

## **Conceptual Framework for Financial Reporting (ED/2015/3)**

### **FRC Response**

**November 2015**

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## **1 Introduction**

1.1 In responding to the Discussion Paper 'A Review of the Conceptual Framework for Financial Reporting' (hereafter 'the Discussion Paper'), we noted that it provided a detailed and thoughtful overview of many complex issues, and contained a number of proposals with which we agreed. Many of these have been retained in the Exposure Draft, and others have been amended in a direction that is consistent with the comments we made. We recognise that the Exposure Draft represents a significant achievement although, as discussed below, we have substantial concerns with many aspects of its proposals.

### **The nature and purpose of the Conceptual Framework**

1.2 We share the IASB's view that the Conceptual Framework is fundamental to the IASB's mission to develop high-quality accounting standards that will foster confidence in financial reporting. It should not only provide a basis for the IASB's deliberations in the development of accounting standards, but also shape the dialogue between the IASB and its constituents. To be effective in this, the Conceptual Framework should clarify the meaning of words. However, confusion rather than clarity results if the Conceptual Framework defines words in a way that conflicts with their usual sense.

1.3 We believe that the Conceptual Framework should discuss concepts that should be considered in the development of accounting standards, but not that the Framework can set out prescriptions that must be rigidly adhered to in all cases, or identify the unique solution to all accounting issues. Accounting standard-setting inevitably involves the exercise of judgement to balance the advantages and disadvantages of alternative approaches, and the Conceptual Framework will not supplant that. Ideas and concepts should therefore be included in the Conceptual Framework if they are likely to be useful in a number of cases, even if there are other circumstances where they are less useful, and greater weight will be given to other considerations.

1.4 We would urge the IASB to ensure that the revised Conceptual Framework is as concise as possible, so that its principles stand out clearly and are not obscured by detail that is more appropriately dealt with in accounting standards (for example, the discussion of internally constructed assets). It should also be self-contained: it should not be necessary to refer to the Basis for Conclusions to understand the

implications of the principles, and principles that are important for the development of standards (such as asymmetric prudence) should be in the Framework, not merely in the Basis for Conclusions. However, a thorough Basis for Conclusions is important for those who critically appraise the Conceptual Framework, and also is an important part of the IASB's due process.

1.5 When the IASB originally undertook its work on the Conceptual Framework (jointly with the FASB) it decided that it should address not only financial statements but financial reporting. It is now proposed to add new Chapters that deal almost exclusively with financial statements, thus necessitating a noticeable change of direction at the start of Chapter 3. This detracts from the overall coherence of the Conceptual Framework and may create confusion and misunderstanding. In any event, we expect that the first two Chapters will often be read as applying only to financial statements. We therefore suggest that the Conceptual Framework should focus on financial statements rather than financial reporting as a whole. It may be helpful to note that some of its contents may also apply to other kinds of financial reporting, but if this is to be considered in detail, it should be a separate project.

### **Our major concerns**

#### *Cornerstone topics*

1.6 As we explain in some detail in Section 2 below, we are strongly of the view that:

- (a) The Exposure Draft's treatment of stewardship fails to acknowledge that investors need information to hold management to account. In order to reflect the importance of stewardship adequately it should not (as in the Exposure Draft) be treated as an ancillary part of an objective of making buy/hold/sell decisions, but either:
  - (i) stewardship should be identified as a separate objective, equal in prominence to that of providing information that is useful for making decisions about the allocation of resources; or
  - (ii) the notion of decision-usefulness could be broadened so that it specifically includes decisions about holding management to account.
- (b) The Conceptual Framework should embrace asymmetric prudence and not only 'prudence as caution'.

- (c) Reliability should be identified as a qualitative characteristic, with equal status to that of relevance.

1.7 In our view, these topics are cornerstones of the Framework. A revised Conceptual Framework should not be issued until the IASB's reconsideration of these is complete.

*Other major topics*

1.8 The Exposure Draft does not provide a sufficiently coherent, conceptual approach to the development of accounting standards on the important topics of measurement (Chapter 6) and financial performance (including the distinction between profit or loss and other comprehensive income) (Chapter 7, paragraphs 7.19–7.27). Considerable further work is necessary on both these topics before sufficient coherence is achieved.

1.9 The IASB may be unwilling to delay the issue of a revised Conceptual Framework until that work can be completed. In that event we have considered whether to advise that the Conceptual Framework be issued without these parts. However, it may be concluded that standard setting does need some framework in the interim and so we think that in those circumstances it would be necessary for the IASB to:

- restrict the discussion of these topics to what is essential and likely to be consistent with future developments; and
- make an unambiguous commitment that the material on these topics will be revised in the light of further, urgent work.

**2 Chapters 1 and 2:  
The Objective of General Purpose Financial Reporting  
Qualitative Characteristics of Useful Financial Information**

**Overview**

2.1 We welcome the IASB's decision to make substantive changes to these Chapters, in particular the greater emphasis given to stewardship and the specific acknowledgement of the concept of prudence. However, further development of these ideas is essential if the Conceptual Framework is to provide a useful basis for the development of high quality accounting standards. In particular:

- The objective of providing information for an assessment of stewardship should not be presented as merely ancillary to that of providing information that is useful to decisions about providing resources, which involve buying, selling or holding equity and debt instruments and providing credit.
- The discussion of prudence needs to embrace asymmetric prudence as well as prudence as caution. Misunderstandings about the relationship between prudence and neutrality are widespread: to avoid these, the term 'unbiased' should be used in place of 'neutrality'.

2.2 It would also be helpful to acknowledge that providing information on the performance of the business model assists financial reporting in achieving its objective.

2.3 We continue to believe that it is necessary for reliability to be identified as a qualitative characteristic. Whilst the increased discussion given to measurement uncertainty is helpful, we do not consider that it should be identified as an aspect of relevance.

2.4 We have suggested in paragraph 1.5 above that the Conceptual Framework should focus on financial statements rather than financial reporting. In discussing Chapters 1 and 2 we continue to refer to 'financial reporting' as that reflects the drafting of the Exposure Draft. However, the points made below are equally applicable if the narrower focus that we urge is adopted.

## **Stewardship**

2.5 An interesting review of the development of the current Conceptual Framework highlights that adoption of the sole objective of decision-usefulness, and the rejection of stewardship, was heavily influenced by FASB members and, more generally, by US thinking.<sup>1</sup> As the IASB is no longer pursuing the objective of developing its Framework jointly with the FASB, the IASB should reconsider whether the objective is fully reflective of the needs of its global stakeholders.

2.6 The Exposure Draft states that the objective of financial reporting is to provide financial information that is useful in making decisions about providing resources, which involve buying, selling or holding equity and debt instruments and providing credit. It goes on to explain that this involves an assessment of the future cash flows to the entity. To this existing discussion, it is proposed to add 'and their assessment of management's stewardship of the entity's resources'.

2.7 It is clear that the Exposure Draft retains the view that stewardship information is merely part of the information for decisions about providing resources. It does not reflect the reality that investors who invest for the long-term are vitally dependent on financial reporting to provide information that enables them to hold management to account. This requires an appraisal of all aspects of a company's performance and position, so that investors can engage in meaningful dialogue about the company's strategy and direction: it is much more comprehensive than merely monitoring risk management and compliance with laws and regulation—which is the implication of paragraphs 1.22 and 1.23 of the Exposure Draft—and therefore requires the provision of a much more complete set of information than that which would fulfil the Exposure Draft's relatively limited objective. Specifically, the stewardship perspective provides equity shareholders with information that enables them to make an assessment on the delivery of the business model and the creation of long-term shareholder value. This requires a complete account of the transactions and events of the period, which contrasts with the predictive, forward-looking perspective, which is required by a focus on decision-usefulness.

2.8 We are encouraged that the IFRS Foundation's recently-adopted Mission Statement says:

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<sup>1</sup> Christoph Pelger, Practices of standard-setting—An analysis of the IASB's and FASB's process of identifying the objective of financial reporting. Accounting, Organisations and Society (2015), <http://dx.doi.org/10.1016/j.aos.2015.10.001>

*IFRS strengthens accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Our standards provide information that is needed to hold management to account.*

We note that these words are repeated in the Introduction to the draft Conceptual Framework, but the status of this is unclear. Including them within Chapter 1 would be helpful, although in itself it would not meet our concerns.

2.9 The importance of stewardship might be reflected in the Conceptual Framework by identifying stewardship as a separate objective, equal in prominence to that of providing information that is useful for making decisions about the allocation of resources. Alternatively, the objective of providing information that is useful for making decisions could be broadened so that it specifically includes decisions about holding management to account as well as decisions about the allocation of resources.

