement basis that takes account of price changes.

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35. The IASB's preliminary views are that:

- (a) *the objective of measurement is to contribute to the faithful representation of relevant information about:*
 - (i) *the resources of the entity, claims against the entity and changes in resources and claims; and*
 - (ii) *how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.*
- (b) *a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;*

- (c) *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;*
- (d) *the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:*
 - (i) *for a particular asset should depend on how that asset contributes to future cash flows; and*
 - (ii) *for a particular liability should depend on how the entity will settle or fulfil that liability.*
- (e) *the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and*
- (f) *the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.*

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

Response to question 11

6.6 As noted above, the proposed objective of measurement merely repeats material from earlier chapters about the objective of financial reporting and the qualitative characteristics, and therefore seems unexceptionable. And we question whether it provides adequate guidance for the development of sound principles that will guide the development of accounting standards.

6.7 As explained in Section 2 above, 'faithful representation' as described in the current Conceptual Framework can be attained, provided adequate disclosure is made, for any conceivable measurement basis. The concept of faithful

representation therefore does not provide any useful content to the proposed objective. In contrast, reliability is a very significant factor in the selection of an appropriate measurement basis, and the Conceptual Framework's treatment of measurement will be incomplete unless the implications of reliability are addressed.

6.8 We agree with preliminary view (b) that a single measurement basis is unlikely to provide the most relevant information for users of financial statements, and that selection of an appropriate measurement basis will enhance the quality of the information in both the statement of financial position and the statement(s) of profit or loss and OCI. We welcome the IASB's preliminary view (c) that the statement of financial position and the statement(s) of profit or loss and OCI should be considered in the selection of a measurement basis.

6.9 The Discussion Paper does not discuss the concept of value and the relationship between the value of an asset or liability and the cash flow that it may contribute. In the absence of such a discussion it is difficult fully to assess preliminary view (d). An advantage of the proposed revisions to the definitions of assets and liabilities is that they bring greater clarity to the distinction between the existence of assets and liabilities and the flows that might result from them: a focus on future cash flows seems inconsistent with this.

6.10 We agree that the appropriate measurement basis for an asset should depend upon the possible ways in which it brings value or cash flows to the entity, and that the manner in which a liability will be settled or fulfilled is relevant to selecting an appropriate measurement basis for it. However, we consider that this insight should be more carefully developed. As stated, it might justify accounting based on management intent. In our view, an asset should not be written down simply because management intend to use it in a sub-optimal manner; nor should assets be written up to values that the entity has no ability to capture. The concept of a business model (which in our view is not dependent on management intent) assists in identifying the ways in which assets may bring value and cash flows to the entity. Examples of this are given in the responses to the following questions.

6.11 We agree with preliminary views (e) and (f). The Conceptual Framework should be clear that a meaningful assessment of the benefits and costs of a particular measurement basis cannot be made in isolation, but only relative to the benefits and cost of alternative measurement bases.

Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96. The IASB's preliminary views are that:

- (a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.*
- (b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.*
- (c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.*
- (d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.*

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

Response to question 12

6.12 We agree that assets which provide inputs to the entity's business model should be measured at entry prices. This faithfully reflects their value to the entity and results in financial statements reporting the margin—the difference between entry prices and revenue—when revenue is recognised and the assets are derecognised.

6.13 We agree that assets that will be sold should be reported at current exit prices subject to the following points.

- (i) The Discussion Paper's rationale for not applying this to inventory is unconvincing: a sounder justification is that inventory is an input to the

entity's business model and therefore should be reported at an entry rather than an exit price.

- (ii) Because the justification for using exit prices for assets that will be sold is to reflect the amount that will be obtained from sale, in our view the costs to sell should be deducted. In any event the Conceptual Framework should provide guidance on the treatment of transaction costs.
- (iii) Where an asset is reclassified as held for sale, the measurement basis should not be increased to a current exit value that is higher than its previous carrying amount. To do so would be to recognise the profit that will be realised on sale while it was still uncertain—indeed perhaps before a buyer has been identified. This would be contrary to the concepts of prudence and reliability.

