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Comments on the Exposure Draft on the Conceptual Framework for Financial Reporting (ED/2015/3)

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Mr Hans Hoogervorst, Chairman
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Dear Mr Hoogervorst

Comments on the Exposure Draft on the Conceptual Framework for Financial Reporting (ED/2015/3)

I am pleased to provide feedback on the above document. The feedback is given in my personal capacity and do not necessarily reflect the positions of my employer or other organizations that I am associated with.

I wish the team all the best in its efforts to arrive at a robust Conceptual Framework and to the IASB on its ongoing efforts to arrive at high quality global standards.

Yours sincerely

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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?*

(a) It is timely to revisit the significance of assessing management's stewardship as an objective of financial reporting, particularly in the aftermath of the 2008 financial crisis and the waves of corporate collapses. The separation of management from ownership requires that management be accountable to the entity's stakeholders. Agency problems abound when managers know more about the performance and financial position of an entity and make decisions that are not necessarily in the best interests of other stakeholders. Information asymmetry and manager's self-interests put the interests of other stakeholders at risks.

However, the assessment of management's stewardship of an entity's resources is not in itself the primary focus of all stakeholder groups. The Conceptual Framework project does not distinguish between long-term and short-term investors. However, in reality, the ownership structure is a complex myriad of different shareholder needs. Arguably, the quality of management's stewardship is more critical to long-term investors than it is to short-term investors. The sum of an entity's performance is determined by firm-specific factors (such as management's stewardship) and external idiosyncratic market movements and/or regulatory decisions. While it can be argued that management has the mandate and responsibility to manage risks and variability caused by market movements and regulatory decisions, the impact of managerial strategy is normally seen only over a longer run horizon. Short-term investors may not be as concerned about the process of management's stewardship as they are about the outcome of the sale of their investments. Likewise, lenders are concerned about the liquidity and solvency of the borrowing entity. They use information to evaluate the attributes that are important to them.

I laud the IASB for returning accounting to its roots to focus on management's stewardship. However, assessment of management's stewardship is not in itself an end goal for many users of financial information in today's complex landscape. Rather, they focus on measures that are critical to their decision-making objectives. The term stewardship is interpreted differently but it has a protective or fiduciary connotation. In Merriam-Webster's dictionary, the word is defined as "the activity or job of protecting and being responsible for something". In today's complex business environment, managers need to balance the goals of being pro-active and protective. A protective posture may give rise to dysfunctional behaviours to not take risks or to hedge excessively. Stewardship also has to do with the process of management. Cambridge Dictionaries Online states that "someone's stewardship of something is the way in which that person controls or organizes it." This suggests a process rather than an outcome Investors are more concerned about outcomes than processes.

Understandably, it is difficult for the IASB to formulate an objective that applies to all user groups. Assessment of management's stewardship could feature in the Conceptual Framework as an example of how financial information may be used but need not be positioned as the objective of financial reporting.

Information needs vary across user groups but it is likely that their objectives are met through information on financial performance, financial position and/or cash flows. Even if the measures that are relevant to them need to be derived from reported information, it suffices that the building blocks of the measures are found in financial statements. Hence, it is proposed that the objective of financial reporting is the provision of financial information that is useful to evaluating the financial performance, financial position and cash flows of an entity.

(b) I do not agree that the concept of prudence should be reintroduced in the determination of neutrality. Users of financial information need information that are a faithful representation of economic reality. Being prudent in conditions of uncertainty introduces an element of bias in judgement that would understate income, understate assets and overstate liabilities. Worse yet, this bias is likely to be counter-cyclical. In good times, management may be more prudent in understating income and in bad times, less prudent. The Exposure Draft proposes that exercise of prudence neither results in over (under) statement of assets (liabilities) and income (expenses) or under (over) statement of assets (liabilities) and income (expenses). Practically, this level of precision in judgement is almost impossible to achieve. We should remember the days when "conservatism" was implicitly or explicitly made to be a desirable attribute in financial reporting. Cookie jar accounting and smoothing of income trends are typically the outcome in such an accounting environment. Such information hardly reflects the real economic trends that the entity is exposed to. The inclusion of the attribute of "measurement uncertainty" is sufficient to ensure that financial information is not misstated to promote preparer's interest.