### **The business model**

2.10 As noted above, an emphasis on stewardship requires information on the performance of the business model (or business activities) of the entity. The Exposure Draft discusses the role played in financial reporting of how an entity conducts its business activities in the context of specific issues (unit of account; measurement; and presentation and disclosure), but omits a general reference to the importance of this perspective in the discussion of the objectives of financial reporting. An acknowledgment that information on the performance of the business model assists financial reporting in achieving its objective would both make the discussion of the objectives more complete, and enhance the cohesiveness of the Conceptual Framework, by providing the premise for the relevance of business activities to the specific issues discussed in later chapters.

### **Prudence**

2.11 The reintroduction to the Conceptual Framework of a specific reference to prudence is very welcome. However, the treatment of it in the Exposure Draft—as support for the idea of neutrality—is wholly inadequate. The essence of prudence is the idea referred to in the Basis for Conclusions as 'asymmetric prudence'—a lower threshold for the recognition of liabilities and losses than for assets and gains—which is absent from the text of the draft Conceptual Framework itself.

2.12 The text of paragraph 2.18 is clearly based on that in the original 1989 Framework. Like that text, it explains that the exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. The 1989 text continued: *'However, the exercise of prudence does not allow...the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses.'* The Exposure Draft proposes to change this text by replacing 'however' with 'equally' and deleting the word 'deliberate' (twice).

2.13 The effect of these changes is significant. In the 1989 text, the avoidance of understatement of assets etc. was a check on the exercise of prudence—which naturally we would support. But in the text proposed in the Exposure Draft, it is placed as part of prudence itself. The result is that the idea of prudence loses any sense of direction, and is indistinguishable from the idea of neutrality.

*Asymmetric prudence*

2.14 In our response to the Discussion Paper we noted the following reasons for our advocacy of asymmetric prudence:

- 'Good news' that is reported before it is reasonably assured may be disregarded and, if it is not confirmed by subsequent events, undermines the credibility of financial reporting.
- In contrast, 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.

2.15 We also noted that asymmetric prudence was required by some standards. A recent example is provided by the constraints on recognition of variable consideration in IFRS 15 'Revenue from Contracts with Customers', which are justified in the Basis for Conclusions to that standard on the grounds that they ensure 'estimates are robust and provide useful information'.<sup>2</sup>

2.16 The Exposure Draft's Basis for Conclusions acknowledges that its proposals are consistent with asymmetric prudence (paragraphs BC2.14, BC5.45 and BC6.57), and accepts that it is a feature of current accounting standards. However, it is perverse to accept that a concept plays a role in accounting standards while omitting

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<sup>2</sup> IFRS 15, paragraph BC204.

a discussion of it from the Conceptual Framework. To do so is to accept that the Conceptual Framework is incomplete and that the IASB will have recourse to undefined and unspecified ideas in the future development of accounting standards.

2.17 The Basis for Conclusions justifies the approach taken by observing that the Conceptual Framework 'should not identify asymmetric prudence as a necessary condition of useful financial information' (paragraph BC2.14) and that 'if [the IASB] were to introduce asymmetric prudence it would need to consider how much bias is appropriate' (paragraph BC2.15). (As we discuss below, we do not accept the equation of asymmetric prudence with bias.) The substance of both these points is met by our view, explained in paragraph 1.3 above, that the Conceptual Framework cannot set out prescriptions that must be rigidly adhered to in all cases. Rather it should embrace ideas and concepts that should be considered in the development of accounting standards, even if there are circumstances where it is concluded that greater weight should be given to other considerations. Thus, in urging the inclusion of a discussion of asymmetric prudence we accept that there are issues in which it would not play a part.

2.18 Specifically, we agree that asymmetric prudence should not have the consequences identified in paragraph BC2.14—prohibiting the recognition of all unrealised gains; all gains not supported by observable market prices; and permitting measurement of an asset that is less than an unbiased estimate using the appropriate measurement basis.

*Prudence and neutrality*

2.19 As set out in our response to the Discussion Paper, in our view prudence is consistent with neutrality, as that term is used in the Conceptual Framework, which is:

*A neutral depiction is without bias in the selection or presentation of financial information. 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.*

Accounting policies that are based on sound and generally accepted accounting principles may reflect prudence, but this does not make them lack neutrality in this sense: they are not slanted or manipulated to affect the reception of the information by users.

2.20 However, it is clear that a different sense of neutrality is used to contrast neutrality and prudence, in which, information is neutral if it reflects economic reality. This would require, for example, that many assets that are not recognised to be reported at their economic value. Clearly this is not the sense in which the Conceptual Framework uses the term (although it may be closer to the everyday meaning of the word than the sense in which it is intended). Alfred Wagenhofer has recently noted a number of respects in which established accounting is not neutral in this sense:

*...recognition of an impairment loss but not a possible gain due to an increase in the economic resource above cost is not neutral, neither as a standard nor as an outcome. In some cases, only downside risks are recognized or disclosed (consider contingent liabilities, onerous contracts, and the like).<sup>3</sup>*

2.21 These practices, like the treatment of variable consideration in IFRS 15 are not 'slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users'. Thus they are neutral as that term is explained in the Conceptual Framework. There is clearly the risk of significant confusion about the meaning of 'neutrality'. In our view, the Conceptual Framework should dispel this by discarding the term 'neutrality' and replacing it with 'unbiased'.

## **Reliability**

2.22 We are very concerned that the Exposure Draft does not propose to identify reliability as a qualitative characteristic, and that measurement uncertainty is discussed as an aspect of relevance.

2.23 In our consideration of these issues, we have profited greatly from the historical review of the replacement of reliability by faithful representation given by Carsten Erb and Christoph Pelger (2015).<sup>4</sup> As summarised in the Abstract to that paper:

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<sup>3</sup> Alfred Wagenhofer, The Never Ending Story of Prudence and IFRS. <http://www.ifac.org/global-knowledge-gateway/business-reporting/discussion/never-ending-story-prudence-and-ifrs>

<sup>4</sup> "Twisting words"? A study of the construction and reconstruction of reliability in financial reporting standard-setting. *Accounting, Organizations and Society* 40 (2015) 13–40.

*Our study reveals that the standard-setters' construction and reconstruction of reliability attempted to undermine traditional practitioner understandings along the lines of objectivity/verifiability in order to extend the boundaries of appropriate financial reporting in the direction of current/fair values.*

2.24 The Basis for Conclusions provides an admirable summary of the arguments for the inclusion of reliability in paragraph BC 2.23. They are much more convincing than the reasons given to support the Exposure Draft's proposals.

2.25 As stated in our response to the Discussion Paper, we doubt whether the term 'reliability' is more ambiguous than many of the other terms used in the Conceptual Framework.

2.26 The Basis for Conclusions juxtaposes the pre-2010 discussion of reliability with that of faithful representation in the table at paragraph BC2.25. As that table shows, the pre-2010 Framework included the idea that reliable information 'can be depended on by users'. That critical idea is not captured by the discussion of faithful representation in the Exposure Draft: to restore it requires the identification of reliability as a qualitative characteristic.

2.27 We appreciate the greater emphasis given to measurement uncertainty proposed by the Exposure Draft. We agree that measurement uncertainty is one of the main implications of reliability (although it is not the only one). However, we do not agree that it should be regarded as an aspect of relevance.

2.28 In ordinary language, information may be highly relevant even if it is unreliable. If the prisoner in the dock claims that he was at home when the crime was committed, his assertion may well be unreliable, but it is clearly relevant (and, if he was in fact at home, may well be 'representationally faithful'<sup>5</sup>). Similarly, information that is subject to a high degree of measurement uncertainty may, in ordinary language, be regarded as highly relevant. Of course, such information may not be very useful: but usefulness and relevance are distinct concepts and clear thinking is hindered if distinct ideas are conflated.

2.29 One of the implications of what is proposed in the Exposure Draft is that the tension between relevance and reliability is replaced by one between measurement uncertainty and other aspects of relevance. This would require advocates of an

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<sup>5</sup> In the sense in which it was described in the FASB's SFAC 2: "correspondence or agreement between a measure or description and the phenomenon that it purports to represent".

approach that minimises measurement uncertainty to argue that it is more relevant than an alternative that is highly subjective: to make their view plausible, they will have to include reminders that they are using the term relevance to include measurement uncertainty, as set out in the Conceptual Framework, rather than its usual sense. As we observe in paragraph 1.2 above, while the Conceptual Framework can clarify discussions by bringing greater precisions to words, it will cause confusion if it provides definitions of terms that conflict with their usual sense.

2.30 In our view, one of the primary tensions in standard-setting is that between relevance and reliability. This requires that reliability is identified as a qualitative characteristic with equal status to that of relevance. Measurement uncertainty should be discussed as an aspect of reliability.