6.14 We agree that financial assets that are held for collection should be measured at entry prices, because they are inputs to the entity's business model, and the reasoning set out in paragraph 6.12 above applies.

6.15 The Discussion Paper's treatment of assets where the entity charges others for use refers to a number of ideas—the number of assets held, the value of the individual assets, and the size of the group of assets. We think the conclusion is that current values are more relevant, but that historical cost may be used where price changes are not likely to be significant and the cost of preparing information based on current prices is significantly greater than that of historical cost. We agree with that conclusion.

Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109. The IASB's preliminary views are that:

- (a) *cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.*
- (b) *a cost-based measurement will normally provide the most relevant information about:*

- (i) liabilities that will be settled according to their terms; and*
- (ii) contractual obligations for services (performance obligations).*

- (c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.*

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

Response to question 13

6.16 The IASB's preliminary views fail to establish the measurement objective that should determine the selection of a measurement basis for liabilities. As stated in paragraph 6.4 above, the Conceptual Framework should identify what that objective should be. Thus, whilst we agree that, for many liabilities, the measurement will necessarily be calculated from an estimate of future cash flows, we do not think that that conclusion will lead to noticeable improvement in financial reporting.

6.17 Liabilities with stated terms will often arise in respect of obligations to provide goods and services to customers. They are inputs to the entity's business model and consistently with our views on assets, are appropriately measured at entry costs. (The Discussion Paper addresses obligations to provide services but does not mention obligations to provide goods: we assume this is an unintentional slip.)

6.18 We agree that current exit prices are likely to be the relevant measure for liabilities that will be transferred—but, as there will often be no market, it is unclear that 'current market prices' is an appropriate description. As with assets, the amount should include the cost to transfer the liability.

Question 14

Paragraph 6.19 states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to

their terms may not provide information that is useful when assessing prospects for future cash flows:

- (a) if the ultimate cash flows are not closely linked to the original cost;*
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or*
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).*

Do you agree with this preliminary view? Why or why not?

Response to question 14

6.19 The Discussion Paper amplifies the question by stating that current market prices are likely to be the most relevant measure for assets and liabilities of this type. We agree that current market prices may be more relevant than cost in the circumstances described in the question. The case of impaired loans would presumably fall within (a).

6.20 Further clarity is necessary about whether 'current market prices' includes estimated current market prices where market information is not available. It may be that a cash-flow based measure would be used. That this is a possible objective for such a measurement is stated in paragraph 6.119 of the Discussion Paper: but the heading of this part of the paper is 'Cash flow measurements other than estimates of current prices'. We are therefore unsure what is intended.

6.21 Because the Discussion Paper does not discuss the concept of value, it does not provide a justification for the circumstances referred to in preliminary view (c).

Question 15

Do you have any further comments on the discussion of measurement in this section?

Response to question 15

6.22 Our principal comments on the discussion of measurement in this Section are set out in paragraphs 6.1–6.5 above.

6.23 The Discussion Paper uses the term 'measurement' rather than 'measurement basis'. But the term 'measurement' is ambiguous—it may refer either to the basis used (for example, historical cost or net selling price) or to the amount at which an asset or liability is stated in financial statements. The terms 'measurement basis' or 'measurement attribute' are preferable as they avoid this ambiguity.

6.24 The Discussion Paper addresses 'Exchange of items with equal value' in paragraphs 6.61–6.64. Most transactions take place because the value of what is exchanged differs: both parties attach a greater value to what they receive than what they give. The same asset may sometimes be sold at different prices in different transactions—for example a wholesale and a retail market. A more accurate description of what is intended may be 'transactions on arms' length terms'. This would additionally avoid the conclusion that such transactions are necessarily concluded at fair value.

7 Presentation and disclosure (Discussion Paper Section 7)

General comments

7.1 We note that there are gaps in the Conceptual Framework relating to presentation and disclosure and we welcome that the IASB is seeking to address these in its review of the Conceptual Framework.

7.2 We also welcome that the IASB is taking a number of steps to encourage disclosures that are more relevant for investors and reduce the disclosure burden for preparers. With that in mind, we consider that the IASB has achieved the right balance between the material that has been included on disclosures in the Discussion Paper and that planned under its 'Disclosure Initiative'.