(c) While one can understand the importance of substance over form in financial reporting, my concern is that this attribute may potentially lead to incomparability in reporting as substance may be interpreted subjectively. By and large, accounting standards do a reasonably good work in ensuring that the principle of substance over form is applied at the specific transaction level. Applying the substance over form principle at the conceptual framework level suggests that this is a general principle that guides accounting decisions in the absence of specific accounting standards. Would this lead to novel accounting? Consider an example. A parent company transfers long-term assets to its subsidiary at a heavily discounted price. Is the discount to be accounted as an income statement item or as an investment in the subsidiary? The relevant standards (IAS 24 Related Party Transactions and IFRS 10 Consolidated Financial Statements) do not prescribe the measurement requirements to such a situation although disclosures have to be made. If left to judgemental application of substance over form, different treatments may arise. I propose that substance over form interpretation is best done at the standard level for the sake of comparability. A number of issues relating to substance over form are already dealt with in accounting standards. Examples include lease accounting, accounting for instruments with elements of debt and equity, accounting for interest-free loans and revenue transactions such as sale and repurchase agreements. It is more meaningful to explain how the substance over form principles is applied in specific contexts in particular standards (for example leases). These principles provide specific guidance and ensure comparability in the application of the substance over form principle in specific contexts. That said, accounting standards should be responsive to deal with situations where the economic substance differs from their legal forms. Hence, I do not believe that a change needs to be made to the conceptual framework in this regard.

(d) I agree with this proposal. Many respondents to the Discussion Paper were concerned with the removal of familiar benchmark terms such as “probable” and “expected” in the definition of assets and liabilities. They are concerned that the broad definition may be applied in a way that would lead to aggressive recognition of assets and liabilities. The inclusion of measurement uncertainty clarifies the situation. However, the attribute of measurement uncertainty is more closely linked with faithful representation than relevance per se. The hierarchy of attributes could be realigned for clarity (please also refer to point e). In a time when fair value accounting is gaining prevalence in financial reporting, the IASB may need to review how the attribute of measurement uncertainty impinges on an entity’s ability to report fair value measures, particularly Level 3 measures for illiquid assets. Would the principle in paragraph 6.55 below provide an override of requirements in specific accounting standards?

> *“However, in some cases, the level of measurement uncertainty is so high that a different measurement basis may provide more relevant information. Moreover, if no measurement basis for an asset or a liability would provide relevant information, it is not appropriate to recognise the asset or the liability (see paragraph 5.13).”*

(e) The conceptual framework, past and present, include terms that overlap in meaning and needed to be defined to show how they differ. The terms that are important to the discussion are “useful”, “relevance” and “faithful representation”. A new term introduced in the Exposure Draft is “measurement uncertainty”. Due to legacy, some of these terms are now established in accounting thought. Chapter 2 of the Exposure Draft is carried forward from Chapter 3 of the current Framework with limited changes (which had also carried forward large segments from the pre-2010 Framework). The present structure needed terms to be defined because they have a special meaning in the realm of accounting. They also overlap in meaning. A new term “measurement uncertainty” is linked to relevance when at first thought it appears to be better aligned with “faithful representation”.

In my opinion, placing “relevance” and “faithful representation” as twin attributes create unnecessary tension in accounting decision making. I believe that the existing structure has been carried forward because of simplicity and familiarity of terms in the accounting community. However, the IASB may wish to consider two alternative models:

Model 1: “Faithful representation” is an attribute of “relevance” because an item cannot make a difference to decision making if it does not represent the phenomena that it purports to represent. Hence, in this model, the focus is on “relevance” with the attribute of “faithful representation” being a pre-requisite of “relevance”. “Measurement uncertainty” would be linked to “faithful representation” because if the estimation is of low quality, economic phenomena would not be faithfully represented. This is a linear model that is less heavy at the top.

Model 2: Remove intermediary terms such as “relevance” and focus on the overriding attribute of “useful” information. Useful information is information that has confirmatory and/or feedback value. To have these values, they must be representationally faithful. This is a parsimonious model and does not require definition of what relevant information is.

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?

(a) I agree with paragraphs 3.11 and 3.12. The fundamental principle is that the reporting entity is separate from its owners and therefore financial statements should be prepared from the perspective of the entity as a whole. The financial statements should therefore be a complete representation of the assets, liabilities and equity of the reporting entity (whether at the legal or economic level). In this regard, I wish to highlight inconsistencies between standard level reporting and the principle highlighted in the Framework. IFRS 3 Business Combinations permit goodwill to be reported from the parent's perspective. This accounting treatment is incongruent with the principle in paragraph 3.9.