### **Verifiability**

2.31 Reliability is supported by the concept of verifiability. The Framework says that verifiability means that different observers could reach consensus that a particular depiction is a faithful representation. However, the idea of the possibility of 'consensus' is weaker than that 'based on objective evidence'. It is also removed from reality, as many accounting amounts are derived from evidence, but it is rare to consult a number of 'knowledgeable and independent observers' to test whether a consensus can be reached. We therefore suggest that verifiability is explained in terms of 'based on objective evidence' rather than 'consensus'.<sup>6</sup>

### **Faithful representation**

2.32 In our response to the Discussion Paper, we noted that the description of faithful representation was too general. As a result it failed to identify the kind of information that should be presented in financial statements. We welcome the addition to the discussion of faithful representation the point that it requires the depiction of the economic substance and not merely legal form, and the deletion of the paragraph formerly numbered QC16.

2.33 The implications of faithful representation are helpfully developed in paragraph 5.23 which emphasises the need to consider not just an individual item, but also related assets, liabilities, income and expenses and disclosures. This is

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<sup>6</sup> Erb & Pelger (op cit) trace the evolution of the idea of 'verifiability'.

helpful because, for example, it counters the impression that faithful representation is all about the selection of a measurement basis for an asset or liability. We would recommend that this is relocated to Chapter 2, which would meet our previous concerns. However, even with these changes, the concept of faithful representation would still require the separate identification of reliability as a qualitative characteristic in its own right: faithful representation cannot include the idea of reliability as a proposition—like the prisoner's assertion referred to in paragraph 2.28 above—may be completely representationally faithful—but still unreliable.

### **The users of general purpose financial reporting**

2.34 The Exposure Draft proposes to retain the current Framework's identification of users of financial reports, that is: existing and potential investors, lenders and other creditors. We support this approach.

2.35 We would emphasise the importance of the variety of the needs of users as described by the Exposure Draft in paragraph 1.8, and the undertaking that *'The IASB, in developing financial reporting standards will seek to provide the information set that will meet the needs of the maximum number of primary users.'* For example, the information needed by equity investors (existing and potential) differs in some respects from that required by lenders, and even within equity investors there may be different information needs. Thus financial statements need to report a wide range of information that will meet all their needs: this is further emphasised by a proper emphasis on stewardship, as urged above.

2.36 In our view it would be a mistake to expand the set of users. There are good reasons why entities may elect or be required to report information that is of benefit to other parties. However, the inclusion of information that is provided to meet the needs of users other than existing and potential investors may result in financial reports that lack a clear focus, and in which the information that is relevant to investors is obscured.

### 3 Chapter 3: Financial Statements and the Reporting Entity

#### The role of financial statements

3.1 The main purpose of this section of the Exposure Draft (paragraphs 3.2–3.10) is to make a transition between Chapters 1 and 2, which deal with financial reporting and the subsequent Chapters, which deal with financial statements. We suggest in paragraph 1.5 above that the Conceptual Framework should focus on financial statements: if this recommendation were adopted, this material could be relocated to Chapter 1.

3.2 We suggest that the Conceptual Framework acknowledge the respects in which financial statements differ from other financial reports. As we pointed out in our response to the Discussion Paper, they comply with accounting standards and other regulations, are published regularly and are audited.<sup>7</sup>

#### Going concern

3.3 The going concern concept is one of the core principles on which financial statements are based. This was reflected in the original (1989) edition of the Framework, which described it as an 'underlying assumption' and accorded it the same prominence as the accrual basis of accounting. The Basis for Conclusions suggests that only editorial changes have been made, but we disagree, and are concerned that the Exposure Draft is much weaker than the existing wording.

3.4 The existing Conceptual Framework states (in the same terms as the 1989 edition) *'The financial statements are normally prepared on the assumption that the entity is a going concern and will continue in operation for the foreseeable future'*. The clear implication of this is that the going concern assumption normally results in the most relevant information. In contrast, the Exposure Draft proposes: *'This [draft] Conceptual Framework is based on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.'* This suggests that the assumption is arbitrary, and loses the implication of the relevance of going concern information.

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<sup>7</sup> The 'competitive advantage' of financial statements is well articulated by Stefano Cascino, Mark Clatworthy, Beatriz García Osmá, Joachim Gassen, Shahed Imam and Thomas Jeanjean (2013) 'The use of information by capital providers'. ICAS and EFRAG.

3.5 Underlining that the going concern basis is appropriate, in all but the most extreme circumstances, highlights the need to distinguish:

- (i) whether it is appropriate for the financial statements to be prepared on the going concern basis; and
- (ii) whether there are uncertainties relating to the entity's ability to continue in operation that need to be disclosed.

3.6 This distinction was highlighted in the report of The Sharman Inquiry.<sup>8</sup> We continue to believe that it is not adequately set out in IFRSs, and hence there is a risk that disclosures about material uncertainties relating to going concern are inadequate.

### **The reporting entity**

3.7 The Exposure Draft effectively proposes no limit on what may be a reporting entity—it need not be a legal entity, and may be a portion of an entity, or two or more entities. The Basis for Conclusions notes that the 2010 Reporting Entity Exposure Draft stated *inter alia* that a reporting entity should be '*a circumscribed area of economic activity*' and that its '*economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists*'. It would be helpful to include these points as it would imply that, where these conditions are not met, the financial statements may not be reliable or representationally faithful. We therefore believe that the IASB should reconsider the exclusion of these paragraphs of the Reporting Entity Exposure Draft.

3.8 The Exposure Draft explains that '*Financial statements are prepared from the perspective of the entity as a whole, instead of from the perspective of any particular group of investors, lenders or other creditors.*' The perspective to be adopted is a pervasive and highly significant issue, and we urged further analysis in our response to the Discussion Paper. Our view remains that further analysis of this issue is required. It may be appropriate for this to be considered in the IASB's research project on 'Financial Instruments with Characteristics of Equity'.

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<sup>8</sup> The Sharman Inquiry may be accessed at: <https://www.frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx>

**Consolidated and unconsolidated financial statements**

3.9 The observation in paragraph 3.23 of the Exposure Draft to the effect that consolidated financial statements are more likely to provide useful information than unconsolidated financial statements is, in our view, inappropriate. As is acknowledged in paragraph 3.20, there are investors whose needs are better met by unconsolidated financial statements. In our view, the Conceptual Framework should not make generalisations of this nature.

3.10 We also consider that the Conceptual Framework should not set out specific disclosure requirements. The comment that it is necessary for unconsolidated financial statements to disclose how the consolidated financial statements may be obtained (paragraph 3.25) should therefore not be included.

## **4 Chapter 4: The Elements of Financial Statements**

### **Income and expenses**

4.1 As stated in our response to the Discussion Paper, it is in our view regrettable that the Conceptual Framework uses the terms 'income' and 'expenses' to refer to the elements that correspond to non-owner changes in assets and liabilities. These terms have established meanings and connotations that are not always appropriate. In particular, they strongly imply that all non-owner changes in assets and liabilities form part of financial performance—for how can financial performance be anything other than income less expenses? It would therefore be more helpful and reduce misunderstanding to use more general terms, such as 'gains' and 'losses' for the elements that correspond to non-owner changes in assets and liabilities. 'Gains' and 'losses' clearly include all income and expenses but also other items that 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, for example to refer to those gains and losses that are reported in the statement of profit or loss.

4.2 The Exposure Draft does not propose to retain the discussion in the existing Conceptual Framework that distinguishes revenue from other gains and expenses that arise in the course of ordinary activities from other losses. The idea of 'ordinary activities'—or, perhaps better 'operating activities'—is important and should be addressed in the Conceptual Framework, although we agree that this need not be in the elements chapter but might more logically be discussed in the chapter on presentation and disclosure.

4.3 The Exposure Draft states that income and expenses include changes in the carrying amount of assets and liabilities. It would be helpful to clarify that changes that do not reflect changes in an attribute of an asset or liability—for example those relating to a change of accounting policy or the correction of errors—are not income or expenses.

### **Completeness of the elements**

4.4 One of the most important contributions of the Conceptual Framework is to require that only items that meet the definition of an element are recognised in financial statements. But the Exposure Draft does not secure this.

4.5 The Exposure Draft does not propose defining contributions of equity and distributions of equity as elements. This gives the odd result that these are not

recognised in financial statements. The Exposure Draft attempts to get around this awkwardness by defining recognition in terms of inclusion in the statement of financial position or statement(s) of financial performance, but this breaks down in the helpful explanation of how the financial statements articulate. It therefore seems necessary to define elements corresponding to changes in equity.

4.6 It is also necessary, if the reclassification of income and expenses is to be permitted or required, to define reclassification adjustments as elements.