7.3 We broadly support the IASB's preliminary views on presentation and disclosure. Our comments on specific aspects of the proposals are set out below.

7.4 The IASB's Conceptual Framework sets out an objective for general purpose financial reporting. We believe that it would be helpful for the Conceptual Framework to identify the boundary of financial reporting and distinguish between financial statements and other financial reports.

7.5 We believe that this point is particularly important for the discussions around the disclosure framework. As currently drafted, some of the discussions in Section 7 of the Discussion Paper seem to be inadvertently expanding the boundary of the notes. As an example, it may be more appropriate to place disclosures describing a company's business model in management commentary rather than in the notes.

7.6 The FRC has developed some ideas around the boundary of financial reporting and other financial reports in its October 2012 Discussion Paper 'Thinking

about disclosures in a broader context'⁶ and in its recent Exposure Draft 'Guidance on the Strategic Report'⁷.

'Presentation' and 'disclosure'

7.7 Whilst there is clearly a strong link between presentation and disclosure, we believe that they are distinct, and should be dealt with in different Chapters of the Conceptual Framework. They are different considerations in the standard setting process. For example, the objective of presentation in IAS 1 'Financial Statement Presentation' is associated with the provision of information for comparability purposes.

7.8 We agree that the term 'presentation' as described in 7.10 is commonly associated with the 'disclosure of financial information on the face of an entity's the primary financial statements'. We consider this to be a suitable starting point for the defining the term. However, we would prefer to define the term as 'the display of information for comparability purposes' as using the word 'disclosure' to describe presentation blurs the boundary between the topics.

7.9 The description of 'disclosure' given in paragraph 7.11 of the Discussion Paper is unhelpful as it includes the whole of financial reporting. It would be helpful for the Conceptual Framework to provide a more focused definition, which would explain the nature of disclosure and differentiate it from presentation. We suggest: 'Disclosure is the provision of information that amplifies the information displayed in the primary financial statements'.

Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the Conceptual

⁶ A copy of the discussion paper can be accessed at <http://www.frc.org.uk/getattachment/99bc28b2-c49c-4554-b129-9a6164ba78dd/Thinking-about-disclosures-in-a-broader-context.aspx>

⁷ A copy of the exposure draft can be accessed at <http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report-File.pdf>

Framework. In developing its preliminary views, the IASB has been influenced by two main factors:

- (a) the primary purpose of the Conceptual Framework, which is to assist the IASB in developing and revising Standards (see Section 1); and*
- (b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8), including:*
 - (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;*
 - (ii) amendments to IAS 1; and*
 - (iii) additional guidance or education material on materiality.*

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the Conceptual Framework on:

- (a) presentation in the primary financial statements, including:*
 - (i) what the primary financial statements are;*
 - (ii) the objective of primary financial statements;*
 - (iii) classification and aggregation;*
 - (iv) offsetting; and*
 - (v) the relationship between primary financial statements.*
- (b) disclosure in the notes to the financial statements, including:*
 - (i) the objective of the notes to the financial statements; and*
 - (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.*

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the Conceptual Framework.

Response to question 16

7.10 We broadly support the IASB's preliminary views on presentation. We believe that it is helpful to define the term 'primary financial statements' and differentiate these from the notes to the financial statements. In addition, we agree with the development of an approach for presentation and disclosure that identifies recognised and unrecognised items as we consider that this will be useful basis for the development of a disclosure framework.

7.11 As stated in Section 2 above, we consider that the Conceptual Framework should identify the provision of information that provides accountability as a primary objective. We also believe that one of the objectives of the primary financial statements is to present information on a consistent basis to facilitate comparison between entities. We suggest that the objective of the primary financial statements should refer specifically to accountability and comparability.

7.12 We believe that the material on aggregation should refer to disaggregation as this will provide a link between the information that is presented in line items on the face of the primary financial statements and note disclosures which disaggregate those line items.

7.13 As noted in paragraph 4.27 above, the Discussion Paper does not provide convincing principles about offsetting. We disagree with the implication of paragraph 7.30 of the Discussion Paper that offsetting should be required only on the grounds of faithful representation and cost/benefit: relevance should also be a consideration.