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. (Paragraph 3.9)

(b) I agree with the substance of the requirements. It is helpful to address the two levels of reporting – the separate and consolidated financial statements. Accounting standards do not give much attention to the reporting of separate financial statements and the Exposure Draft has done well to recognize this set of financial statements that is informative for legal reasons. However, I find the terms "direct control" and "indirect control" ambiguous on first reading. IFRS 10 *Consolidated Financial Statements* uses the term "control" and does not separate between "direct control" and "indirect control". The IASB may want to consider alternative terms such as "holding as a passive investment" and "holding as a subsidiary" or "reporting as a legal entity" and "reporting as an economic unit".

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?

(a) I agree with the approach taken by the IASB to separate the identification of an asset from its recognition and measurement. The removal of the familiar term "expected" benefits focuses on the existence of an asset and not on its likely outcomes. However, the proposed definition of an asset requires another definition of economic resource. The new definition of economic resource incorporates the concept of "rights". Many "rights" are not recognized as assets in the financial statements and many accounting standards do not define assets in terms of rights (other than for example, IAS 38 *Intangible Assets* and IAS 32 *Financial Instruments: Presentation*). The word "economic resource" has been used in the Framework in the present and in the past, and assuming that the meaning is well understood, a simpler definition without a need for a sub-definition may be as follows which encapsulates the elements of past event, present control and future benefits.

An asset is a present economic resource controlled by the entity as a result of past events to produce future benefits.

(b) I agree with the removal of the term "expected" from the definition of a liability to separate the identification of a liability from its recognition and measurement. The likelihood of a subsequent revision to the definition of liabilities and equity to address issues relating to instruments that have both elements is not ideal but is accepted for the sake of expediency.

(c) Agree, pending the outcome of the project on instruments with characteristics of equity and liability.

(d) The definition of income as a residual can be improved, pending the outcome of the Performance Reporting project.

(e) Agree

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

The term "expected" is removed in line with the focus on the definition of a liability rather than its recognition. However, the definition of a present obligation requires that the entity has no practical ability to avoid the transfer and the obligation has arisen from past events. There is a thin line separating "expected" outflow and "no practical ability to avoid the transfer". Both point towards an expectation of a transfer of resources from the entity.

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.

- It would be helpful to provide more authoritative principles (rather than examples) to facilitate the identification of contracts lacking in commercial substance and units of accounts. At this point, it appears to be piecemeal examples that do not contribute to a holistic understanding of the accounting principles relating to these two areas. The constraint of cost over benefit should not be explicitly included as a criterion.

- Presently, many executory rights and forward contracts not covered under IFRS 9/IAS 39 *Financial Instruments* are off-balance sheet. Effectively, assets and liabilities under executory contracts are set-off and hence have a zero value. The Exposure Draft explains the set-off principle:

  "The entity has an asset if the terms of the exchange are favourable; it has a liability if the terms of the exchange are unfavourable. Whether the asset or the liability is included in the financial statements depends on both the recognition criteria (see Chapter 5) and the measurement basis adopted for the contract (see Chapter 6), including, if applicable, any test for whether the contract in onerous."(Paragraph 4.41).

  Reporting entities generally do not recognize an executory contract as an asset and a liability and set them off. They are simply not recognized until the asset is received. With the exception of IFRS 9/IAS 39 Financial Instruments, accounting standards do not require the transaction to be recognized at the point of contracting. With the change in definition of assets, it is theoretically correct for a reporting entity to recognize an asset and liability at contract date and set them off. At the point of contract, a right exists that should be recognized if it meets the recognition criteria. However, most reporting entities are not likely to record the transaction at all, as accounting standards such as IAS 2 *Inventories* and IAS 16 *Property, Plant and Equipment* do not require initial recognition at the point of contracting. The IASB may wish to review the impact of the new focus on rights on the recognition requirements of accounting standards. The Conceptual Framework could provide proposed guidance on overarching principles of set off of rights and obligations arising from assets and liabilities and items of income and expenses.

- The Exposure Draft defines control of an economic resource as follows:

  "An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that flow from it." (Paragraph 4.18)

  The definition of control is not aligned with that in IFRS 10 where the outcome of control is framed in terms of "returns" rather than "benefits".