4.7 The Exposure Draft does not propose defining elements for the cash flow statement. We would hope that this will be considered within the research project 'Primary Financial Statements' and that the IASB will be prepared to amend the Conceptual Framework if that work shows that it is necessary. We also note that the research project on 'Financial Instruments with Characteristics of Equity' may lead to proposals to amend the definition of equity.

#### **Definition of a liability and supporting guidance**

4.8 We do not consider the observation in paragraph 4.25 that if one party has an obligation another party must have a corresponding asset to be necessary: it may be that it confuses rather than clarifies, for example where the 'party' that has the asset is as vague as society at large. We welcome, however, the statement in paragraph 4.26 that the recognition and measurement of the liability by one party may differ from that of the asset by the other, which is consistent with asymmetric prudence.

4.9 The supporting guidance on liabilities and the idea of a present obligation seems helpful and may provide a basis for further work that will lead to sound accounting solutions to issues such as levies. However, further development of these ideas seems to be necessary. In particular:

- (i) It would seem that, despite the words 'for example', paragraph 4.32 is intended to constrain the interpretation of 'no practical ability to avoid a transfer' to extreme cases—significant business disruption or economic consequences significantly more adverse than the transfer itself. While such a restriction might be appropriate in an accounting standard, it does not seem to be conceptually correct: the obligation would exist where any action that is practicably available to the entity is more adverse, even by a small amount, than the transfer itself, rather than 'significantly' more adverse.

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- (ii) It would also be useful to make the point that where action to avoid the obligation would involve a transfer of economic benefits, an obligation (and hence a liability) for that smaller transfer exists.
- (iii) It is arguable that the approach confuses the existence of a liability with its measurement. An obligation that an entity has the practical ability to avoid through its future actions is a present obligation until that action is taken: however, where the entity has the practical ability to avoid it the obligation is less onerous and, if it is recognised, this should, perhaps, be reflected in its measurement.

Suppose, for example, an entity is subject to a levy if its revenues exceed a threshold. As it earns revenue it incurs a liability, as its future ability to earn profits is constrained. However, if it can (or even will) take action to avoid paying the levy, then this should be reflected in the measurement of the liability. Where the future action involves no transfer of economic benefit, the liability would be measured at nil.

Whether the issue is one of definition or measurement is, perhaps, a conceptual nicety. It would seem that either approach would lead to the same answer in the majority of cases, and that excluding obligations that the entity has the practical ability to avoid from the definition has the practical advantage of limiting the number of possible obligations that need to be considered.

- (iv) The idea of 'the extent of the obligation' seems rather vague. Whatever it means precisely, it is clear from the Basis for Conclusions (paragraph BC4.63) that it does not determine the measurement basis, and hence is not necessarily equivalent to the amount that will be included in financial statements. However, it may be appropriate for clarification of this to be made in accounting standards rather than the Framework.

4.10 These thoughts are intended to assist in clarifying the conceptual issues. Of course, other issues would need to be considered in the development of an accounting standard.

*Executory contracts*

4.11 We agree with the discussion of executory contracts.

## **Unit of account**

4.12 Identifying the unit of account is a matter of some practical importance. We therefore welcome the inclusion of guidance regarding the determination of the unit of account and support the IASB's current approach of providing examples of possible units of account and factors that standard setters should consider when selecting the unit of account.

4.13 We do believe, however, that the Conceptual Framework should require accounting standards to identify the unit of account and the reasons for its selection. Providing such information in each accounting standard is consistent with the IASB's belief that selecting the unit of account should be a standards-level decision.

4.14 The examples and factors set out in the Exposure Draft represent useful guidance and we broadly support the text as it is currently drafted. There are, however, two areas that we suggest the IASB consider amplifying when finalising the Conceptual Framework.

4.15 First, although the Exposure Draft acknowledges that the unit of account can, in some circumstances, be different for recognition and measurement purposes, it would be helpful if the Conceptual Framework clarified the starting position. Our reading of the current text indicates that, from the IASB's perspective, the starting point should be the same for both recognition and measurement. If that is the IASB's view, a statement to that effect and a justification of that view would be appropriate.

4.16 We also note that it is quite common for there to be more than one unit of account for measurement depending on the lens through which the asset or liability is viewed. For example, an asset might be componentised for the purposes of depreciation but valued together with other assets for the purposes of determining fair value or value-in-use. The Conceptual Framework should, therefore, acknowledge the inter-relationship between the unit of account and the selection of a measurement basis.

4.17 Secondly, we believe that whilst the cost constraint may ultimately require the unit of account to be modified, we do not believe that this factor should be taken account of in the first instance, that is, when determining the unit of account on a theoretical level. The analysis of the unit of account logically precedes the determination of the point of recognition and measurement basis, and standard setters should be required to determine and describe the unit of account at that

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theoretical level. If another unit of account is ultimately chosen for pragmatic reasons, this should be explained and justified in the relevant standard.

## **5 Chapter 5: Recognition and Derecognition**

5.1 The views expressed in Section 2 above on the objective of financial reporting and the qualitative characteristics would require significant revisions to the Chapter on recognition. In particular:

- If the Conceptual Framework is to include the idea of asymmetric prudence, it would be necessary to acknowledge that early recognition of liabilities and losses may be more relevant than that of assets and gains.
- If reliability is identified as a qualitative characteristic, it would be necessary to recognise that a balance needs to be struck between relevance and reliability (including measurement uncertainty).

5.2 However, we support the general approach to recognition adopted in the Exposure Draft, which we would characterise as setting out the ideas to be thought about in considering issues of recognition, rather than developing precepts that should be rigidly followed in all cases. It is doubtful whether a rigid approach can be developed that would command general support and would lead to reasonable answers in all cases.

5.3 It would be helpful for the Conceptual Framework to note that, when considering recognition issues, alternatives, such as disclosure in the notes, should be considered.

5.4 We agree with the discussion of derecognition.

## **6 Chapter 6: Measurement**

6.1 The Exposure Draft's discussion of measurement is significantly revised from that in the Discussion Paper and contains a number of improvements. In particular, we welcome:

- the treatment of cash flow techniques as techniques for estimating the amount of an asset or liability on a particular measurement basis rather than as a separate category of measurement; and
- the use of the term 'measurement basis' rather than the ambiguous 'measure'.

### **The need for further analysis**

6.2 Despite these improvements, in our view, like that in the Discussion Paper, the Exposure Draft's discussion of measurement 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.

6.3 We strongly agree with the observation in paragraph BC6.3 that the lack of guidance on measurement is serious gap in the existing Conceptual Framework. The implications of the remainder of this paragraph appear to be that:

- the IASB does not consider further research on measurement to be necessary; and
- the proposals in the Exposure Draft are more than 'high level guidance' and are expected to be sufficient to guide the choice of measurement bases in accounting standards for the foreseeable future.

We strongly disagree with both these propositions.

6.4 In our view, the Conceptual Framework should specify the objective of measurement that will provide the information that can be expected to achieve the objectives of financial statements. (This might build on the discussion of accrual accounting given in paragraphs 1.17–1.19.) The Framework should then set out how measurement bases with different features can contribute to that end.

6.5 Such an exploration is likely to be illuminating. To illustrate:

- As noted in paragraph 6.30 of the Exposure Draft, some may find fair value not relevant for assets that will not be sold. It would be helpful to analyse whether that is because they do not consider an exit price is relevant for an asset that will not be sold, or because they do not consider changes in the value of such assets relevant.
- As noted in paragraph 6.31 of the Exposure Draft, fair value may result in different entities reporting identical assets at similar amounts and this arguably assists comparability. This may be because of the restatement of acquisition cost to current values, or it may be the market participant perspective. (We comment on this point further in paragraph 6.11 below.)

6.6 Clearly it will take some time to complete this challenging task. As stated in the Introduction, we suggest that, if the IASB is unwilling to delay the issue of a revised Framework, the IASB should commit itself to further work on major topics, including measurement, at the time the revised Framework is issued. Some of the principal topics that the further work on measurement should address are indicated below. We would emphasise that this is intended to identify issues and demonstrate their importance rather than to advocate particular solutions.

*Historical cost*

6.7 The Exposure Draft describes historical cost as it is presently used in practice. However, it does not provide a theory of the underlying rationale of historical cost. It therefore leaves decisions to be taken in the development of accounting standards to be taken on an *ad hoc* basis. Some of the issues such a theory might illuminate are:

- When an asset is recognised at historical cost, which costs should be included, and why? For example, should borrowing costs be capitalised? Why are transaction costs included?
- Should the historical cost of an asset be adjusted when a related liability is remeasured, or should the change be reported as income or expense? This issue arises, for example, in the case of decommissioning liabilities, foreign currency payables and lease liabilities.

- What are the objectives of depreciation? The Basis for Conclusions to IAS 16 'Property, Plant and Equipment' notes that a broad project is required to explain the notion of 'consumption of economic benefits'.