7.14 We consider that it would be helpful to develop an objective for the notes to the financial statements as this would assist in determining which disclosures should be placed in the notes to the financial statements and those which should be located in other parts of the annual report. Overall, we consider that this section is based on a number of assumptions around the boundaries of financial reporting disclosures and placement of information without addressing these explicitly. The FRC has given considerable thought to placement and the FRC's draft 'Guidance on the Strategic Report' (particularly pages 9–13) may be of interest to the IASB. The

FRC is developing a 'core and supplementary' approach to structuring information in an annual report, which will enable the information that is important to investors to be given prominence.

7.15 We are concerned that the approach adopted in the Discussion Paper for developing an objective for the notes and determining the scope of the notes in paragraphs 7.33–7.41 of the Discussion Paper, is expanding the scope of the type of disclosures that would be included in the notes. Our specific comments relating to this section are set out below.

7.16 Paragraph 7.33 of the Discussion Paper describes the objective of the notes as 'to supplement the financial statements'. Many disclosures could be considered as 'supplementary' to the financial statements, including those that are included within management commentary. The IASB's 2010 Practice Statement 'Management Commentary' notes that the management commentary to 'complements and supplements the financial statements' (paragraph 10). Using the same terminology for disclosures is confusing and does not clearly differentiate between those disclosures that are placed in the notes and disclosures that would be located elsewhere.

7.17 We consider that the factors in sub-paragraphs 7.33(a) and (b) of the Discussion Paper are part of the objective of financial reporting. There is some repetition of these factors in paragraph 7.34 and 7.35(a) of the Discussion Paper. In addition, we are unclear as to how paragraphs 7.34(a) and (b) of the Discussion Paper relate to the objective of the notes to the financial statements.

7.18 We consider that the types of information included in paragraph 7.35 of the Discussion Paper would be relevant to investors. However, we question whether it is appropriate for all this information to be included within the scope of the notes.

7.19 As an example, Table 7.1 in the Discussion Paper includes a description of the business model. This is a disclosure which in practice most companies include in the front half of their annual report. The UK Government has recently introduced new regulations, to mirror current practice, which require disclosures of the business model to be provided as part of the management report.

7.20 Similarly, paragraph 7.35(d) of the Discussion Paper refers to risk information. In our view, risk information could be located in different parts of the annual report. The information about the types of risks faced by an entity and an entity's risk

management, as set out in Table 7.1 in the Discussion Paper, are also often included in management commentary or a governance statement.

7.21 There is also a need for further debate on whether all disclosures relating to unrecognised assets and liabilities should be included in the notes. An example would be information about unrecognised intangibles which may be useful to investors.

7.22 We acknowledge that placement of disclosures is an area that will vary by jurisdiction. However, we suggest that it would be helpful if the Conceptual Framework facilitated a flexible approach whereby disclosures could be provided outside of the notes. This could be achieved through the use of cross-referencing or by adopting the approach in IFRS 7 (paragraphs B6 and BC43–BC46). We believe that this would be a step towards reducing duplication that exists in annual reports.

7.23 We believe that it is important for the IASB to include some guidance on when forward-looking information should be included in the notes and the nature of forward-looking information that should be included in management commentary. We broadly agree with the IASB's preliminary view that forward-looking information should be included in the notes when it relates to existing assets and liabilities that exist at the end of the reporting period. This would include disclosures around material uncertainties that affect the going concern status of the entity as they relate to the valuation and classification of existing assets and liabilities.

7.24 We suggest that the explanation given in paragraph 7.42 of the Discussion Paper on comparative information should be included in the section on presentation in the Exposure Draft.

Question 17

Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing Conceptual Framework. Consequently, the IASB does not propose to amend, or add to, the guidance in the Conceptual Framework on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the Conceptual Framework project.

Do you agree with this approach? Why or why not?

Response to question 17

7.25 Yes. We broadly agree with this approach as we consider that a comprehensive project on materiality is required which would go beyond the scope of the Conceptual Framework. In our view, additional guidance on the application of materiality to disclosures is an important part of changing behaviour in this area and would cut clutter.