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?

It is presumed that information on items that meet the definition of an asset or liability, income, expense or change in equity would be relevant. The examples of items that have significant uncertainty in their existence are unlikely to have met the definition in the first place. The relevance attribute should be met in the definition rather than the recognition process. Items that qualify as assets, liabilities, income, expense and equity should by default be presented on the financial statements, subject to faithful representation criteria. The response to Question 1 (e) proposes that measurement uncertainty is best linked to faithful representation rather than to relevance. The cost and benefit constraint should not be given equal prominence as “relevance” and “faithful representation” in accounting choice.

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?

Greater clarity in the principles of derecognition will be helpful to guide the accounting treatment of transfer of assets whose risks are retained. Examples are given but principles are needed. The proposed treatment of disclosure (paragraph 5.31) should be supported by principles of when disclosure is appropriate and when it is not. As a general principle, disclosure is not a substitute for recognition and measurement and further clarification is necessary.

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?

The measurement bases are correctly identified although in the corporate world, they may be differently described. There are other forms of current value that are not on the list, such as replacement cost and deprival value but these may be proxied by other current value measures. The advantages and disadvantages are properly described.

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

The three overarching principles of relevance, faithful representation and cost and benefit are presented as the main factors. Greater amplification can be made of the business model principle that is significant to the relevance attribute. Given that the business model approach is likely to feature prominently in future standards and the support that this model receives from the business community, more clarity is required.

Placing pragmatic cost and benefit considerations on par with the two user-oriented attributes leads to a sense of unease. Although most measurement standards are determined by the IASB and preparers have limited choice, making this constraint explicit in choices may not be an appropriate signal for reporting entities to provide useful information as an overriding objective.

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?

I agree that footnote disclosures may provide information on an alternative measurement basis (for example, as in the case of disclosures on financial instruments). However, the proposal in paragraph 6.76 that one measurement basis is used in the statement of financial position and another used to determine income with the difference taken to other comprehensive income should be restricted to a minimum and justified. At this point, the Framework lacks principles that define items that can be taken to other comprehensive income and the dual treatment is prescriptive and arbitrary.

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.

The definition of profit or loss is necessary since the statement of profit or loss is deemed to be the primary source of information about an entity's financial performance for the period. However, at this point, profit or loss appears to be a residual rather than a measure of performance. The IASB is encouraged to pursue its project on performance reporting which was suspended in 2010. Before the measure of profit or loss can be defined, critical issues relating to OCI and net income – a conceptual and not procedural definition of these measures, the impact of OCI on the informativeness of the income statement, the principles determining recycling, informativeness of the component parts of income (e.g. core and non-core earnings, persistent and transitory earnings) should be evaluated and researched on.

Greater clarity is required to explain the rebuttable presumptions relating to profit or loss (paragraphs 7.23 and 7.24) and other comprehensive income (7.26 and 7.27). The Basis of Conclusions offer clearer explanations and it will help the reader to understand the principles underlying the rebuttable presumptions.

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?

Without a conceptual definition of other comprehensive income and without principles to determine and explain the existence of this special group of income items, the proposals would remain arbitrary and solely determined by the judgement of the IASB board members. A more appropriate model is to have all items flowing through the statement of profit or loss. However, more research needs to be carried out on whether OCI improves the informativeness of the statement of profit or loss. The IASB is encouraged to pursue its performance reporting project to focus on issues of substance rather than the form of reporting.

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

Same comments as in Question 13 applies. More research is required to determine the informativeness of OCI and subsequent recycling.

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

Increasingly, the concept of the business model is being applied in different accounting standards (for example, IFRS 9 *Financial Instruments* and IAS 12 *Income Taxes*). The concept also underlies the relevance of information arising from different measurement bases (paragraph 6.30). The Exposure Draft does not include a general discussion on the role of a business model on financial reporting, other than a restricted discussion on the impact of the business model approach on the unit of account, measurement and presentation and disclosure. A deeper and more complete discussion would be beneficial to avoid a piecemeal approach to the application of the business model concept.

Greater clarity should be given in the Conceptual Framework to guide the decisions as to when the business model may be used, how it may be appropriately applied and the criteria that must be in place to ensure that relevance, faithful representation and comparability are not compromised in the application of this entity-specific approach.