*Entry and exit values*

6.8 Although the Exposure Draft notes that historical cost and current cost are entry values, it does not provide any discussion of when an entry or exit value should be used. The Basis for Conclusions reports the IASB's view that that 'there is often little difference between entry and exit values in the same market, except for transaction costs...' (paragraph BC6.18(a))

6.9 This misses the point that in practice an entity often buys assets on one market and sells them in another. For example, a retailer buys in the wholesale market (which its customers cannot access), and sells in the retail market. For this reason exit and entry prices differ—often markedly. The Exposure Draft does not explain whether, and if so how, financial statements are to report the margin made on sale if input assets are not stated at entry prices.

*Entity-specific and market measures*

6.10 Although the Exposure Draft identifies some measurement bases as entity-specific and others as market values, we think that further analysis of these notions would be profitable.

6.11 The Exposure Draft suggests that market values enhance comparability because, in principle, they result in different entities reporting identical assets at the same amount, while entity-specific values could result in different measures for identical assets thus arguably reducing comparability (paragraphs 6.31 and 6.44). It is questionable, however, whether true comparability requires that different entities report identical assets at the same amount if opportunities available to the entities are different. As paragraph 2.26 says: *'For information to be comparable...different things must look different'*.

6.12 In this connection, it should be recognised that even fair value as specified in IFRS 13 'Fair Value Measurement' is entity-specific as the entity must have access to the market: *'Because different entities...with different activities may have access to different markets, the...market for the same asset or liability might be different for different entities'* (IFRS 13, paragraph 19).

*Price changes*

6.13 A striking omission of the Exposure Draft is a discussion of price changes. As we stated in our response to the Discussion Paper, it is a mistake to assume that changing prices are a major issue only in highly inflationary economies, as the cumulative effect of even moderate inflation can be significant. Also, while in many economies the level of general inflation has been low in recent years, specific price changes have been extremely volatile. We are not suggesting the wholesale introduction of price-level adjusted accounting, merely that the Conceptual Framework should consider the implications of changing prices for financial statements.

**Missing or incomplete concepts**

6.14 There are a number of ideas and measurement bases that are not addressed in the Exposure Draft, and the reasons given in the Basis for Conclusions for their exclusion are inadequate.

*Deprival value*

6.15 We are surprised that the IASB finds deprival value complex. It is similar to the application of historical cost, under which assets are written down when impaired to the higher of value-in-use and net realisable value. The difference is simply that current replacement cost is used in place of historical cost (which requires thought to be given to the presentation of holding gains). Nor does the fact that deprival value is not well accepted in some jurisdictions provide an adequate ground for discarding it. We are not suggesting that the IASB should necessarily adopt deprival value, but merely that it merits consideration. It seems particularly relevant as it provides a rationale for selecting particular measurement bases in the context of a mixed measurement system, which the IASB is proposing, and which we support. It therefore seems likely that an analysis of the strengths and weaknesses of deprival value would be helpful.

*Current cost*

6.16 Although current cost is mentioned in the Exposure Draft, the Basis for Conclusions explains that: a detailed discussion is unnecessary *'because the IASB would be unlikely to consider selecting current cost as a measurement basis when developing future Standards.'* No grounds are given for the IASB's rejection of a measurement basis that has received strong support in the theoretical literature, and

is identified as a possible measurement basis in the existing Conceptual Framework: as a result the draft Conceptual Framework fails to fulfil its purpose.

*Cost of release*

6.17 We do not understand why the Exposure Draft does not include cost of release as a possible measurement basis for liabilities. We agree that it is relatively rare for entities to negotiate a release from liabilities instead of fulfilling them, but no more than it is relatively rare for non-financial assets to be impaired. Indeed, the Exposure Draft notes (in paragraph 4.29) that liabilities may be settled by negotiating a release from the obligation. When faced with an onerous contract it may be clear that the amount required to obtain release is much less than the loss that would be incurred by fulfilling the contract. Often, the entity will be required to reimburse the other party for the loss caused by cancelling the contract, but this would not include costs that the other party has yet to incur. In such a case, if cost of release can be measured reliably, it would be the obvious measurement basis to use.

**Fair value**

6.18 Fair value has become an established feature of some IFRSs, almost by stealth. It was often introduced because it was perceived (in our view, incorrectly) as the only alternative to historical cost. Debate was therefore limited.

6.19 Nor was the conceptual merit of fair value tested during the development of IFRS 13. The objective of that project was always firmly stated to be how fair value should be determined, and there was no willingness to discuss whether it should be used. Although the Exposure Draft notes some circumstances where the use of fair value may not be relevant, it falls short of an analysis of the strengths and weakness of fair value.

6.20 The Exposure Draft notes some difficulties in estimating fair value where it cannot be observed (paragraph 6.32). This understates the problem. Richard Barker and Sebastian Schutle<sup>9</sup> present a convincing argument that, in the case of assets that are not traded on a market, meeting a demand for fair value measurement is not merely difficult but logically impossible.

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<sup>9</sup> Representing the market perspective: Fair value measurement for non-financial assets. Accounting, Organizations and Society (2015), <http://dx.doi.org/10.1016/j.aos.2014.12.004>

## The role of business activities

6.21 The Exposure Draft proposes that one of the factors to consider when selecting a measurement basis is how the asset or liability contributes to future cash flows, which depends in part on the nature of the business activities conducted by the entity (paragraph 6.54). The underlying idea seems to be to distinguish between assets that are essentially held for use in the business and those that will produce cash flows only through realisation or sale, and potentially apply different measurement bases to them.

6.22 We support this line of thought, although we consider that it needs more development, and that its implications need to be thought through. In particular we agree with the observation in paragraph BC6.51(b) that *'in many cases, the nature of the business activities is a matter of fact instead of an opinion or management intent'*. In our view, conceptually, the measurement of an asset or liability depends on the economic constraints and opportunities that are available to the entity, and not on what management intends to do with the asset or liability.

6.23 More specifically:

- (a) for assets and liabilities that can only give rise to cash flows through realisation or settlement (such as non-transferable debtors or liabilities) , the value of the future cash flows would seem to be the only relevant measurement basis;
- (b) assets and liabilities that will contribute to future cash flows or enhancement of value through being used in the business (for example, fixed assets or inventory) might be more relevantly stated at another amount.

6.24 The measurement basis used for assets and liabilities of type (b) requires further thought. In particular, there is no clear reason why historical cost should be the conceptually preferred solution for these assets and liabilities. Of course, even if current measures are conceptually preferred, historical cost may be selected for practical reasons in the development of standards.

6.25 We note that the IASB has rejected the idea that assets that are inputs to an entity's business model are appropriately reported at entry rather than exit values. This seems primarily to be based on the IASB's scepticism of the validity of the distinction between entry and exit values, which we address at paragraphs 6.8–6.9 above. Whatever may be the implications, the distinction seems to be very similar to

that which the IASB is proposing should be considered. We note however, that a distinction based on 'inputs to an entity's business activities' explains why inventory is not measured at (or close to) selling prices, while a distinction based on 'assets that will be sold' does not.

### **Characteristics of the asset or liability**

6.26 The Exposure Draft suggests that a factor to consider when selecting a measurement basis is: *'the characteristics of the asset or the liability (for example, the nature or extent of the variability in the item's cash flows, or the sensitivity of the value of the item to changes in market factors or to other risks inherent in the item)'* (paragraph 6.54(b)). This seems to mean that if the value of an asset or liability is likely to be significantly affected by changes in prices, it is probable that a current measurement basis will be relevant. We agree with this point. However, because the Exposure Draft does not contain any discussion of the notion of 'value', it does not explain why changes in value are relevant.

6.27 We recognise that the concept of value is far from straightforward but, as this issue demonstrates, it clearly has a role to play in accounting measurement.

### **More than one relevant measurement basis**

6.28 We deal with the proposals in paragraphs 6.74–6.77 of the Exposure Draft in Section 7, below, at paragraphs 7.28–7.31.

## **7 Chapter 7: Presentation and Disclosure**

7.1 We welcome the IASB's decision to include a chapter on presentation and disclosure in the Exposure Draft of the Conceptual Framework. The inclusion of principles for presentation and disclosure will make the Conceptual Framework more comprehensive than the existing Framework, which did not address these issues.

### **The objectives of the primary financial statements and the notes**

7.2 Paragraphs 7.2 and 7.3 of the Exposure Draft set out the content that should be provided in the primary financial statements and the notes, and refer to the overall objective of financial statements in paragraph 3.4. In our view, it would be helpful to establish separate objectives for the primary financial statements and the notes to help determine the content of each.