7.26 Whilst we agree that the concept of materiality is generally understood, we believe that, the description of materiality in the Conceptual Framework should make an explicit reference to the disclosure of immaterial information as it is a source of clutter in annual reports. We would therefore suggest including the following wording, which is in line with paragraph 7.46(c) of the Discussion Paper, in the Exposure Draft:

'When immaterial information is given in the financial statements, the resulting clutter can impair the understandability of material information. In such circumstances, the immaterial information will need to be excluded.'

7.27 Furthermore, we agree that the points made in paragraph 7.46 of the Discussion Paper are important points to emphasise in the additional guidance on materiality.

Question 18

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52.

Do you agree that communication principles should be part of the Conceptual Framework? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

Response to question 18

7.28 We believe that the communication principles are important and should be included as part of the Conceptual Framework. We concur with the view expressed

in paragraph 7.49 of the Discussion Paper that disclosures should focus on the communication of relevant information to investors rather than be considered a compliance exercise.

7.29 We agree with the communication principles proposed. In addition, we would suggest that:

- (a) the word 'concise' is added to principle (b) as we consider that it is important for disclosures to be written concisely;
- (b) principle (e)—we believe that duplication is more of a problem between information that is contained in the financial statements and other parts of the annual report. Therefore, we suggest that this principle is amended to read 'disclosure guidance should not result in the duplication of the same information in different parts of the financial statements or the financial report.'; and
- (c) the following principle is added:

'Disclosures should be current.'

7.30 We believe that it is necessary for the IASB to review disclosures periodically to ensure that disclosures that are no longer relevant are removed. For example, some disclosures may have been added in response to the financial crisis may no longer be a relevant in a few years' time.

7.31 In our view, organisation of disclosures is important, this is referred to in paragraph 7.50(c) of the Discussion Paper. Although the FRC's draft 'Guidance on the Strategic Report' focuses on narrative reporting, it sets that in the context of the annual report as a whole. We are hearing from preparers that they would like flexibility in financial reporting so that they can 'tell the story'. We would suggest that the IASB is mindful of this when setting standards to enable preparers to experiment and innovate with where disclosures are located and how they are organised.

7.32 Finally, we agree with the approach whereby the IASB sets a disclosure objective in each standard. We would also encourage the IASB to move away from setting disclosure requirements in standards which contain lists of detailed requirements as, in our view, this could lead to disclosure requirements being applied in practice as a checklist.

8 Presentation in the statement of comprehensive income—profit or loss and other comprehensive income (Discussion Paper Section 8)

General comments

8.1 The development of a principle-based approach to the reporting of financial performance should be a high priority for the IASB. We welcome the IASB's undertaking a research project reviewing IAS 1 'Presentation of Financial Statements', IAS 7 'Statement of Cash Flows' and IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. Work on the standards-level project and the Conceptual Framework should be carried out in tandem, as the work on each should inform the other.

8.2 We would emphasise the importance of cash flow reporting in this connection. Information on liquidity is highly significant, particularly from an accountability perspective. Information on cash flow and profitability is most useful if the links between the statement of profit or loss and the cash flow statement are transparent and easily understood.

8.3 The Discussion Paper discusses only one issue relating to the reporting of performance: the distinction between profit or loss and OCI. It is, however, difficult to consider that issue in isolation. Approaching the reporting of performance in this way focuses on aggregate amounts (profit or loss and other comprehensive income), and essentially poses the question of dividing the totality of income and expense between two broad and undefined buckets. We suggest that an information set approach would be more fruitful. This would identify the components of income and expense that would provide relevant information to users and develop proposals for how income and expenses can be presented to highlight those components. One such component should be an operating result, consistent with the entity's business model.

8.4 In developing this part of the Conceptual Framework, the IASB should consider whether the label 'Other Comprehensive Income' is appropriate. In our view, it is misleading, because financial statements cannot be comprehensive, as some assets and liabilities are not recognised. A preferable label may be, for example, 'other recognised income and expenses'. As noted in paragraph 4.13 above, we suggest that it would be appropriate for the Conceptual Framework to use

terms such as 'gains' and 'losses' in place of 'income' and 'expense'. If this were adopted, the term 'other recognised gains and losses' could be used in place of 'other comprehensive income', which would be more accurate and reduce the risk of misunderstanding. It would also allow the terms 'income' and 'expenses' to be used for a narrower class of changes in assets and liabilities that would correspond more closely with the natural meaning of those terms.