7.3 We recognise that the Basis for Conclusions states that the IASB proposes to establish separate objectives for the primary financial statements and the notes within the Primary Financial Statements and Disclosure Initiative projects, respectively. If the objectives will be developed after the revised Conceptual Framework is published, we suggest that the IASB updates the Conceptual Framework to include these objectives following the completion of these projects. We believe that this would be the appropriate place because the objectives will be fundamental to setting presentation and disclosure requirements in future accounting standards.

### **The boundary of financial statements and that between the primary financial statements and the notes**

7.4 There are two boundary issues that we believe should be clarified in the Conceptual Framework:

- (i) the boundary between the financial statements and the financial report (and other forms of financial reporting); and
- (ii) the boundary between the primary financial statements and the notes.

7.5 We have suggested in paragraph 1.5 above that the focus of the Conceptual Framework should be limited to financial statements. If the IASB does not accept this suggestion, we believe that the Conceptual Framework should establish a clear demarcation between financial reports and financial statements to ensure that the boundary does not become blurred. The FRC has explored the placement of

information in financial reports in its Discussion Paper 'Thinking about disclosures in a broader context'.<sup>10</sup>

7.6 The objective of financial statements described in paragraph 3.4 of the Exposure Draft is broad. While we agree that the financial statements should focus on the elements (both recognised and unrecognised) in existence at the end of the reporting period, we note that other sections of the financial report may encompass a much wider range of information that also assists users in assessing the prospects for future net cash inflows and in assessing management's stewardship.

7.7 We welcome that the scope of the notes described in paragraphs 7.2–7.3 is narrower than that proposed in the Discussion Paper: however, in our view, it is still too broad because it will capture information that is better disclosed in management commentary. The Basis for Conclusions argues that it is appropriate to include risk disclosures in the notes because information about the risks associated with an entity's existing assets and liabilities is likely to be useful in assessing the entity's ability to generate future cash flows and also in assessing management's stewardship of the entity's resources (paragraph BC7.12). We recognise that in certain circumstances it may be appropriate to include information on risks in the notes and that in some cases this may be specifically required by a Standard. However, in our view the rationale provided for its inclusion would expand the scope of the notes. On this logic it could be argued that other types of disclosure usually included in management commentary (for example, key performance indicators) should also be included in the notes, as they also provide information that is likely to be useful in assessing the entity's ability to generate cash flows and in assessing management's stewardship.

7.8 Cross-referencing enables entities to produce clearer and more concise reports by grouping related disclosures from different sections of the financial report. It would therefore be helpful for the Conceptual Framework to set out principles for the use of cross-referencing.

#### **'Primary financial statements': terminology**

7.9 We note that the term 'primary financial statements' was included in the Discussion Paper but removed from the Exposure Draft. In our view, it should be

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<sup>10</sup> The FRC's discussion paper is available at <https://www.frc.org.uk/getattachment/99bc28b2-c49c-4554-b129-9a6164ba78dd/Thinking-about-disclosures-in-a-broader-context.aspx>.

reinstated in the final draft of the Conceptual Framework to assist the IASB with drafting standards more clearly. The use of this term in the Conceptual Framework would avoid the confusion currently caused by the term 'financial statements' being used to refer to either the primary financial statements or the financial statements including the notes.

7.10 Since the Performance Reporting project has been renamed as the Primary Financial Statements project the use of the term 'primary financial statements' seems uncontroversial. It is also used in the IASB Exposure Draft ED/2015/8 'IFRS Practice statement: Application of Materiality to Financial Statements'. The term is widely understood and can be defined easily (as a complete set of financial statements excluding the notes, perhaps through reference to paragraph 10 of IAS 1 'Presentation of Financial Statements').

### **Forward-looking information**

7.11 We welcome the guidance on forward-looking information in paragraph 7.4. We agree that forward-looking information should be included in the financial statements to the extent that it provides relevant information on the elements that existed at the end of, or during, the reporting period. Paragraph 7.5 is helpful in drawing the distinction between this and other types of forward-looking information that may be provided elsewhere, such as in management commentary.

### **Communication principles**

7.12 The Discussion Paper contained a separate sub-section on communication principles which is absent from the Exposure Draft. These communication principles were similar to those set out in the FRC's 'Guidance on the Strategic Report'.<sup>11</sup> While some of the themes of the removed sub-section (regarding entity-specific information and 'boilerplate', relevance, understandability, comparability, flexibility and avoiding duplication) have been relocated to paragraphs 7.17–7.18 of the Exposure Draft, others (regarding placement of information, emphasis and prominence, linkage of related disclosures, and cross-referencing) are omitted from the Exposure Draft.

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<sup>11</sup> The FRC's guidance is available at: <https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Narrative-Reporting/Guidance-on-the-Strategic-Report.aspx>

7.13 We suggest that the sub-section on communication principles is reinstated. We are aware that the IASB has been considering communication principles within its Disclosure Initiative project. However, in our view, communication principles are pervasive and should be included in the Framework so that they are given sufficient prominence. We believe this would provide a helpful guide for the IASB when setting presentation and disclosure requirements, as well as a useful reference for preparers.

### **Materiality**

7.14 Although the IASB is consulting on a Practice Statement on materiality, it is concerning that the presentation and disclosure chapter of the Conceptual Framework Exposure Draft makes no reference to the application of materiality given the relevance of materiality to this topic, in particular to the notes. In our view, the appropriate application of materiality is essential to clear communication and ensuring that important information is not obscured. A high-level discussion of materiality in chapter 7 would enable the IASB to highlight that the assessment of materiality operates in a different way in the context of the primary financial statements (where it is a matter of the level of aggregation or disaggregation) and in the context of the notes (where immaterial information should be omitted entirely). As a minimum, we believe this chapter should contain a cross-reference to the discussion of materiality in paragraph 2.11.

### **Objectives and principles for presentation and disclosure**

7.15 We welcome the Exposure Draft's acknowledgement that it may be preferable for Standards to identify specific disclosure objectives rather than listing numerous detailed disclosure requirements. We support an objective-based approach to disclosure because we believe this will result in more useful and relevant information for investors and we welcome the work that the IASB and NZASB have been undertaking in this regard within the Disclosure Initiative project.

7.16 The combined general objectives and principles for presentation and disclosure set out in paragraphs 7.16–7.18 of the Exposure Draft are a good starting point. However, we believe that presentation and disclosure are distinct and that separate definitions and objectives for each should be articulated clearly in the Conceptual Framework. Ideally, the Conceptual Framework should contain separate chapters on presentation and disclosure, as it does for recognition and measurement.

7.17 We believe it will be difficult for the IASB to set more effective presentation and disclosure requirements at a Standards level without distinguishing between presentation and disclosure. This is particularly pertinent since the IASB intends to divide its current work on presentation and disclosure between the Primary Financial Statements and Disclosure Initiative projects. If the terms 'presentation' and 'disclosure' are not clearly defined, this may lead to overlaps or omissions. We therefore think it would be helpful to distinguish:

- (a) presentation, which can be defined as the display of elements, at an appropriate level of aggregation or disaggregation to enable users to understand the classification, nature and magnitude of the balances and transactions; and
- (b) disclosure, which can be defined as the provision of the additional information that is necessary to provide users with a sufficient understanding of the recognised and unrecognised elements that existed at the end of or during the reporting period.

7.18 Such a distinction, together with the definition of 'accounting policies' provided by IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' would help clarify that a change in presentation (for example, if certain overheads, previously included in cost of sales, are now to be included in administrative expenses) is a change of accounting policy, but a change in disclosure (for example a decision to disaggregate remuneration to show the bonus element separately) is not.

### **Classification and aggregation**

7.19 We welcome the sections of the Exposure Draft on classification and aggregation (paragraphs 7.10–7.15). Paragraph 7.15 highlights the important point that relevant information can be obscured by excessive aggregation or by a large amount of insignificant detail (for example, excessive disaggregation of line items in the notes). As noted in our response to the Discussion Paper, we believe it would be useful for this section to refer explicitly to disaggregation because this provides a link between information that is presented in line items in the primary financial statements and note disclosures that disaggregate those line items. An explicit reference to disaggregation would help to emphasise that the primary financial statements and the notes have different purposes and explain why a lower level of aggregation is often needed in the notes, as described in paragraph 7.14(b).

7.20 A similar point is raised in the alternative view of Mr Finnegan, set out in paragraph AV34(a) of the Basis for Conclusions. We agree with Mr Finnegan that it is important that information is provided in a way that highlights the effects of different economic attributes, different measurement bases and different trends, and that the Conceptual Framework should establish principles that would result in Standards specifying appropriate levels of disaggregation.

### **The statement of profit or loss and other comprehensive income**

7.21 In our response to the Discussion Paper, we noted that developing a principle-based approach to the reporting of financial performance should be a high priority for the IASB. We expressed the view that it was difficult to consider the distinction between profit or loss (P&L) and other comprehensive income ('OCI') in isolation, and suggested that a broader approach should be adopted that would develop principles for how income and expense should be presented to highlight components that are relevant to users. We remain of this view, and hope that the IASB's research project on 'Primary Financial Statements' will meet this challenge.

7.22 It is difficult to dismiss the thought that the Exposure Draft may have been developed to provide a brief discussion of the P&L/OCI distinction that will be acceptable to as many readers as possible. Indeed, the Basis for Conclusions reports the IASB's conclusion that a definition or precise description is not feasible, and that the proposals in this area should be regarded as 'high-level guidance' (paragraph BC7.36).

7.23 We therefore agree with the alternative view of Mr Cooper and Mr Finnegan set out in paragraphs AV2–AV4: the Exposure Draft represents a missed opportunity to identify a conceptual basis for the use of OCI, with the IASB effectively being in no better position than it is now in determining how it should be used.

7.24 The Exposure Draft states:

*7.20 The purpose of the statement of profit or loss is to:*

- (a) depict the return that an entity has made on its economic resources during the period; and*
- (b) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.*

*7.21 Hence, income and expenses included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period.*

7.25 We acknowledge the similarity of paragraph 7.20 with the objective of the statement of profit or loss that was suggested in our response to the Discussion Paper. However, although these paragraphs may provide a helpful starting point, without the support of an analysis of terms such as 'returns' and 'financial performance', they are too vague to specify what income and expenses should be reported in the statement of profit or loss and what in OCI.

7.26 The presumption that all income and expenses should be reported in profit or loss unless their exclusion would enhance the relevance of the information in that statement for the period appears sensible and plausible. However, a robust conclusion on this can only be reached once the analysis suggested above is completed.

7.27 The description of which items should be included or excluded from the statement of profit or loss given in the Exposure Draft is obscure almost to the point of impenetrability. However, the Basis for Conclusions helpfully explains that it means that income and expense that relate to transactions and events of the period are to be reported in the statement of profit or loss: the only candidates for exclusion are other changes in value. We suggest that the Conceptual Framework reflects the drafting of the Basis for Conclusions rather than that of the Exposure Draft. It would also be helpful to explain how information about changes in value differs in quality and relevance from that about transactions and other events. It would, however, be wise to recognise that it is not always possible to distinguish these classes, for example where an asset is impaired.

*Different measurement bases for the statement of financial position and the statement(s) of financial performance*

7.28 Chapter 6 of the Exposure Draft notes that, in some cases, a current value measurement basis is used for the statement of financial position and 'a different measurement basis'—often, presumably, historical cost—is used to determine the related income and expenses. We would expect that this would arise only in rare cases. Generally, it should be the case that the measurement basis selected for the statement of financial position reflects the value of an asset, and that the

consumption of that asset would be fairly represented by reporting an expense equal to the loss of that value.

7.29 We accept, however, that there may be cases where it is appropriate to reflect a component of value in the statement of financial position but that changes in that component do not reflect the performance of the period, and therefore might be reported in other comprehensive income rather than in profit or loss. Without a defined notion of performance, views will differ as to where this should be used. But it would be possible, for example, that changes in the value of a liability due to changes in the entity's own credit risk would be one example; another might be changes in the amount of a provision that reflect changes in the discount rate rather than changes in the cash flows. In our view, it would be much clearer to describe the process as reporting separately different components of the income and expense relating to a particular asset or liability rather than the use of two different measurement bases. We note that the possibility of presenting separately different components of income and expenses arising from a change in the carrying amount of an asset or liability is referred to in paragraph 7.11 of the Exposure Draft.

7.30 The discussion in Chapter 7 proposes that, where an asset or liability is measured at a current value, it should be required to report in the statement of profit or loss components of income and expense that 'are separately identified and are of the type that would arise if the related assets and liabilities were measured at historical cost'. This would seem to be consistent, for example, with the requirements of IAS 16 'Property, Plant and Equipment' that depreciation of a revalued asset is based on revalued amount, rather than cost. Because this is addressed separately from the possibility of using a different measurement basis for the statement of financial position from that used for the statement of profit or loss, the draft Conceptual Framework seems to offer a choice. In developing a future accounting standard that requires the use of current values for the statement of financial position, the IASB might reason either:

- (a) that income and expense reflecting that current value and are 'of the type that would arise under historical cost' must be reflected in profit or loss; or
- (b) that income or expense relating to that asset or liability should be reported in profit or loss on a historical cost basis.

7.31 The existence of such a stark choice is hardly consistent with the stated purpose of the Conceptual Framework, which includes assisting in the development

of accounting standards based on consistent concepts. As a minimum, the Conceptual Framework should identify the circumstances in which each approach is appropriate.

*The presumption of reclassification*

7.32 We disagree strongly with the proposal that it should be presumed that all income and expenses that are reported in OCI in one period will be reclassified (or 'recycled') to the statement of profit or loss in some future period. In our view it is of the essence of statements of financial performance that they report income and expenses resulting from events of the period. This is reflected in the Exposure Draft itself: paragraph 7.20(a) refers to *'the return that the entity has made on its economic resources during the period'*; and paragraph 7.24(b) proposes as one condition for exclusion of income and expenses from the statement of profit or loss that to do so *'would enhance the relevance of the information in that statement for the period'*.

7.33 The Basis for Conclusions argues that the presumption is justified because the statement of profit or loss is the primary source of information about an entity's financial performance for the period, and claims it follows that the cumulative amounts should be as complete as possible. But the presumption is contradictory to, rather than a logical consequence of, the objective of providing information on the events of the period. The focus is either on the flows of the period, or in providing an update of the cumulative flows: it cannot be both. We can see no reason why the statement of profit or loss for 2025 should report a gain or loss when an asset is sold at the amount to which it was restated in 2010 when the change in carrying amount was (for whatever reason) reported in OCI.

7.34 We do, however, see a role for recycling in the case of mismatches of recognition, of which cash flow hedging is an example. The rationale is that the gain or loss arising on the hedging instrument is not relevant to the performance of the entity in the period in which it arises: in the period in which the hedged transaction takes place, the most relevant information is the income or expense after taking account of the gain or loss on the hedging instrument.

**Chapter 8: Concepts of Capital and Capital Maintenance**

8.1 'Capital maintenance' can be used to refer to a legal concept that seeks to protect the interests of creditors by restricting the payment of dividends and entering into other transactions that may reduce an entity's legal capital. However, as the term is used in Chapter 8 it refers to the concepts that may be used to determine income (or performance) by distinguishing inflows that are a return of capital from those that are a return on capital.

8.2 We have emphasised in this response the need for further research and analysis on the concept of performance. It is possible that this will identify a role for one or more concept(s) of capital maintenance. However, until that research is completed, we do not think that there is any value in retaining the discussion of capital and capital maintenance provided by Chapter 8 of the Exposure Draft which merely contrasts financial and physical capital maintenance, suggests that the Framework is 'applicable to a range of accounting models' and notes that the IASB has no intention to prescribe a particular model (other than in exceptional circumstances).

**Responses to questions set out in the Invitation to Comment****Question 1—Proposed changes to Chapters 1 and 2**

*Do you support the proposals:*

- (a) *to give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources;*
- (b) *to reintroduce an explicit reference to the notion of prudence (described as caution when making judgements under conditions of uncertainty) and to state that prudence is important in achieving neutrality;*
- (c) *to state explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form;*
- (d) *to clarify that measurement uncertainty is one factor that can make financial information less relevant, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant; and*
- (e) *to continue to identify relevance and faithful representation as the two fundamental qualitative characteristics of useful financial information?*

*Why or why not?*

**Response to Question 1(a)**

Yes. We support the proposal to give more prominence to the importance of stewardship within the objective of financial reporting. However, as explained in paragraphs 2.5–2.9, the discussion needs to be expanded and either the provision of information on stewardship should be identified as a separate objective, equal in prominence to that of providing information that is useful in making decisions about the allocation of resources, or the notion of decision-usefulness should be broadened to include explicitly decisions other than resource allocation decisions.

Also, as noted in paragraph 2.10 above, the importance of providing information on the performance of the business model (or business activities) should be addressed within the discussion of the objectives of financial reporting.

**Response to Question 1(b)**

Yes. We support the reintroduction of a reference to the notion of prudence. However, as discussed at paragraphs 2.11–2.21, we consider that the Conceptual Framework should admit the notion of asymmetric prudence and the drafting of 'prudence as caution' should be reviewed.

As discussed in paragraphs 2.19–2.21, the relationship between prudence and neutrality should also be clarified. To do so, it would be helpful to replace the term 'neutrality' with 'unbiased'.

**Response to Question 1(c)**

Yes. We support the inclusion of a specific statement that faithful presentation requires that the substance of a transaction or arrangement is reported and not merely its legal form. For our further observations on faithful presentation, see paragraphs 2.32–2.33.