8.5 We also suggest that the proposition that all changes in assets and liabilities (other than those relating to transactions with owners) are 'income and expenses' should be reconsidered. An obvious exception is capital maintenance adjustments. There may be other changes, such as translation differences on foreign operations that should not be considered as income or expenses.

Question 19

The IASB's preliminary view that the Conceptual Framework should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22.

Do you agree? Why or why not?

If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or revising particular Standards?

Response to question 19

8.6 We agree that the Conceptual Framework should require a total or subtotal for profit or loss as it is used as the main indicator of an entity's performance and provides a starting point for analysis. However, we do not think it is adequate for the Conceptual Framework to omit any material on its nature or purpose. This is necessary to clarify its significance and to provide a rationale for what should be included or omitted from it. One means of meeting this need this would be for the Conceptual Framework to describe the objective of the statement of profit or loss. We suggest this should be along the following lines:

'The objective of the statement of profit or loss is to present income and expenses for the period in order to report the returns of the period, and facilitate an assessment of accountability and future returns.'

8.7 The Conceptual Framework should also observe that the predictive value of the statement of profit or loss is enhanced by distinguishing the results of the entity's operations (corresponding to its business model); income and expenses relating to financing and taxation; and non-recurring items.

Question 20

The IASB's preliminary view that the Conceptual Framework should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23–8.26.

Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?

If you do not agree, how would you address cash flow hedge accounting?

Response to question 20

8.8 We agree that all income and expenses should be reported in profit or loss unless their exclusion is required by an accounting standard. The treatment of such income and expenditure should depend on the reasons for its exclusion:

- (a) If they are excluded because reporting them in profit or loss is not consistent with the objective of the profit and loss account, they should not be recycled.
- (b) If they are excluded because an assessment of the entity's business model is facilitated by their inclusion in profit or loss for a later period, they should be recycled—that is, reported in the period that facilitates an assessment of the entity's business model.

If the Conceptual Framework provides for both types of exclusion they should be clearly differentiated.

8.9 The Conceptual Framework should require, rather than simply permit, all income and expenses that meet the criteria to be excluded from profit or loss and (if appropriate) recycled. We accept that in setting standards the IASB may depart from

the Conceptual Framework (if it provides a justification for doing so). It is not, however, appropriate for the Conceptual Framework itself to set out principles that may be observed on an optional basis.

8.10 We do not agree that all items reported in OCI should be recycled. The main justification for this view seems to be that all income and expense should be reported in profit or loss at some point. But the role of the profit or loss account is to provide information of the income and expenses of the reporting period, not to ensure that the cumulative amounts reported have any particular significance. Including an item in profit or loss simply to report the 'right' cumulative position is inconsistent with that objective.

8.11 Recycling should only be required when it provides relevant information about an event of the period. The Discussion Paper suggests (paragraph 8.24(b)) that realisation is an example of such an event. However, we question whether recycling is the only or best means of providing the information about realisation that is required in order to fulfil the objectives of financial statements. The decision on how this information is best reported may be better addressed in the development of standards rather than in the Conceptual Framework.

Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78) and a broad approach (Approach 2B described in paragraphs 8.79–8.94).

Which of these approaches do you support, and why?

If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

Response to question 21

8.12 The approach we support is set out in paragraph 8.8 above.

8.13 We do not support the narrow approach (Approach 2A) as it fails to allow for some income and expenses (such as some changes in surpluses and deficits on defined benefit pension plans) that should not, in our view, be reported in profit or loss.

8.14 If the Conceptual Framework is to embed the use of 'bridging items' it should require that the IASB identify the reasons why a different measurement basis may be required in profit or loss from that used in the statement of financial position. A superior rationalisation may be that it is more informative to present separately different components of the change in the amount at which assets and liabilities are stated. For example, in the event that property, plant and equipment are revalued, it is clearly more useful to present the cost of consumption (represented by depreciation) separately from the holding gain that arises in the period. We do not necessarily agree that cost-based information on consumption is always more relevant than that based on more up to date prices and regret that the Discussion Paper assumes this, without a convincing justification.