**Response to Question 1(d)**

No. Whilst we appreciate the enhanced discussion of measurement uncertainty, we do not believe that it should be discussed within the context of relevance, as discussed at paragraphs 2.27–2.29. In our view, as explained at paragraphs 2.22–2.30, reliability should be identified as a qualitative characteristic, with equal status to that of relevance, thus highlighting the need to balance relevance and reliability.

**Response to Question 1(e)**

No. As explained above, in our view reliability should be identified as a qualitative characteristic with equal status to that of relevance.

**Question 2—Description and boundary of a reporting entity**

*Do you agree with:*

- (a) *the proposed description of a reporting entity in paragraphs 3.11–3.12; and*
- (b) *the discussion of the boundary of a reporting entity in paragraphs 3.13–3.25?*

*Why or why not?*

**Response to Question 2(a)**

No. In paragraph 3.7 we suggest that the IASB consider including some material from its earlier Exposure Draft on the reporting entity concept. Also, as noted in paragraph 3.8, we consider that further analysis is required of the perspective from which financial statements is prepared.

**Response to Question 2(b)**

While we are broadly content with the discussion of the boundary of a reporting entity, we believe some changes are necessary, as set out in paragraphs 3.9–3.10.

**Question 3—Definitions of elements**

*Do you agree with the proposed definitions of elements (excluding issues relating to the distinction between liabilities and equity):*

- (a) *an asset, and the related definition of an economic resource;*
- (b) *a liability;*
- (c) *equity;*
- (d) *income; and*
- (e) *expenses?*

*Why or why not? If you disagree with the proposed definitions, what alternative definitions do you suggest and why?*

**Response to Question 3**

We agree with the definitions of assets, liabilities and equity, while noting that the research project on 'Financial Instruments with Characteristics of Equity' may lead to proposals to change the definition of equity.

As set out in paragraphs 4.1–4.7, we believe that the terms 'income' and 'expenses' should be replaced by more general terms such as 'gains' and 'losses', and that definitions of further elements are required. We hope that the need to define elements for the cash flow statement will be considered as part of the work on 'Primary Financial Statements'.

**Question 4—Present obligation**

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

**Response to Question 4**

We believe that the description and proposed guidance are helpful, and may provide a basis for future work. Our specific comments are set out in paragraphs 4.8–4.10.

**Question 5—Other guidance on the elements**

*Do you have any comments on the proposed guidance?*

*Do you believe that additional guidance is needed? If so, please specify what that guidance should include.*

**Response to Question 5**

We agree with the discussion of executory contracts.

We also consider that the discussion of unit of account is a helpful start, but have some further comments, which are set out in paragraph 4.12–4.17.

**Question 6—Recognition criteria**

*Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why?*

### **Response to Question 6**

As discussed in Section 5, we agree with the general approach to recognition, but note that some of our views on the objectives and qualitative characteristics would have significant implications for the discussion in Chapter 5.

### **Question 7—Derecognition**

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

### **Response to Question 7**

We agree with the discussion of derecognition.

### **Question 8—Measurement bases**

*Has the IASB:*

- (a) correctly identified the measurement bases that should be described in the Conceptual Framework? If not, which measurement bases would you include and why?*
- (b) properly described the information provided by each of the measurement bases, and their advantages and disadvantages? If not, how would you describe the information provided by each measurement basis, and its advantages and disadvantages?*

### **Response to Question 8(a)**

No. We identify additional measurement bases that should be discussed in paragraphs 6.15–6.17.

### **Response to Question 8(b)**

As set out in Section 6, we consider that a more fundamental analysis of the properties of different measurement bases is required in order to provide an insight into the usefulness of different measurement bases. These include: further exploration of the rationale for historical cost; entry and exit values; entity-specific and market measures; and price changes.

The summary set out in Table 6.1 is uncontentious, but merely shows what information various measurement bases provide, and not whether that information can be expected to contribute to the objectives of financial statements.

As noted in paragraphs 6.18–6.20, we regret that the IASB has not taken the opportunity to provide a thorough analysis of the strengths and weaknesses of fair value.

**Question 9—Factors to consider when selecting a measurement basis**

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

**Response to Question 9**

In Section 6, we set out a number of issues that, in our view, should be analysed in order to develop ideas that will be useful in selecting a measurement basis when developing accounting standards.

As discussed in paragraphs 6.21–6.25, we agree that it is relevant to consider how an asset or liability contributes to future cash flows, which we suggest is a similar idea to considering whether they are ‘inputs to a business model’, and consider that this merits further development.

As discussed in paragraph 6.26 we agree that whether an asset or liability gives rise to variable cash flows, or its value is sensitive to changes in market factors, is relevant to the selection of a measurement basis. However, the Exposure Draft fails to establish principles that show why this is relevant.

**Question 10—More than one relevant measurement basis**

*Do you agree with the approach discussed in paragraphs 6.74–6.77 and BC6.68? Why or why not?*

**Response to Question 10**

We discuss the possibility of using more than one relevant measurement basis in paragraphs 7.28–7.31. We accept that it may be useful to reflect part of the change in value of an asset in the statement of financial position, but that part would not be regarded as ‘performance’ and hence reported in other comprehensive income rather

than in profit or loss. However, this requires a defined notion of 'performance', which is not provided by the Exposure Draft. We note that the Exposure Draft's proposals provide a number of ways in which information about different measurement bases may be communicated and believe that, if this is to be retained, the circumstances in which each approach is appropriate should be identified.

**Question 11—Objective and scope of financial statements and communication**

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

**Response to Question 11**

Our comments are set out in paragraphs 7.1–7.20.

**Question 12—Description of the statement of profit or loss**

*Do you support the proposed description of the statement of profit or loss? Why or why not?*

*If you think that the Conceptual Framework should provide a definition of profit or loss, please explain why it is necessary and provide your suggestion for that definition.*

Please refer to our response to question 13.

**Question 13—Reporting items of income or expenses in other comprehensive income**

*Do you agree with the proposals on the use of other comprehensive income? Do you think that they provide useful guidance to the IASB for future decisions about the use of other comprehensive income? Why or why not?*

*If you disagree, what alternative do you suggest and why?*

**Response to Questions 12 and 13**

We discuss the statement of profit or loss and other comprehensive income in paragraphs 7.21–7.31.

Whilst the description of the purpose of the statement of profit or loss set out in paragraph 7.20 of the Exposure Draft provides a helpful starting point, it requires to be supported by an analysis of key terms such as 'returns' and 'financial performance'.

We do not consider that the proposals for the use of other comprehensive income provide useful guidance.

#### **Question 14—Recycling**

*Do you agree that the Conceptual Framework should include the rebuttable presumption described above [i.e that items of income or expenses included in other comprehensive income of one period will be reclassified into the statement of profit or loss, if doing so will enhance the relevance of the information included in the statement of profit or loss for that future period]?*

*Why or why not?*

*If you disagree, what do you propose instead and why?*

#### **Response to Question 14**

We discuss reclassification (recycling) in paragraphs 7.32–7.34. We do not support the presumption of recycling as it is contradictory to the purpose of the statement of profit or loss which is to provide information on the income and expenses of the period. We would restrict the use of recycling to recognition mismatches—that is where a transaction is recognised in an earlier accounting period than that of a related transaction, as in cash flow hedges.

#### **Question 15—Effects of the proposed changes to the Conceptual Framework**

*Do you agree with the analysis in paragraphs BCE.1–BCE.31? Should the IASB consider any other effects of the proposals in the Exposure Draft?*

#### **Response to Question 15**

We agree with the analysis in paragraphs BCE.1–BCE.31.

**Question 16—Business activities**

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

**Response to question 16**

As we state in paragraph 2.10, in our view the Conceptual Framework should acknowledge that information on the performance of the business model (or, perhaps, business activities) assists financial reporting in achieving its objectives. This would make the discussion of the objectives more complete, and enhance the cohesiveness of the Conceptual Framework, by providing the premise for the relevance of business activities to the specific issues discussed in later chapters.

**Question 17—Long-term investment**

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

**Response to question 17**

Our comments in respect of stewardship (see paragraphs 2.5–2.9) and the recognition given to the variety of the needs of users (see paragraph 2.35) will, in our view, assist the development of accounting standards that serve the needs of long-term investors. We do not consider that the Conceptual Framework needs to set out specific considerations for entities whose activities include long-term investments.

**Question 18—Other comments**

*Do you have comments on any other aspect of the Exposure Draft? Please indicate the specific paragraphs or group of paragraphs to which your comments relate (if applicable).*

*As previously noted, the IASB is not requesting comments on all parts of Chapters 1 and 2, on how to distinguish liabilities from equity claims (see Chapter 4) or on Chapter 8.*

Please refer to the body of this response.