8.15 We are not convinced that the principle set out in the Discussion Paper that 'the cumulative amount recognised in profit or loss since the entity acquired the asset or incurred the liability should be consistent with the results of a meaningful, understandable and clearly describable measure of the asset or the liability' (paragraph 8.59). As stated above, the profit or loss reports on events of the period: the cumulative amount recognised has no relevance and may be inconsistent with that objective.

9 Other issues (Discussion Paper Section 9)

Question 22

Chapters 1 and 3 of the existing Conceptual Framework

Paragraphs 9.2–9.22 address the chapters of the existing Conceptual Framework that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the Conceptual Framework highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the Conceptual Framework.

Response to question 22

9.1 As explained in Section 2 of this response, we are very strongly of the view that the IASB should revise Chapters 1 and 3 to:

- Identify the provision of information on accountability as a primary objective of financial reporting, equal in prominence to that of providing information that is useful for making decisions about the provision of resources to the entity.
- Reconsider the replacement of 'reliability' with 'faithful representation'; the description of 'faithful representation' and the relationship between relevance and reliability/faithful representation.
- Identify prudence as a qualitative characteristic, confirm that it is not inconsistent with neutrality, and clarify its role.

9.2 We also note in paragraph 2.3 above that Chapter 3 would be the most logical place for the Framework to discuss the importance of reporting the substance of transactions. It would also be an appropriate place to acknowledge the importance of providing information that assists in an assessment of the entity's business model (see paragraphs 2.39-2.46 above) and to describe the going concern concept and its implications (see paragraphs 2.47-2.49 above).

9.3 The implications of these changes are explained elsewhere in this response.

Question 23

Business model

The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not?

If you agree, in which areas do you think that the business model concept would be helpful?

Should the IASB define 'business model'? Why or why not?

If you think that 'business model' should be defined, how would you define it?

Response to question 23

9.4 As explained in paragraphs 2.39–2.46 of this response, we consider that the Conceptual Framework should acknowledge that information is particularly relevant if it assists in an assessment of the entity's business model. It is not necessary for the Conceptual Framework to define the term 'business model'; but we suggest that it provide a general description of it as discussed in paragraph 2.42 above.

Question 24

Unit of account

The unit of account is discussed in paragraphs 9.35–9.41. The IASB's preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

Response to question 24

9.5 The unit of account issue is a highly significant issue that is pervasive in financial reporting. It is therefore not satisfactory for the Conceptual Framework to omit a discussion of the issue. Whilst we acknowledge that it is not feasible to identify principles that would unambiguously point to a satisfactory solution, the Conceptual Framework should set out indicators that would guide the development and application of accounting standards.

9.6 The Conceptual Framework should also require that accounting standards clearly identify the unit of account that has been selected, and the reasons for its selection.

Question 25

Going concern

Going concern is discussed in paragraphs 9.42–9.44. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

Response to question 25

9.7 As explained in paragraphs 2.47–2.49 of this response, it is important that the Conceptual Framework continues to reflect the concept of going concern, and explains that information that is prepared on a going concern basis is usually the most relevant.

Question 26

Capital maintenance

Capital maintenance is discussed in paragraphs 9.45–9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised Conceptual Framework largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

Response to question 26

9.8 As stated in paragraph 6.5 above, the issue of changing prices is too important an issue to neglect in the Conceptual Framework. It is not merely an issue for highly inflationary economies. Even moderate inflation has a significant cumulative effect, and specific price changes as well as general price changes need to be considered.

9.9 Concepts of capital maintenance are usually debated in the context of aggregate measures: as stated in Section 8 above, our view is that an information set approach, focussing on different components of income is likely to be more fruitful than a focus on high-level aggregate amounts. However, it would be possible to select different concepts of capital for different components of income. It may be, for example, that a physical concept of capital is appropriate for operating activities, but that this should not be applied to financial activities. We therefore think it would be regrettable if the IASB were to preclude further developments in its thinking in this area.